Follow-up Study for the Economic Development Policy in the Transition toward a Market-oriented Economy in Viet Nam

VOL. 2 Financial and Monetary Matters

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Ministry of Planning and Investment
The Socialist Republic of Viet Nam

Japan International Cooperation Agency

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Issues and Findings: Reform of the Financial Sector

Shinichi Watanabe
International University of Japan
Le Quoc Ly
Ministry of Planning and Investment

Background of the Follow-up Project

1. Almost two years have passed since the start of the Asian crisis. The crisis that started as a currency crisis in Thailand spread to other nations in the region and eventually to other part more part of the world vulnerable to speculative attacks. But the damage of the crisis was greatest in the east and southeast Asia, which had been widely believed to serve as the growth center for the world economy for decades to come before the crisis. The region is still struggling to move out of the deep economic recession and its growth prospect is now much more modest than before.

2. The more moderate growth prospect of the region has three immediate implications for the growth prospect of Viet Nam:

(1) Because the import demand from the region will decline, the growth rate of export of Viet Nam will decline. Given the constraint on the overall trade balance, this will imply that the capacity to import will also decline. The export will become more difficult and the opportunity cost of the import will increase. The two together will imply that the growth prospect of Viet Nam needs to be revised downward, possibly quite significantly. How long the growth in the Asia will remain depressed is not known, but it could be five years or longer before it resumes a rapid growth path if we consider the worst case scenario.

(2) Because of their prospect of much lower growth, the ASEAN economies as a whole will receive much smaller amount of FDI from outside the region, and so will Viet Nam. Furthermore, FDI from within the ASEAN economies such as Thailand and Singapore to Viet Nam will also decline because of the difficulties of its mother countries. Both combined, investment supported by FDI will decline in Viet Nam, which will reduce the growth rate of Viet Nam by reducing the investment/GDP ratio. Furthermore the decline in FDI implies that the permissible upper bound of trade deficits and thus imports will become lower for Viet Nam.

(3) The decline of the growth rates of real GDP, exports, imports and FDI for the macro

economy implies the erosion of business conditions at the micro economic level. A large number of business firms will need to adjust their business activities to the lower than expected sales growth, more limited foreign currencies available for imports and debt repayment, and less opportunity to find joint venture partners. All of these factors will create financial difficulties for them, especially when they borrowed heavily for their investment, expecting a rapid increase in the demand for their products or when their activities are highly dependent on imports.

3. It is inevitable that these difficulties of the real sector of the economy soon appear in the hardships of the banking sector as well. If macroeconomic conditions deteriorate sharply, a large number of firms will find it difficult to repay their debts on schedule. And this is more true when their troubles are deeper. Viewed from the side of banks, it means that banks will not only find it difficult to recover their loans on time but also need to allocate more funds to the borrowers in deep trouble and thereby assume greater credit risks themselves. As a consequence, the quality of the portfolio of their assets will suffer.

4. In the final report of the last VJJRP we have emphasized the importance of the banking reform for the economic development of Viet Nam. We have argued that the state of the banking sector in Viet Nam is best described by a model of financial repression, in which regulations such as the ceiling on interest rates spread restrict the development of the banking sector and its contribution to the growth of the economy. The practice of equating bad loans to corruption (a criminal act) is another example of financial repression. Under the existing institutional environment banks have little incentive nor capacity to expand their deposit base and strengthen their capability as financial intermediaries. The fraction of households which have deposits in banks and other depository institutions in 1997 is mere 5%, the same as in 1992-1993 when the activity of the banking sector was at its lowest point. We have argued that this must be corrected as soon as possible. Regulatory environment of the banking sector must be restructured substantially to support its expansion.

5. We have also noted, however, that it will take a long time to build effective financial intermediaries and a monetary mechanism in Viet Nam. We expressed our concern that the banking sector reform will not be sustainable if it is separated from the reform of other sectors of the economy, in particular, the sector of state enterprises:

However it is not necessarily the case that a growth in bank lending will improve the present situation. The reason is that the financial health of firms in Viet Nam is beset by instability and a lack of transparency, making evaluation of the prospect of investment projects a difficult task for the banks. In other words, a rapid increase in lending in line with expansion in demand is likely to lead to a problem of the soft budget constraint on the part of firms. There is no easy answer to this problem. However, necessary conditions *for an expansion of lending are: immediate institutional reforms with a view to improving the clarity of financial state of the (mainly state-owned) enterprise sector and constructing a framework for evaluating the soundness of loans.* (Horiuchi et al, Final Report, Volume 3, p.123, February 1998)

6. The effects of the Asian crisis on Viet Nam observed from 1 to 3 make it more urgent to consider the problem of the soft budget constraint and its consequences for the stability of the banking sector. The banking sector of Viet Nam has been always very fragile. But the cause of its fragility is not only rooted in the banking sector itself but also in its relationships with its borrowers and with the government. In order to discover the clues to strengthen the financial sector, it is necessary to study the nature of the existing relationships between banks, enterprises and the government much more carefully. This is the background of the Follow-up Project for the financial sector reform.

7. Eleven papers listed at the end of this paper have been contributed to the Follow-up Project of the financial sector reform. They are denoted from paper 1 to Paper 9.[1] The purpose of this paper is to present an overall assessment of the current state of the financial system and its problems on the basis of the analyses of these eleven papers and to ident ify the issues and problems for further studies. Part I is the core of this paper and evaluates the current state of the financial system and its problems. Part II describes the tentative results of pilot studies which examine some of the problems identified in part I. Part III describes the agenda for further studies and the policy implications of the analyses provided in Parts I and II.

Part I. The Current State of the Financial System and its Problems

8. Part I consists of four sections from Section I to Section IV. Section I evaluates the current financial state of banks and enterprises(in particular,state enterprises)and serves as the basis of this paper. Section II evaluates various ad hoc measures implemented by the government and the SBV to mitigate the negative effects of the Asian crisis on banks and enterprises. Section III reviews the medium and long term structural policy measures that have been already implemented for the reform of the financial sector. Section IV discusses the tension between ad hoc measures and long term measures and enlists the set of policies described in the contributed papers for further reform of the financial sector.

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1 Papers 3A and 3B address the same questions. So do Papers 4A and 4B. The difference between them turns out to be quite informative about the complexities of the legal environment of the financial activities. So they are not integrated into one paper.

I. Financial Conditions of Banks and Enterprises

9. The argument of this section is primarily based on the analyses of four contributed papers. Papers 1 and 2 evaluate the current financial states of banks and enterprises (in particular, state enterprises) and the relationships between them. Papers 3A and 3B evaluate the effect of the depreciation of dong on the financial states of banks and enterprises.

A. Financial conditions of banks

8. How are the current financial conditions of banks? The values of the return (current profits before tax)on equity(ROE) and the return on assets(ROA) of the commercial banks as a whole were 4.9% and 0.6% respectively for 1998. While the consistency of the numbers is not clear,these figures are much lower than the ones reported for earlier years in the Final Report of Phase 2.[2] But a more serious problem with these numbers is the possibility that they may overevaluate the financial conditions of the commercial banks significantly. The ratio of overdue loans was 9.5% for the commercial banks as a whole at the end of 1998. If credit risks were adequately taken into account, the profits for 1998 might have been negative and the net worth of the banks significantly smaller.

9. Furthermore, it is quite misleading to evaluate state of the banking sector as a whole by average figures because of the importance of externalities in the banking industry. The presence of a small number of weak banks could exert disproportionately large distabilizing effect on the performance of the entire banking sector. For this reason, it is necessary to pay special attention to the weakest segment of the banking sector.

10. The fraction of overdue loans at the end of 1998 was 8.2%, 15% and 2.3% for the state owned commercial banks(SOCBs), joint stock banks(JSBs) and joint venture banks and foreign bank branches respectively. Clearly JSBs were the weakest segment of the banking sector. The SBV assessed their financial states as of end of June 1998. The result of the inspection revealed the surprisingly high exposure of a number of banks to credit risk: the ratio of overdue loans exceeded 20% for 10 banks, 50% for 4 banks and even 90% for 2 banks[3]. These numbers show that a number of joint stock banks were insolvent in the middle 1998. The opportunity cost of keeping such insolvent banks could be quite high, especially in the institutional environment in which deposits are implicitly guaranteed by

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[2] See Table 6(p.318)in "5-6 Financial Analysis on Vietnamese Commercial Banks"by K.Mori in the Final Report(Phase 2),Vol.3,Fiscal and Monetary Policy,1998.

[3] Dow Jones Newswires reported that the ratios of overdue loans of Incombank, Vietcombank,BIDV and VBARD were 17.95%,12.78%,1.77% and 3.57% respectively as of June 30,1998. The ratios of overdue loans of the following JSBs exceeded 10%: 98% for Tu Giac Long Xuyen,94% for Nam Do,62% for Hai Phong, 54% for VP Bank,47% for Gia Dinh,39% for De Nhat,29% for Viet Hoa,28% for Saigon Bank,26% for Phu Tam,21% for Dai Nam,18% for Habubank,17% for Eximbank and 16% for Mekong Bank.

the government. The bank management as well as the stake holders of such banks may allocate their credits to overly risky projects or may aggravate the financial conditions of banks further by postponing the problems to the future as much as possible.

11. But, of equal importance is the fact that a number of deeply insolvent banks were able to keep their normal operation and continue to accumulate extremely high credit risk in their assets until their financial conditions became totally out of control. This implies that the capability of the regulatory system to detect problem banks was very weak and that the clear rules did not exist that determine which banks should exit from the banking sector when and under which conditions.

12. The minimum capital requirement offers an example which indicates the existence of practical difficulties of enforcing regulations. Circular No.223/QD-NH5 dated 27/11/1993 stipulated the minimum charter capital requirements for newly established non-SOCBs. The required amounts were VND70 billion for JSBs in HCMC, VND50 billion in Hanoi, VND20 billion in other cities, and VND3 billion and VND1 billion for rural JSBs with and without branches respectively. Existing banks were also required to reach the said minimum level in 3 years.[4] But, in HCMC for example, 8 out of 17 JSBs did not satisfy the condition at the end of 1998.

B. Financial conditions of major borrowers

13. The credit risk carried by the banking sector is ultimately attributable to a variety of risks undertaken by its borrowers and the way how the risks are shared between banks and their borrowers. There was a sizable difference in the portfolio of outstanding loans between SOCBs and non-SOCB banks in terms of the ownership of borrowers. In comparison with SOCBs, non-SOCB banks allocate more credits to non-SOEs. That is, 57.5% of the non-government loans of SOCBs was directed to SOEs, but only 38.5% of those of non-SOCB banks was directed to SOEs.[5] Therefore, the financial state of non-SOCB banks depended more heavily on the financial states of non-SOEs.

14. Paper 2 describes the financial performance of SOEs for 1997: 40% of SOEs earned positive profits, 44 % around zero and 16% suffered losses. SOEs earning positive profits accounted for 71.5% of equity of SOEs and 82.6% of the contribution to the government budget by SOEs. The debt to equity ratio of the SOEs was 128%. As for the term structure, 64% of their debts was of short term and 29% of long term. The level of their accounts receivable was about 50% of their equity.

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[4] The history of JSBs is new. Its legal framework was first established in 1990. There were 35 JSBs as of end of 1993.

[5] Calculated from Table 24 in IMF(1998): "Viet Nam: Selected Issues and Statistical Annex."

15. The debt to equity ratio of 128% needs to be interpreted carefully, because the figures are much larger for many large highly indebted SOEs.[6] An SOE exists whose debt to equity ratio is even 20 times higher than its capital.[7] Such firms are bound to be vulnerable to interest rate risk.

16. The financial states of non-SOEs are quite precarious. Paper 2 argues that non-SOEs are accumulating a large amount of arrears in accounts payable to SOEs as well as among themselves. Two factors are particularly important for the accumulation of arrears. One is the lack of a clear legal mechanism to enforce payments or to punish the firms that fail to repay their debts. The other is a severely limited access to credits for non-SOEs. These two factors combine to induce firms, particularly non-SOEs, to keep at hand as much liquidity as possible and to delay their payment to their suppliers whenever the penalty for the arrears is small. Credit risk carried by firms in such an environment could be quite high, even when their liquidity level is high. Furthermore, such an environment cannot separate efficient firms from inefficient ones, resulting in too many inefficient firms being kept alive in spite of them being virtually bankrupt. As a consequence, the financial relationships among firms as well as between firms and banks are placed in the financial state quite vulnerable to external shocks.

C. Foreign exchange risk

17. Because of the sizable depreciation of ASEAN currencies against currencies of major industrial countries, VN dong has been placed under continuous economic pressure toward further depreciation. But, different from other ASEAN economies, Viet Nam has managed to avoid both sudden and large depreciation of VN dong and the consequent financial crisis. Yet VN dong depreciated by about 24% in two years from VND11,200 per dollar at the end of 1996 to VND13,900 per dollar at the end of 1998. What were the effects of the dong depreciation on banks and enterprises, particularly on their balance sheets? How vulnerable are banks and enterprises to foreign exchange rate risks? Papers 3A and 3B address these questions.

18. Paper 3A evaluates the effects of the dong depreciation on the balance sheet of the banking system as a whole, including SBV. The value of net foreign assets held by the banking system as a whole against non-residents has been positive, increasing from $1.3 billion (1996) to $2.3 billion (1998). In addition, some of the assets and liabilities of banks held against domestic economic units are denominated in foreign currency. Loans in foreign currency decreased from $1.7 billion (1996) to $1.4 billion (1998), while foreign currency deposits increased from $1.2 billion (1996) to $1.8 billion (1998). In all, the net

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[6] Paper 4A states that "A lot of SOEs have loans which are 4 to 10 times higher than their own capital."

[7] See p.143 of Vol. 4 of Final Report(Phase 2). In addition,much of its debts is in dollar.

foreign currency position of the banking system as a whole increased from \$1.6 billion (1996) to \$1.9 billion (1998). Therefore, the depreciation of dong yielded foreign exchange gain to the banking system as a whole.

19. However, the foreign exchange gain is not symmetric between the SBV and deposit money banks. Foreign assets and liabilities held by deposit money banks were about the same and that their net foreign assets was around zero from 1995 to September 1997. Therefore, foreign exchange gain attributed to the positive net foreign assets held by the banking system belonged almost entirely to SBV. The contrast was sharper in 1998, when the deposit money banks suffered from losses by VND600 billion but the SBV gained by VND 3.7 trillion.

20. Foreign exchange risk for banks is not limited to the direct effects on their foreign currency denominated assets and liabilities. It affects their credit risk indirectly through its effects on balance sheets and income of their borrowers. Non-SOCB banks had relatively higher exposure to foreign exchange risk because 58.7% of their loans were in foreign currency, while only 29.4% of the SOCB loans were in foreign currency.[8] Therefore, non-SOCB banks were much more vulnerable to the credit risk caused by dong depreciation than SOCBs. This should explain at least partly the observation in the paragraph 10 that joint stock banks had a higher overdue loan ratio than SOCBs.

21. It is important to note also that foreign exchange risks are not distributed uniformly among SOEs or non-SOEs. A relatively small number of firms and industries exist which are highly exposed to foreign exchange risk in comparison with other firms and industries. Examples are manufacturing firms of cement, petroleum, steel, paper, cotton textile and electricity. They are either highly indebted or heavily dependent on imports. (Papers 3A and 3B)

22. Note also that net foreign assets held by SBV include only short-term liabilities. The amount of the medium and long term external liabilities of the government (including government guaranteed debts) was \$4.8 billion at the end of 1996, which was much higher than the net foreign assets held by the SBV (\$1.7 billion at the same period). Therefore the dong depreciation resulted in higher external debt obligation in terms of dong for the government and the SBV combined.

II. Ad Hoc Measures to Mitigate Credit Risk and Foreign Exchange Risk

23. The papers presented in Section I indicate that the economy is caught in an inefficient and unstable equilibrium in which the weakness of the financial states of banks and

[8] Calculated from Table 24 in IMF(1998): "Viet Nam: Selected Issues and Statistical Annex."

enterprises is mutually reinforcing. In response to such a weak state of the economy, the government and the SBV have implemented various policy measures ranging from ad hoc policy measures to ease the current financial difficulties to long run policy measures to address the fundamental weakness of the economy. This section reviews the ad hoc policy measures.

24. Since the spring of 1997, the government and the SBV issued a series of ad hoc measures aimed at mitigating the financial difficulties of SOEs. Papers 4A and 4B evaluate the effects of these measures.[9] Many of them stipulate conditions under which banks are allowed to reschedule their overdue loans to SOEs and to reclassify them into normal loans. They give a better appearance to the financial states of banks and SOEs in the short run. But their long run effect could be just the opposite and result in more serious problems in the future if they delay the necessary adjustment of SOEs to the new market environment after the Asian crisis.

A. Ad hoc measures to mitigate credit risk

25. Decision No. 49/CP-m dated 06/05/1997 and Document No. 417/CV-NH14 dated 31/05/97 removed various prudential regulations imposed earlier on lending activities of banks. Under the new regulation, SOCBs may lend to SOEs without taking collateral and may extend new loans even when the debt/capital ratios of SOEs exceed 100% or when they are making losses, if the credits are to be used to implement efficient production plans or efficient investment projects. The regulation further indicates that the key criterion to be used to evaluate the efficiency of production and investment plans is whether they have been approved either by ministries or People's Committee. But such an efficiency criterion could result in serious misallocation of credits in a rapidly changing market environment.

26. Instruction No. 09/CT-NH1 dated 27/08/1997 allowed banks to reschedule the terms of repayment of SOE loans, in particular, to transform short term loans into medium and long term loans, and medium term loans into long term loans, when SOEs cannot repay their debts on time but operate "efficiently." (Paper 4A)

27. Circular No. 03/1997/TTLT/NHNN-TC dated 22/11/1997 allows banks to roll over or reschedule or write off their loans if the failure of borrowers to repay the debts are due to force majeure such as draught, flood or storm. (Paper 4B)

28. Document No.433/CV-NH14 allows banks to reschedule their loans to SOEs in financial difficulties when the latter play important functions for the economy or society. It also

[9] Some information is drawn from Paper 6.

allows banks to put overdue loans into a blocked account when they result from the policy change or the suspension of SOEs. Document NO.433/CV-NH1 allows banks to write off the unrecoverable overdue loans caused by storm, flood or bankruptcy of SOEs. (Paper 4A)

29. Instruction No. 08/1998/CT-NHNN14 dated 03/10/1998 specify various measures to alleviate the burden of SOEs to repay their debts. SOEs in financial difficulties are allowed to repay only the principal of their debt first and to pay interest later.[10] Also they do not have to pay penalty interest for their overdue debt if they can only pay principal and normal interest. Furthermore, if they are suffering losses and cannot make repayment on time, then banks can ease the debt obligation of SOEs by extending the maturity date of the loans to the future. (Paper 4A)

30. In order to mitigate the lack of capital of SOEs, Official Letter No. 309/KTTH-Tym dated 08/09/1997 was issued to provide SOEs with additional fund for buildings and working capital. (Paper 4B)

31. In order to lighten the financial burden of the banks, the income tax rate of the banks was reduced from 45% to 32% as of 01/01/1999. (Paper 4B)

32. Paper 4A shows that the fraction of loans extended to SOEs increased from 49.6% in 1997 to 53% in 1998 after it declined steadily during 1990s. Both Papers 4A and 4B evaluate these measures highly and argue that they helped SOEs expand and continue their production activities. But the opportunity costs exist. The availability of credits to non-SOEs has become more limited. Banks are potentially much more vulnerable to credit risks because an increasingly larger part of their loans is allocated to the SOEs in financial difficulties, even though the ratio of overdue loans declined in the short run because of rescheduling.

33. A potentially most damaging element of the ad hoc measures to mitigate the financial difficulties of SOEs is the criterion used to judge the efficiency of their production plans or investment plans. In effect, the efficiency of plans is judged by the condition whether or not the plans have been approved by ministries or people's committee. Such a mechanism could delay the adaptation process of investment activities in Viet Nam to rapid changes in its external environment.

B. Ad hoc measures to mitigate foreign exchange risk

34. Paper 5 evaluates the purposes and the effects of various ad hoc measures implemented by the government and the SBV to strengthen their control over foreign exchange

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[10] If the amount of the repayment is constant,then most of the earlier payment is interest.

transaction and external borrowing and lending.

35. Foreign exchange transactions were regulated by Decree 161/HDBT dated 18/10/1988 and Decision No. 396/TTg dated 04/08/1994, but they were not effective to prevent the hoarding of foreign currencies (practically US dollar) when firms and individuals expect dong to depreciate. Transaction volumes in the foreign exchange market declined sharply since the beginning of 1997, from \$3 million per week to \$1 million per week in February 1997 and further to \$0.2 million per week in February 1998 (Paper 3B). That is, the supply of dollar virtually disappeared from the market.

36. A series of regulations were issued to restore the volume of transactions in the foreign exchange market and to strengthen the control of the government over the speculative hoarding of dollar. They are Decision No. 37/1998/QD-TTg dated 14/02/1998, Decision No. 267/1998/QD-NHNN7 dated 06/08/1998, Decision No.173/1998/QD-TTg dated 12/09/1998 and Decision No. 232/1998/QD-TTg dated 01/12/1998. The regulation over the hoarding of foreign currency was made increasingly tighter, and Decision No. 232 required the firms to sell 80% of the foreign currencies to the banks as soon as they receive them in their foreign exchange accounts.[11] (Paper 5)

37. Serious troubles occurred in trade finance. The amount of L/C with deferred payment increased sharply in 1996, causing serious concern over the implications of the excessive growth of L/C for trade deficits and the stability of the financial sector. Furthermore disputes erupted between VP Bank and Viet Hoa Bank with Korean banks over L/C in 1997.[12] They prompted the government to tighten regulations over deferred L/C and issued a series of regulations such as Decision No. 207/QD-NH7 dated 01/07/1997, Decision No. 802/TTg dated 24/09/1997 and Circular No. 07/1997/TT-NHNN dated 04/12/1997. They clarified the responsibility of related parties over issuing L/Cs. Partly as a consequence of such measures, the balance of short-term external debt including bank guarantees and deferred L/C declined significantly in 1997 and 1998.

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[11] Surrender requirement of foreign exchange earned by residents to foreign exchange banks is a typical mechanism to control the portfolio of financial assets held by residents. It has both positive and negative effects on the economy. When speculative demand for foreign exchange is strong and the supply of foreign exchange has disappeared from the foreign exchange market,the surrender requirement can serve at least partially to restore the supply of foreign exchange by pooling it in the foreign exchange banks or in the monetary authority. It eliminates one important source of the pressure of depreciation driven by self-fulfilling expectation on domestic currency. The negative side of the control is that it will distort foreign trades by limiting the capability of individual economic unit to control its foreign exchange risk.

[12] The failure of reputed banks to settle L/C lowered the credit standing or Viet Nam."Thomson Bank Watch downgraded Viet Nam's sovereign debt in 1997 from B-to C. The decision was prompted by the inability or unwillingness of Viet Nam's largest bank, Vietcombank,to meet a deadline on about \$40m of overdue letters of credit."(Economist Intelligence Viet Nam, 4th Quarter,1998). But,other cases exist which unduly damaged the reputation of Vietnamese banks. The Vietincombank won the dispute on a L/C with MeesPierson NV in the Singapore High Court on August 17,1998. But the damage was done to its reputation already.(Viet Nam Investment Review,August 31-September 06,1998)

Ⅲ. Structural Reform Measures Already Implemented to Strengthen the Financial Sector

38. The observations in Sections I and II reiterate the double characteristics of the difficulties that Viet Nam has to overcome, a transition from a peasant economy to an industrial economy and a transition from a centrally planned economy (a subsidy mechanism) to a market economy. First of all, the difficulties of the transition are most visible in the financial difficulties of the newly established joint stock banks, which reflect the weakness of emerging non-SOEs. In general, economic organizations under private ownership seem to be facing more financial difficulties than those under the state ownership.

39. Secondly, various ad hoc policy measures have been issued to mitigate the financial difficulties of SOCBs and SOEs. They might have improved the appearance of the financial state of SOCBs and SOEs. But such effects may be only short lived. A temporary relief created by the ad hoc measures such as rescheduling does not change the basic economic conditions which caused the financial difficulties of SOCBs and SOEs. The most it can accomplish is that it provides policy makers, banks and firms with a limited time to carry out deeper structural reforms that will enable them to function effectively in a new and continuously changing external economic environment. This section reviews how the government and the SBV have been using the time to address the long run structural problems of the financial sector. Discussion is primarily based on Papers 1, 4A, 6 and 7. In particular, Paper 6 reviews the progress of the institutional reform accomplished up to present. Paper 7 studies the relationships between the development of securities market and the equitization of SOEs.

A. Building institutional infrastructure for regulation and supervision

40. Paper 6 reports an important progress in building the institutional framework for measuring, managing and monitoring various risks associated with banking activities. The basic legal framework for banking activities was given by the Law on State Bank and the Law on Credit Institutions dated 26/12/1997 and made effective from 01/10/1998. The SBV has strengthened various prudential regulations under the Law.

41. Decision No. 48/1999/QD-NHNN5 dated 08/02/1999 of the Governor of the SBV aims at strengthening the capability of credit institutions to manage their credit risks by providing guidelines how to classify their assets and to set aside loan loss reserves and when to write off bad loans. It replaced the Decision No. 299/QD-NH5 dated 13/11/1996 for classifying non-performing loans.

42. Official Letter No. 3449/KTTH dated 12/07/1997 was issued to allow credit institutions to count the addition to their loan loss reserves as a part of their expenses and thereby

to exempt them from paying income taxes for increasing provisions for loan losses (Papers 4A and 4B). It helps banks be better prepared for the possible future loan losses and smooth the streams of their net earnings over time.

43. Decision No. 292/1998/QD-NHNN5 dated 27/08/1998 established a criterion to evaluate the risks of joint stock banks and to identify the problem banks among them. It is based on the so-called CAMEL rating and classifies joint stock banks into four categories from A (best) to D (worst) by their scores. The criterion is used both for the self-evaluation by joint stock banks and for the supervision by the SBV.[13]

44. An important progress has been made also in the accounting system of enterprises and banks. Decision 1141/TC/QD/CDKT dated 01/11/1995 (made effective 01/01/1996) established a new corporate accounting system in order to evaluate the value of enterprises more accurately and to meet various requirement in a market economy. Availability of reliable financial records is the essential prerequisite for banking activities. All the SOCBs and a number of joint stock banks have been already subjected to the auditing by external auditors. External auditing is also required for SOEs, but its implementation level is still very low.

B. Restructuring joint stock banks (JSBs)

45. The observation in Section I shows that a radical restructuring is necessary for JSBs. Various regulations have been issued for that purpose: Decision 96/1998/QD-TTg dated 19/05/1998 on consolidation of JSBs in HCMC and Decision No. 241/1998/QD-NHNN5 dated 15/07/1998 on mergers of JSBs. Restructuring process started in September 1998 after the inspection by the SBV. Nam Do Bank and Mekong Bank were "closed" in September 1998.

46. In addition, in October 1998, the SBV set the target date on October 2001 for JSBs to reach the minimum capital requirements, which were VND70 billion in HCMC and Hanoi and VND50 billion in other cities. They will be closed unless they reach the required level by the target date. Dong A Bank took over Long Xuyen Commercial Bank in March 1999. Phuong Nam Bank, a grade A bank in the SBV rating, took over Dong Thap Bank in 1997 and merged with Dai Nam Bank suffering from a large amount of non-performing loans in May 1999.[14]

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[13] Whether enforcing such a criterion or any other criterion enhances the efficiency and stability of banks should not be taken for granted. The actual effects of the point system contained in the regulation need to be reviewed carefully.

[14] Viet Nam Investment Review, May 10-16, 1999.

C. Reform of SOCBs

47. Reform of existing organizations is always much more difficult than establishing new ones under new leaderships and new decision making rules. The same is true for SOCBs which inherited their organizational routines and the relationships with SOEs from the regime of central planning. But there was some progress in reorganizing SOCBs, including the change in the top management.

48. Government issued Decision No.859/QD-TTg dated 24/09/1998 in order to provide SOCBs with additional funds to increase their charter capitals. This remedied the serious undercapitalization of SOCBs relative to the levels required by Decree No.82/1998/ND-CP dated 03/10/1998. But,except for Agribank which has reached 97% of the required level, the charter capitals of SOCBs are still significantly short of the required levels, 73.5 % for IncomBank, 72.8% for VietcomBank and 70.3% for BIDV. (Papers 1, 4A, 4B).

D. Measures to develop security markets

49. Paper 7 examines various obstacles for developing security markets in Viet Nam and describes a set of measures which would enhance the development process of securities market. It further evaluates the relationships among the measures of developing banks and securities markets and of equitizing state enterprises.

50. In principle,the development of securities markets could be complementary to the development of the banking sector. But conditions exist in which the dominance of the banking sector deters the development of securities markets. For example,when an SOE has an easy access to bank credits with preferential terms, it will have little incentive to participate in the equitization program and to raise its funds by selling its stocks to public. The existence of the soft budget constraint creates an incentive to maintain the status quo.

51. Decree No.48/1998/ND-CP dated 11/07/1998 provided a basic legal framework for the institutional infrastructure necessary for issuing and trading securities,such as stocks and bonds. However,the institutions are not yet operational. The basic reason is the lack of a large number of eligible stocks to be listed in the stock exchange or traded over the counter. But Decree No.44/1988/ND-CP dated 29/06/1998 established a mechanism to speed up the equitization process of SOEs. The number of equitized SOEs reached 116 by the end of 1998, consisting of 5 SOEs equitized from June 1992 to April 1996, 25 SOEs from May 1996 to May 1998, and 86 SOES from June 1998 to December 1998.

E. Financial liberalization

52. The restriction on the spread between loan and deposit interest rates was abolished in

1998. But the ceilings on loan interest rates were retained. Papers 4A and 6 argue that the ceilings on loan interest rates are necessary at the present stage of the transition and will be removed as the financial condition of SOEs is improved. Paper 6 points out, however, that such an interest rate policy is deterring the development of the banking sector.

53. SBV used credit ceilings to control the growth process of domestic assets held by banks since 1994. Partly because of the application of credit ceilings,the Credit to Non-government Sectors/GDP ratio remained roughly between 19% and 20% since 1994. In 1998, however, credit ceilings were no longer binding. This should be attributable partly to the credit crunch caused by a higher concern over bad loans and partly to the decline in credit demand caused by the lower economic growth.

54. Various regulations over lending activities were integrated and superseded by the lending rules issued with Decision No.324/1998/QD-NHNNI dated 30/09/1998. (Papers 4A and 7)

F. Convertibility of dong and external debt management

55. A new legal framework for foreign exchange transactions was established by Decree No.63/1998/ND-CP dated 17/08/1998,which replaced Degree 161/HDBT. It classifies economic units into residents and non-residents,and foreign exchange transactions into current account transactions,capital account transactions and inter-bank transactions. It is intended to provide a more comprehensive framework for achieving convertibility of dong for current account transactions in the future.(Paper 5)

56. Decree No.58/CP dated 30/08/1993 regulated all external borrowings. But it was not effective for controlling external debts,especially short term foreign debts. It is now replaced by Decree No.90/1998/ND-CP dated 07/11/1998. While firms have the right to borrow directly from abroad for business purposes, they are required to consult with SBV. Both the loan disbursement and debt servicing must be carried out through banks in Viet Nam with foreign exchange license.(Paper 5)

IV. Further Structural Reform Policies and Ad Hoc Measures

57. Section I has shown that the financial states of a large number of banks and enterprises are quite precarious and that the equilibrium among different sectors of the economy is inefficient. Various temporary measures adopted to ease the financial difficulties of SOEs have been reviewed in Section II. They provided SOEs,banks and policy makers with some time to prepare for the necessary adjustment to address the fundamental weakness

of the equilibrium. Section III has reviewed structural measures that have been implemented to strengthen the financial sector in the long run and to enhance the transition process toward a market economy. In sum,the present state is best described as an inefficient equilibrium pulled toward different directions by two opposing forces,to one direction by ad hoc measures and to the other by long run structural reform measures.

58. But the effects of ad hoc measures on the economy depend not only on the long term reform measures implemented in the past or at present,but also on the structural policy measures to be taken in the future. Expectation that a new set of rules will be implemented in the future will be able to reduce the negative incentive effects of ad hoc measures on economic units.

A. Expected structural reform policies in the future

59. All the papers (in particular, Papers 1,2, and 6) reviewed above contain certain answers to the question what policies are necessary in the coming years in order to continue the doi moi process and to move the economy toward a more efficient and stable growth path. The major directions of reform policies are:

(1) To eliminate the ask-give relationships (or the so-called soft budget constraint) between banks and enterprises,between banks and the government(and SBV) and between the government and enterprise(Paper 1,2,6)

(2) To strengthen the organizational capabilities of banks as financial intermediaries and make them more robust to credit risks and market risks(Paper 1 and 6)

(3) To develop security markets and gradually liberalize interest rates(Paper 1,6)

(4) To gradually integrate the financial sector with international financial market(Paper 1 and 6)

(5) To liberalize foreign exchange transactions associated with current account transactions (Paper 5)

The final goal of the financial sector reform is clear in these statements. It is to establish efficient and stable financial markets and financial institutions highly integrated with the world financial market.

60. Specific policies listed in the papers to achieve the goal are:

(1) To establish a clearly defined safety net such as a deposit insurance scheme[15] (Paper 6)

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[15] The analysis of the safety net in Viet Nam is quite limited because of the lack of information on how the costs of insolvent banks were allocated among their owners,depositors,other creditors and so on. Nevertheless the nature of the safety net is extremely important for determining the efficiency and stability of the banking sector.

(2) To further strengthen the organizational capability of SBV to monitor banking activities and enforce prudential regulations; to establish and implement risk based criteria of the international standard to evaluate banking activities (Paper 1,6)

(3) To restructure the group of joint stock banks, consolidate their capital base and strengthen their organizational capability as financial intermediary (Paper 1,6)

(4) To strengthen the operational efficiency of SOCBs and to recapitalize them (Paper 1, 6); to equitize one of the SOCBs and let a foreign bank have a strategic stake in the bank to improve its operation (Paper 1)

(5) To separate preferential or directed credits from commercial credits and use a newly established policy bank for the former (Paper 1)

(6) To improve the legal framework for mortgage and foreclosure on collateral to enhance the lending activities (Paper 1, 6)

(7) To establish a mechanism to restructure overdue loans/debts of banks and enterprises (such as a debt trading company or the center for managing and selling mortgaged assets) (Paper 1, 6)

(8) To remove the restriction on banking activities of joint venture banks and foreign branches (Paper 6)

(9) To develop government bond markets and the mechanism necessary for open market operation (Paper 6, 7)

(10) To enhance the equitization of SOEs (Parer 2, 7)

The list of the reform policies mentioned above is rather exhaustive and includes most of the standard policy measures described in WB(1989) as prerequisites for financial development.[16] This fact is worth noting. A common understanding is being formed among the authors of the papers of Part I about the goals of financial reform and the policies necessary to achieve that goal. And they are largely consistent with the standard prescription for financial development that was derived from the experience of many developing countries.

B. Tension between long run structural reform policies and ad hoc measures

61. Tension exists between the long run reform policies and the ad hoc policy measures. The ad hoc measure to reschedule bank loans to SOEs in financial difficulties seems to contradict with the long run policy orientation aiming at eliminating the soft budget constraint. The ad hoc measure to delay the settlement of bad loans seems to make banks more vulnerable to greater credit risks in the future.

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[16] The standard reference concerning the prerequisites for successful financial liberalization is WB(1989). A policy measure which is not mentioned explicitly in the list but is repeatedly emphasized in WB(1989) of its importance is a disclosure of financial information. Without it prudential regulations will not be enforceable.

62. But,it is also possible to interpret ad hoc measures as an attempt by the government to help economic units adapt their behavior to a new market environment more smoothly. Papers 4A, 4B and 6 see the ad hoc measures in that way:

Paper 4A: Ad hoc measures contributed to maintaining smooth flows of funds from banks to SOEs and, thereby, increased economic growth, reduced unemployment, gave financial resources necessary for equitization and improved the financial state of SOEs.

Paper 4B: The SOE system is now undergoing a major reform process and it is necessary for the govemment to help SOEs obtain the funds necessary for their development.

Paper 6: Document No.417/CV-NH14 and Instruction No.09/CT-NHI corrected the errors committed under the tight monetary policies in earlier years. Short-term credits had been provided for medium and long term investments. The new regulations did not worsen the credit risk of banks but rather reduced it by allowing them to reevaluate the credit demands of SOEs more accurately and rewrite the loan contracts on the basis of more accurate evaluation.

63. The relationships between ad hoc measures and long run structural measures are neither straightforward nor easy to evaluate. Do they help SOEs adjust their behavior to a new market environment? Or do they help SOEs delay necessary adjustments? Did not the ad hoc measures send wrong signals to SOEs about their debt obligations? Is it not more appropriate to interpret ad hoc measures as a temporary setback to the transition process from a centrally planned economy toward a market economy? Is it not possible that a "temporary" setback creates perverse incentives among SOEs and leads to a more long term setback to the transition? Did not ad hoc measures deter the equitization process of SOEs rather than enhanced it? Did not ad hoc measures worsen the credit risk of SOCBs?

64. A good example exists which exposes the tension between ad hoc measures and long run reform policies. The fraction of credits extended to SOEs out of the total non-government credits increased to 53% in 1998,after its continuous decline from 92.3% (1992) to 49.6% (1997). How should we evaluate this reversal of the adjustment process of the allocation of credits from SOEs to non-SOEs? Is it a progress toward a more efficient and stable market economy or a setback?

65. It is not possible to answer this question definitively without further evidence on the progress of reforms in SOEs. But the reversal of the trend in the fraction of credits allocated to SOEs is also the result of the dismal financial state of joint stock banks and non-SOEs. They are the most typical economic organizations in the world market. Why are they doing so badly in Viet Nam? What are the major reasons of the dismal performance of a large number of joint stock banks? What kind of difficulties does it reflect? Are the

regulations biased against the development of the private sector? Are the credit risks of small private enterprises too large for joint stock banks? Are private firms too small to serve as an organizational basis for industrialization? Are there some elements in the current financial system which are deterring the development of non-SOEs? Aren't the credits to the SOEs in financial difficulties crowding out credits to non-SOEs, especially credits to small and medium sized private firms?

66. These questions indicate that the tension between the ad hoc measures and the long run structural reform policies of the financial sector is closely associated with their effects on the progress of reforms in the enterprise sector,including both SOEs and non-SOEs. The reform of the financial sector and the real sector cannot proceed separately.

67. The tension between the ad hoc measures and the long run structural reform policies also reflects the fact that the effects of long run structural policies depend on the specific historical conditions of a country and that it is not easy to find out which reform measures should be implemented first and how to implement them in the given historical conditions of Viet Nam.[17]

Part II. Pilot Studies to Evaluate How to Implement Reform Policies

68. The papers reviewed in Part I show that the long run goals of the financial sector reform and the policies to achieve them are now relatively clear. But questions still remain how to implement them and when. Further, many ad hoc measures have been implemented that seem to contradict with long run reform policies. The consistency between the long run policies and the ad hoc measures depends on the consistency of their effects on the incentives of banks and enterprises to continue the reform toward a market economy. Further evidence is necessary to judge whether this is the case.

69. Two papers were written to make some progress to find out "optimal extent, sequencing, and timing of financial liberalization" in Viet Nam.[18] Paper 8 examines the policies to liberalize interest rates in Viet Nam and their implications for its financial development, Paper 9 reviews the Asian economies suffering from currency and financial crises since 1997 and tries to draw lessons from their experience for the financial sector reform in Viet Nam. It also reviews the financial sector reform in China which started the reform in late 1970s.

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[17] Fry(1995,p.465) argues that "Although agreement has now been reached on the prerequisites for successful financial liberalization,there exists very little analysis on the optimal extent,sequencing,and timing of financial liberalization."

[18] Fry,ibid.

I. When and How to Liberalize Interest Rates?

70. One important area of financial liberalization is the liberalization of interest rates, removing ceilings and floors on lending and deposit rates. Paper 8 asks how the attempt to liberalize interest rates in Viet Nam affected the development of the financial sector at an early stage of its development.

71. Paper 8 argues that the current interest policy does not match the stage of economic development of Viet Nam,destabilizes the banking sector and is detrimental to its financial deepening. Ceilings exist on loan interest rates, but deposit interest rates are freely chosen by commercial banks. In the economy where information asymmetry is severe and prudential regulations are difficult to enforce, such an interest rate policy could easily result in extremely high non-performing loans for some banks. A bank that falls in a financial trouble for one reason or another is tempted to resolve its cash flow problem by attracting new depositors with higher deposit interest rates, further eroding its own profit basis, approaching closer to a pyramidal scheme. But the existence of such banks could destabilize the entire banking sector and deter its development. Furthermore, such an interest rate policy erodes the profit margin of banks and does not help banks solve the fundamental problem they have to overcome, that is, to gain the confidence of public in the safety of their deposits in the banks.

II. Lessons from East Asian Economies in Crisis and China

72. Paper 9 addresses the question what reforms are necessary in the financial sector of Viet Nam,but does so from the perspective somewhat different from the papers presented in Part I. It evaluates the necessary reform measures on the basis of the experience of East Asian economies (including China) battered by the financial crisis.

73. The most important lesson of the Asian crisis repeatedly emphasized in Paper 9 is the observation that the effect of the crisis depends heavily on the robustness of the financial sector to the external shocks. When the financial sector is robust to various risks, including credit risks,interest rate risks and foreign exchange risks,the effects of external shocks on the economy are rather limited. But when the financial sector is vulnerable to risks, the effects of external shocks will be amplified through the financial system and destabilize the entire economy. The second point is importance of the order of liberalization or the sequencing of policy reforms. First is the macroeconomic stability. Then, an attempt should be made to strengthen prudential regulations and improve the robustness of banks to risks. Next comes the financial liberalization under the condition that the prudential regulations are enforced effectively. Then,the policy should be found to improve the competitive environment of financial markets and enhance the competitive capability of

financial institution. Last step is a prudent and judicious liberalization of capital flows, with due control over short-term capital flows.

74. These lessons drawn from the experience of Asian economies in Paper 9, however, are largely consistent with the standard policy prescription described, for example, in WB (1989, p.1, pp.122-132) or Fry (1995, pp.450-472). What is new in Viet Nam in comparison with the standard prescription of financial reform is the role of SOEs in the economy. Paper 9 casts doubt whether prudential regulations can be effectively enforced when flows of credits are influenced heavily by the concern over the financial states of the weak segment of SOEs. Prudential regulations over risk taking may not be compatible with the incentives of bank managers who are placed under the supervision of multiple government organizations, including SBV, ministries, People's committee and other State agencies, some of which are stake holders of SOEs at the same time.

Part Ⅲ. Agenda for Further Studies

75. Papers in Part I describe what kind of financial reform policies are necessary for Viet Nam in the near future. They are largely consistent with the standard prescription for financial development that was derived from the experience of many developing countries. But,papers reviewed in part I and part Ⅱ also verify the importance of taking into account the special historical conditions of Viet Nam in determining how and when to implement the reform policies. They also show that the success of the financial sector reform depends crucially on the progress of the reform in the real sector,especially in the enterprise sector. This is particularly true when various seemingly contradictory ad hoc measures are implemented to ease the financial difficulties of SOEs. Both research agenda for further studies and policy implications of the Follow-up Study are related to the point how to combine the special historical circumstances of Viet Nam with basic principles of financial development.

I. Agenda for Further Studies

76. Firstly,it is important to study the combined effects of ad hoc measures and long run reform policies on the incentives of bankers,managers and workers of SOEs, their regulators and so on. Are the negative effects of ad hoc measures being effectively controlled? The answer to this question will depend on how widely and deeply the common understanding of the financial reform found in the Follow-up Study are shared by bankers, managers and workers of SOEs and government officials.

77. Secondly, it is equally important to examine when and how to implement the long run reform policies. The problem is inherently difficult because every country is different and

the difference matters in its solution. But still the experience of other economies should be helpful in analyzing the problems to the extent that common factors exist. For example, long run reform policies such as building accounting and legal systems should be implemented in the initial stage of reform.[19] The unique historical conditions of Viet Nam are that it is in the transition process to a modern market economy from both a centrally planned economy and a peasant economy at an early stage of economic development. Both of these conditions make it extremely challenging to build publicly available information channels. For the development of the financial sector,it is equally important to note that Viet Nam experienced hyper inflation in the middle 1980s and that the credit unions collapsed nationwide at the end of 1980s.

78. Thirdly, it is important to study the mechanism operating in Viet Nam to resolve the problems caused by non-performing loans and recapitalize the banking sector. It will be also useful to study the effectiveness of various mechanisms adopted in other economies for comparison. The analysis of the safety net in Viet Nam is quite limited because of the lack of information on how the costs of insolvent banks were allocated among their owners, depositors, other creditors and so on. Nevertheless the nature of the safety net is extremely important for determining the efficiency and stability of the banking sector.

79. Fourthly, it is important to study how to develop money markets and money market policy instruments. The main instrument of monetary control has been credit ceilings imposed on commercial banks on a bank-by-bank basis since 1994. While they were found to be quite effective as an instrument to control inflation, they also brought about negative side effects on financial deepening by discouraging banks to develop their depositor base. Developing money market policy instruments in place of credit ceilings for controlling money supply process is now high on the agenda of the financial reform from the macroeconomic viewpoint.

II. Policy Implications of the Follow-up Study

80. A temporary relief created by the ad hoc measures such as rescheduling does not change the basic economic conditions which caused the financial difficulties of SOCBs and SOEs. The most it can accomplish is that it provides policy makers,banks and firms with a limited time to carry out deeper structural reforms that will enable them to function effectively in a new and continuously changing external economic environment. In order to minimize the negative incentive effects of ad hoc measures,the final goal of the financial sector reform needs to be clarified and the long run structural policy measures should be implemented without delay.

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[19] WB (1989, p. 127).

81. Stronger efforts should be made both to find prudential regulations that can be easily monitored and effectively enforced in Viet Nam and to improve the organizational capability of the SBV, banks and enterprises to implement the regulations.

82. The current regulations on interest rates do not match the need for financial development in Viet Nam. When ceilings on loan interest rates exist and prudential regulations are difficult to enforce,the absence of the upper bound of deposit interest rates increases the vulnerability of the banking sector (particularly, joint stock banks) to external shocks.

83. The emphasis on prudential regulations alone could worsen the credit crunch when banks have a large amount of non-performing loans already. A mechanism must be established to allow commercial banks to dispose of non-performing loans and to recapitalize themselves. But it has to be accompanied by the reform of SOCBs and SOEs at the same time. Otherwise the problem would be recurrent.

References

Background papers:

Part I: The current state of the financial system and its problems

(Paper 1) Nguyen Thu Ha,"Evaluating the current financial conditions and prospects of banks."

(Paper 2) Nguyen Duc Tang,"Evaluating the financial state of enterprises (especially SOEs) and the factors affecting their relationships with banks and the government."

(Paper 3A) Nguyen Thi Thu, "Assessing the effects of depreciation of the VN dong on foreign currency denominated assets and liabilities of banks and enterprises(A)."

(Paper 3B) Do Minh Tuan, "Assessing the effects of depreciation of VN dong on foreign currency denominated assets and liabilities of banks and enterprises(B)."

(Paper 4A) Nguyen Ngoc Bao, "Evaluating the purposes and effects of various ad hoc measures implemented by the SBV and the government to mitigate the financial difficulties of state enterprises and banks(A)."

(Paper 4B) Nguyen Van Sau, "Evaluating the purposes and effects of various ad hoc measures implemented by the SBV and the government to mitigate the financial difficulties of state enterprises and banks(B)."

(Paper 5) Chu Thi Hong Minh, "Evaluating the purposes and effects of various ad hoc measures implemented by the SBV to strengthen its control over foreign exchange transactions."

(Paper 6) Duong Thu Huong, "Reviewing the medium and long term solutions adopted to restore and consolidate the financial sector."

(Paper 7) Tran Cao Nguyen, "Evaluating the obstacles of opening securities markets and the measures to make a further progress toward equitization of SOEs."

Part II: Pilot studies to evaluate how to implement reform policies

(Paper 8) Watanabe Shinichi, "Does the current regulation on interest rates match the need of the financial sector at an early stage of its development?"

(Paper 9) Seiichi Masuyama, "Lessons for Viet Nam's Financial Sector from the Financial Crisis in Asia."

Other References:

Final Report of Phase 2, Vol.3 (Fiscal and monetary policy) and Vol.4 (State enterprise reform)

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2

Global Capital Mobility and the Financial Control in Viet Nam

Akiyoshi Horiuchi
The University of Tokyo

Viet Nam has achieved raid economic growth depending on the substantial amount of capital imported from abroad for the last decade. The major part of imported capital consists of foreign direct investments and ODA. Thus, at present Viet Nam can be immune from the financial crisis that struck East Asian countries, where the inflow of a large amount of bank loans and portfolio investments expanded domestic economies, particular the non-traded good industries such as real estate developments, and the sudden reversal in capital flows occurred in 1997 caused severe financial crisis. However, we can derive some lessons for the Vietnamese economy from the recent crisis in East Asia, because Viet Nam will soon face the issue either whether free capital movement should be allowed or what policy should be taken to deal with liberalized capital flow. This note reviews the recent East Asian financial crisis and examines how to deal with the international capital mobility in the process of economic development.

1. Benefits of Capital Movements

According to the standard economic theory, free access to international capital markets allows developing countries to borrow abroad to smoothe consumption in the face of shocks or to finance productive investment even if domestic savings are low. The ability to trade international financial assets also increases the scope for risk-pooling.

However, these benefits of free capital movements cannot be realized unqualifiedly. Although most economists agree with potential benefits of foreign direct investment as a means of technology transfer, they would not claim that the free capital movement always brings net benefits to developing countries. In other words, the advantage of capital mobility is 5 contingent. The notion that free capital mobility contributes to economic welfare of accepting countries crucially relies on the absence of distortions in domestic markets. Unfortunately, there exist various distortions in developing countries. The distortions cause the social costs of capital inflows to be higher than the private costs. Thus, they tend to lead to excess inflows of capital into developing countries, and thereby undermine efficiency and stability of both financial and economic systems in accepting countries.

Free capital mobility limits autonomy of domestic macroeconomic policy. Since the maintenance of fixed exchange rates, free capital mobility and a domestically oriented monetary policy represent an "inconsistent trinity," a move to freer capital movements implies that autonomy with respect to either the exchange rate or monetary policy must be sacrificed (Obstfeld(1998)). As a consequence, a government's freedom of manipulating may be curtailed in certain situations. At the same time, disturbances in international financial markets that bear no relation to developments in the domestic economy are likely to have a more direct impact on the domestic economy. Thus, economies with open capital accounts need greater policy discipline and robustness to external disturbances than those that are less liberalized.

2. Distortions in the Domestic Economy

What are distortions in the domestic economy? One example is the policy of favoring specific industrial sectors that are suffering from inefficiency at the expense of other sectors. Capital inflows to those sectors will aggravate inefficient resource allocation. Thus, the industrial policy without long-term basis of efficiency is a distortion in the domestic economy. In the following, I will not discuss the industrial policy in this context. I will take up only distortions in the financial markets.

The most important distortion in the domestic financial markets is the lack of capacity of financial mediation on the side of domestic banks and financial institutions. The major part of recent capital inflows into South East Asian countries was inter-mediated by banks. Domestic banks borrowed a huge amount of funds from non-residents, and lent the funds to domestic borrowers. The banks should have been motivated to examine borrowers and monitor their managerial behavior in order to make this form of capital mobility. If the banks are not motivated to efficiently inter-mediate, the huge amount of capital inflows will lead to misallocation of financial resources, and thereby resulting in a serious non-performing loan problem. For most of the countries in the process of transition to market-oriented economy (including Viet Nam), this domestic distortion is very serious.

It is also a domestic distortion that banks have neither capacity nor incentives to manage risk properly. Many banks located in South East Asia borrowed a large amount of short-term funds denominated in foreign currencies, and lent the funds to domestic borrowers in the long-term maturity and in terms of domestic currencies. This management strategy taken by banks involves both foreign exchange risk and interest rate risk associated with wide maturity transformation, undermining stability of the domestic financial system. Even if individual banks are sufficiently rational in managing risk exposures, they tend to undertake excessive risk-taking from the viewpoint of the financial system as a whole, because they do not consider externality of their risk-taking.

The current rule of BIS capital adequacy favors short-term lending to banks located in non-OECD countries over other loans to private borrowers in terms of risk assessment. The BIS risk weights are 20% of total asset value for short-term loans to non-OECD banks and all loans to OECD banks, but 100% for long-term bank loans and loans to the private sector. This is an example of distortions in the global financial system that may have "excessively" increased the amount of short-term bank loans to some emerging countries during the 1990s.

3. How to Control Capital Movements

If free capital mobility causes financial turmoil in the host economy due to those distortions, we should directly tackle them instead of controlling capital mobility. This is the first best policy. For example, the lack of bank capacity to monitor borrowers is a distortion, we should give banks incentives to increase monitoring capacity. If the government has not yet built up the supervisory system, we should require the government to establish the system as soon as possible.

However, it will take long time to delete the distortions particularly in developing countries. Some distortions may be derived from the public policy to pursue specific social objective such as that of protecting specific sectors of developing countries. If so, it is almost unacceptable or infeasible to remove the distortions at once. Then, the second best policy is applicable. Free capital mobility is likely to cause turmoil in the domestic economy if the domestic financial system does not prepare efficient monitoring capacity on the side of banks and effective supervisory capacity on the side of government. Thus, we derive a conclusion regarding sequencing of financial reforms that before introducing free capital mobility, the government should build up efficient domestic financial system based on the sound supervision by the regulators (McKinnon(1991)).

For most South East Asian countries where the efficient financial system has already been established, it would be unnecessary to introduce direct controls on capital mobility. It would be almost impossible for them to directly control capital movements because domestic agents could easily undertake disguised capital transfer under extensive network of trade transactions. The best policy for them is to take the policy of indirectly mitigating bad influences of the distortions. For example, it is effective to require banks to keep additional reserves corresponding to an increase in debt denominated in foreign currencies. This policy will increase the cost for banks to take excessive foreign exchange risk in the process of mediating capital inflows for domestic borrower firms. Nowadays, it is usual for the government to impose requirements of capital or liquid reserves on banks according to the degree of liquidity and risk of bank portfolios. This is reasonable policy for capital mobility (World Bank (1999)).

4. The Case of Viet Nam

As this report describes, Viet Nam has not yet established sufficient capacity of financial inter-mediation. The government has just started introducing systematic supervision on management of banks and other financial institutions. There remains doubt about effectiveness of the financial regulatory system in Viet Nam. Thus, we may say that it is too early for Viet Nam to take free capital mobility.

This conclusion seems quite commonplace. The urgent policy for Viet Nam is to build up efficient system of financial inter-mediation as soon as possible. In particular, Viet Nam is facing with the issue of how to promote inter-mediation by banks that are suffering from the huge amount of non-performing loans produced by the long-term relationships with state owned enterprises. To resolve this issue, we need the policy of disposing non-performing loans in a lump. The Vietnamese government should tackle this issue as soon as possible.

Needless to say, the well-functioning financial inter-mediation is indispensable even while Viet Nam is constructing full-scale market-oriented financial system. For the time being, Viet Nam could depend on high quality financial services supplied by foreign banks and joint venture banks located in domestic markets. The government should promote activities of those banks and financial institutions instead of suppressing them. However, those banks would require freer capital account transactions before extending their activities in Viet Nam further. Without intimate connections with global capital markets, foreign banks and joint venture banks could not deploy efficient financial inter-mediation. If the government prevents them from smoothly connecting with global capital markets, their activities will be reduced and in the worst case they will retreat from Viet Nam. It would bring forth a vacuum of financial inter-mediation. Thus, it is not easy for the Vietnamese government to follow the conventional policy of sequence that introduces free capital mobility after fully establishing efficient financial system in the domestic economy.

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I－1

Evaluate Current Financial Conditions and Prospects of the Banks

Nguyen Thu Ha
The State Bank of Viet Nam

Over 10 years of renovation and more than 8 years of implementation of 2 Banking Decree-laws, the Vietnamese banking system has significantly changed, gradually integrated into international market, and has met the requirements of transforming the economy from centrally - planned to market mechanism. In fact, the Vietnamese banking system has increasingly developed in terms of the size and scope of operations, providing various kinds of products and services, actively contributed to promoting economic growth, national monetary stability, enhancing the development of multi-sector goods economy and implementing the strategy of industrialization and modernization of the country. It is impossible to discuss the success of the Viet Nam's economy over recent years without mentioning about the role of the banking system as a key factor contributing importantly to the course of development and integration.

Especially, during recent 2 years (1997 - 1998), despite of the fact that the economic environment was difficult due to the impacts of the natural calamities and the regionally financial - monetary crisis, a transforming economy has not had a complete legal framework, which is hiding unstable factors, the Vietnamese banking system has continuously made efforts in maintaining economic growth and curbing inflation. However, the impacts of the above mentioned factors are big challenges to the performance of the banking system. Now, besides the achievements, some banks fall into financial unsoundness. The non-performing loans originated from previously subsidized mechanism have not completely repaid, the chartered capital of the banks is small, making the issue of safety operation of the banks be of concern, which requires the immediate solutions.

I. Evaluate the Current Financial Conditions of Banks

1. General evaluation

It is possible to access the financial conditions of banks through evaluating some financial ratios relating to the banks' solvency, capital size, assets' quality, banks' performance such as the ratio of liquid assets to total assets, equity to total assets, overdue debts to outstanding loans, return on equity, operating costs to profit bearing assets etc. Nevertheless, regarding the case of Viet Nam, due to the limited reporting and statistic system, the evaluation of the financial condition of its banks has mainly based on some major financial criteria on capital size, overdue debts and the outcome of banking business.

Firstly, it should be noted that at present the banks in Viet Nam have small size of chartered capital and of their own capital (equity). Although, recently, the banks' capital tends to increase over time, so far many banks (including SOCB and joint stock banks) have not had adequate legal capital, as required by the Governments stipulation in the Decree No. 82/1998/ND-CP dated 3rd October 1998. This situation partly makes impacts on the performance of the banks, especially the banks solvency, which, in turn, to some extent effects the outcome of banking business and the banks' profit.

The issue of our concern is that the credit quality of banks is still not very good, which is reflected by the ratio of overdue debts to total outstanding loans of the whole system of 9.5 % as end of Dec., 1998, compared with the acceptable ratio of 5%. It can be noted that recently the speed of credit growth has been maintained. Nevertheless, the credit quality is not quite good, resolving of remains is slow. In fact, emergence of the overdues originated from the new loans is limited, but the overdues originated from the old ones are still existing. Thus, in general, the ratio of overdue debts to the outstanding loans has decreased, but at low pace.

Theoretically, it is obvious that the higher the ratio of overdue debts to outstanding loans the lower the degree of solvency the banks have. The prolonged existence of high level of non-performing loans may easily cause the insolvency of banks, ultimately cause bankruptcy. In reality, the ratio of overdue debts to outstanding loans of the whole system tends to decrease, but the high ratio of overdue debts, as mentioned earlier, certainly cause our concern over the solvency of banks, especially of the joint - stock banks which usually have the highest ratio of overdue debts in the whole banking system. The general picture is that the banks are still under the burden of having the overdue debts and collateral in the forms of real estate.

As mentioned earlier, there is existence of overdue debts, non-performing loans in arrears partly due to the fact that the outstanding overdue debts in the past have not been repaid, which is a burden to the banks. Besides, the banking business of some banks, especially of the joint - stock banks has not met the requirements of market economy, the operations are still risky, the monitoring, supervision and internal control are not efficient, especially the legal documents have not been synchronic, which are the reasons behind the current situation of overdue debts.

Relating to the situation of overdue debts, an issue to which the banking system has paid attention is the resolving of collateral and mortgage, so far the bank's big amount of overdue debts have not been uncollected, as many loans have been backed by the customers collateral, mortgage. As for the whole country, the value of overdue debts of the commercial banks which is related to and guaranteed by property, real estate is not relatively negligble. A big amount of property's value is "frozen" in the form of collateral mortgage that has not been sold, and has not been used effectively for the economy. A big amount of capital has been blocked in the court's cases such as Tamexco, Minhphung Epco, and Nam Dinh Textile. Recently, the banking system makes efforts to enhance the efficiency of its performance, the strength in doing business and the financial soundness. Especially, the State Bank of Viet Nam has consecutively formulated and improved the legal framework to make it be comprehensive and synchronic to facilitate the commercial banks to overcome the situation of overdue debts. Besides that, with regard to the banking business of the whole system, it can be noted that the banks themselves actively stimulated lending and investment activities to provide capital for production and business, as well as to create banks' profits. In fact, as of end 1998, as estimated, the ratio of outstanding loans to total deposits and mobilized funds was 72%. According to some economists, with regard to the management of banking business of each bank, the ratio of capital utilization, i. e the ratio of outstanding lending and investment to the total mobilized funds of between 70% and 75% was considered as ideal outcome, the ratio of more than 80% reflected a sign of weakness in solvency (payment capacity), the ratio of less than 60% reflected inefficient business. Thus, the recent performance of the Vietnamese banking system is still showing optimistic signs.

Moreover, the above comment can be further affirmed by the outcome of the whole system. So far the return (profit before tax) on equity of the whole system is 4.9% and the ratio of return on total assets of the whole system is 0.6%. The business return (difference between income and expenditures of the banking group (categorized by the type of ownership) is adequate to compensate the costs and to make contribution to the State Budget. However, it is possible to obtain the most accurate outcome after carrying out risk provisioning and paying the outstanding debts.

2. Evaluate each banking group

2.1. The group of state-owned commercial banks (SOCBs)

a. General comments:

So far, within the Vietnamese banking system, there have been 6 state - owned commercial banks (including 2 newly established banks: Bank for the Poor and Bank for House Development of Cuulong River Delta). The recent performance of the SOCBs has showed that the SOCBs have maintained and developed their leading role in the monetary and banking business. Especially in the circumstances of the impacts of the regionally financial and monetary crisis, the status of the SOCBs has been consolidated. This can be noted through the fact that the ratio of the mobilized funds of SOCBs reached 80% of total mobilized funds of the whole system. Besides that, the credit share of SOCBs as well as the return of SOCBs also accounted for a big proportion of the whole system.

b. Main financial conditions:

Firstly, as the general evaluation on the size of own capital, chartered capital of banks in general in Viet Nam, state-owned commercial banks (SOCBs) still have limitation on capital size. Capital of many banks is under the legal capital level, which is from 1,100 to 2,200 billion VND as stipulated by the Government. At present, the insufficience of chartered capital as approved is also a big difficulty for state-owned banks, limitation on capital size leads to limitation on solvency (payment capacity), competitiveness and finally on the return of banks. Therefore, the Vietnamese Government is now supplementing capital to state-owned commercial banks to strengthen operating ability, ensure the maintenance of the leading role of these banks in the system.

There are still outstanding problems on credit quality of state-owned banks that need to have measures for resolution. Lending activity is not really effective due to the limitation on administrative and executive capacities and the fact that the professional level of credit officers is poor, many officers still lack in experiences and there are limitations in the mechanism and policies. A heavy burden to state-owned banks is that they have to take the role as policy banks, when necessary, to solve the remains of the past as well as to provide directed lending in accordance with the Government's instructions. Consequently, up to now, the ratio of overdue debts of state-owned banks is up to about 8.2%, a little lower than the average level of the whole banking system. Many overdue debts, bad debts relating to loans for which the collateral assets can not be resolved. In reality, if all capital amount "frozened" in the form of collateral assets is resolved, the ratio of overdue debts and bad debts of state-owned banks will reduce considerably.

However, generally speaking, there are improving signs in state-owned banks' activities, the ratio of newly-arised overdue debts is getting limited, the resolution of frozen debts and bad debts is strengthening. State-owned banks make profits in their business activities which create the accumulative source and contribute a big revenue to State Budget annually. The most remarkable thing is that state-owned banks are recently continuing to contribute a significant part in lessening the adverse impacts of the regional crisis on the country's economy.

2.2. Joint-stock bank group

a. General evaluation:

Firstly, within only 7 years of implementing the renovation of the banking system, up to now, there are 51 joint-stock banks in the Vietnamese banking system, of which, 31 banks are urban joint-stock banks mainly locating in HoChiMinh City and the South. The establishment speed is rather fast and the quantity of joint-stock banks, up to now, is rather big. Over the past few years, joint-stock banks constantly developed on their size, capital and operating organization, met the demand of capital for economic development, particularly in the area, gradually formed some strong banks which operate effectively so as to help reinforce the banking system after the renovation period. Joint-stock banks have, with their initial results, gradually affirmed themselves of their establishments, which are in line with the common trend and the market mechanism. However, there is still much concern about the operating quality of joint-stock banks' group at present, especially some banks which were established from bad-performing credit co-operatives in the past, their remains have not completely solved, credit worthiness is low, which may trigger an unsecured case.

b. Financial conditions:

The most common feature of joint-stock banks is that their size is too small and they do not operate effectively, their chartered capital is low and they are meeting difficulties in increasing their chartered capital in accordance with the regulation of the Government (until the year of 2001, up to a minimum level of 70 billions VND for urban joint-stock banks in Hanoi and HoChiMinh Cities, 50 billions VND for other urban joint-stock banks). If no measures are to be taken to increase chartered capital of joint-stock banks in order to widen their size and enhance the safety in operation in a strongly competitive environment, especially in HoChiMinh city area, joint-stock banks will hardly develop in a strong way. In reality, all joint-stock banks' chartered capital, up to now, which is added up, is still too small as compared to that of state-owned bank group, joint-venture banks' and foreign banks' branches'group. Moreover, many joint-stock banks have not, in a long period of time, increased enough capital in accordance with the Government's regulation. Up to now, there still have more than a third of urban joint-stock banks is lacking in chartered capital pursuant to regulation. In HoChiMinh city, many joint-stock banks lack in chartered capital, many banks have capital level which is lower than 50 billions VND, or even lower than 25 billions VND.

In other words, operating quality still reflects weaknesses, lack of business experience in market mechanism which includes a lot of risks, the limitation in management also cause 5 overdue debt situation or losses in guarantee for export-import letter of credit (L/C). At present, joint-stock banks are the first in lending ineffectively with the overdue debt of 15%, the average ratio of overdue debts of joint-stock banks is nearly 2 times higher than that of state-owned banks, some joint-stock banks fail to make payment. Rural joint-stock banks have the ratio of overdue debts over the total outstanding loans lower than that of urban joint-stock banks, but their credit activities are still risky. In general, the bad-performing activities of joint-stock banks are because of subjective reasons of banks, which relate to the professional level, limitation in management, business capacities, etc, and objective reasons relating to customers of these banks who are mainly private businesses, households with higher risks as compared to other banks. However, the business outcomes of joint-stock bank group show that there are some banks which initially make profits and contribute a certain part to State Budget.

2, 3. Joint-venture banks and foreign banks' branches group

a. General evaluation:

According to the State Bank's figures, up to now, there are 25 foreign banks' branches, 4 joint-venture banks operating in Viet Nam. In general, as evaluated, foreign banks' branches and joint-venture banks operate more effectively than local banks, contribute considerably to assisting the economy stable and growth. Business result reflects the difference between revenues and expenses which are gradually increased over the years and at a high speed. The overdue debts ratio of joint-venture banks and foreign banks' branches is still at the lowest level as compared to that of other banks in the whole banking system in Viet Nam. Foreign banks' branches, joint-venture banks have paid attention to maintain the safety proportion in business activities.

b. Financial conditions:

Joint-venture banks and foreign banks' branches' own capital have gradually increased over the past few years. Notably, as of end of October 1998, foreign banks' branches' own capital increased by 22.6% as compared to December 1997, while joint-venture banks' own capital only increased by 11.4% in the same period. The main reason was that the subsidized capital and chartered capital of these banks are in USD, so they are increased when converted to VND due to the devaluation of VND to USD.

With regard to the credit quality, the overdue debts ratio of joint-venture banks and foreign banks' branches are lowest in comparison with that of other banks in the banking system. The ratio of overdue debts over the total outstanding loans of these banks is about 2.3%, the ratio of bad debts is about 1.2% as compared to the total outstanding loans. However, a remarkable issue is that although the ratio of overdue debt to the total outstanding loans in 1998 only in foreign banks' branches was still at the lowest level (1.52%), but the growth of new overdue debts is faster than that of other banks in the system. According to the State Bank's evaluation, the sign of increasing ratio of overdue debts especially of bad debts of foreign banks' branches and joint-venture banks, is a problem that needs to be solved quickly.

However, in general, foreign banks' branches and joint-venture banks still achieved a rather satisfactory result in their activities. It was reflected in the ratio of profit before tax over equity of 6.75% of these banks, the ratio of return over total assets of 1.72%, while these ratios of the whole banking system, as mentioned above, are 4.9% and 0.6% respectively. Foreign banks' branches achieved remarkable results and in 1998, their profit before tax increased considerably, as compared to the end of December 1997 and occupied about 30% profit of the whole banking system.

II. Prospect of Banks

1. The banks will take measures to strengthen financial situation and reduce overdue debts to an allowed level of about 5% of the total outstanding loans

As evaluated above, overdue debt is now the most outstanding problem in commercial banks' activities which requires a solution for this issue. Moreover, in reality, there are many different reasons that cause overdue debt and bad debt situation, however, the main reason is that there are a lot of regulations on this issue, which are not concrete, complete and synchronic, which cause difficulty in applying uniformly. There are many difficulties and problems relating to the possessions' right and the right of using those assets for resolution, sale of collateral assets to recover capital for banks. As a result, one of the measures for resolving overdue debt and collateral and mortgage problems is to improve regulation on ensuring borrowings, collateral and mortgage of bank's loans. In the near future, banks will gradually increase their self-control rights and bear responsibilities in lending and making decisions on whether or not to have security for borrowings and restrict and gradually eliminate the "Asking-Giving" mechanism in collateral and mortgage which likely cause the adverse and negative impacts to credit activities and cause overdue debts. Besides, commercial banks' rights in resolving collateral and mortgage assets will be enhanced.

According to the estimation of some banking experts, as other countries in the world, the establishment of the Debt Trading Company or the Center for Management and Auction of collateral assets in the future will assist banks to lessen the burden on overdue debt and on unrecoverable loans because of difficulties in resolving collateral assets.

Apart from renovation in resolving collateral assets, the banking system keep on renewing in classifying loans and establishing risk provision funds to prevent and limit the new overdue debt arised and solve the remains (Solving frozen debts, overdue debts, bad debts through writing-off, rescheduling debts etc.). By implementing new regulations on these contents, banks will enhance their management abilities, prevention of risk and credit quality, and ensure the safety of operations.

Moreover, up to the year 2000, the constant strengthening of the banking supervision, inspection and the implementation of regulations on safety ratios in monetary-credit activities of banks and periodically evaluating and classifying banks in accordance with CAMELS standard, the strengthening of the internal control will contribute to ensure the safety and healthiness. It is hoped that, with the above renewals, banks will achieve their objectives in decreasing overdue debt and limiting it at an allowed level of 5%.

2. Based on the restructuring of banks, the Vietnamese banking system will develop on capital size, operating scope and become a multi-functioned banking system

An issue raised at present is to overcome the problem that the quantity of bank is rather big, but the number of banks which are really strong is small and the banking system needs to be quickly reinforced and reorganized. In the coming time, banks will, with the plan on strenthening and restructuring of joint-stock banks and state-owned banks, be strengthened on authorized capital size and own equity so as to strengthen the payment capacity and enhance the competitiveness in their business that leads to an increase in profit level and contribution to the State Budget. In the short-run from now to 2001, chartered capital of banks will be gradually increased to achieve the level stipulated by the Government to each banking group categorized by ownership type.

According to the plan, the restructuring will be executed for all joint-stock banks in 2 years, from 1999-2000, after pilot restructuring in HoChiMinh City. Based on the ranking of joint-stock banks pursuant to the level of safety of operation, number of banks which operate weakly and badly, have signs of incurring insolvency and hardly have ability to increase chartered capital will be closed or merged. The remaining banks will be reorganised and reinforced their operations. Consequently, until the year 2000, joint-stock banks will consist of banks with larger size as compared with the present and have higher capacity to bear risks and enough competitive power in operation. Besides, real financial situation of state-owned banks is also evaluated by implementing the independent auditing. Therefrom, state-owned banks will solve the remains such as increasing chartered capital to legal capital, solving frozen debt, overdue debts and bad debts, and making progress in arranging and reinforcing their operations. As estimated, in 2 years, state-owned banks will be strengthened in operational scale and managing and executing system and the internal checking and controlling systems will be reinforced. In the long-run, some state-owned banks are expected to be equitized with shares contributed by foreign counterparts. Especially, the preferential credit activities and directed lending of commercial banks will be transferred to policy banks. Thus, Vietnamese banking system will comprise multi-functioned banks and ensuring the financial healthiness, safety and effectiveness in operations.

3. Banks will develop in the direction of enhancing the self-control in business, liberalization and integrating with the international market

To raise effectiveness, in the future, banks will be self-control in their business, especially in ensuring capital source for lending. Each bank will actively and independently strengthen the mobilization and the intervention and assistance in the form of refinancing from the Central Bank will be gradually reduced. Besides, banks will be more and more independent in their business decision, ensuring loans and defining the necessity in requiring collateral and mortgage for loans as well as the resolution of these assets.

Moreover, it is impossible that Vietnamese banks can not, in the recent economic environment, take part in the liberalization trend in the region and the world. In the coming time, banks' activities will, with such spirit, become more and more competitive in a "level playing field", complying with the principles of the market economy. Banks will be more and more independent in their decision on interest in accordance with the supply-demand changes in the market. To ensure the safety in operation, financially healthiness, transparency and integrating with the international market, banks will upgrade their accounting system in line with the international standards. As mentioned above, the regular ranking of banks under the CAMELS method is also a step in the renewal program to maintain the safety of the system and alignment with the international standards.

To meet the increasingly demand of the economy, apart from raising financial ability, managing and executing capacities and the good implementation of regulations on safety ratios, banks will constantly enhance the quality of services through strengthening the modernization of banking technology and upgrading the officers' professional level.

Conclusion

This writing concentrates on basic aspects on financial conditions of banks operating in Viet Nam in general, as well as banking groups categorized by ownership type in particular. Based on the assessments on the real situation, this writing gives projections on prospects of banks in the short-run as well as in the long-run.

It is said that banking activities in present economic environment are facing many difficulties such as: scale and financial abilities of banks are limited and the issue of overd ue ebts is requiring a measure to solve quickly. However, in the coming time, the Vietnamese banking system will make significant changes. The restructuring of banks, especially joint-stock banks and state-owned banks together with the establishment of policy banks and a number of renewals on the mechanism, policies, supervision and controlling activities etc. will assist banking system to become strong in scale and healthy in finance and ensure to meet the increasingly demand of the economy.