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Obstacles in Setting up a Securities Market in Viet Nam

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I.

1. Socio-Economic Settings

a. The world's financial crisis has adversely affected Viet Nam's economy and its preparation for the inauguration of a securities market. Money speculation may lead to review the policies and steps towards free flotation of exchange and liberalization of securities market.

b. Increasing bad debts will give rise to strengthen the state owned commercial banks and to restructure joint-stock banks. It is, therefore, required to take into account the balance between developing banking system and opening a securities market.

c. General public are not familiar with securities and securities market. They have very little knowledge about securities market.

2. Commodities to be Brought into the Market

a. Equitization process initially has been under way, but equitized enterprises are rather small in size and most of them do not satisfy the requirements for being listed in the securities market. Here arises a problem on what to do with the stocks of companies that are not eligible to be listed on the market? Among 161 equitized companies, there are only 20 equitized enterprises who own over VND10,000 Billion of capital.

b. Equitised enterprises themselves have not been fully aware of benefits they may enjoy from having their shares listed in the market. They worry about listing and information disseminating costs. The dissemination of corporate information, financial statements in particular, has not been practised by vietnamese enterprises. Enterprises' management worries about losing benefits once they be transformed into corporate governance structure. Incentives may include favorable taxes and giving easy access to banks' loans.

c. The number of companies formed under corporate governance structure is rather moderate (less than 200) and they are mostly operated in banking and financial sector. Their bad debts are still increasing. Previous sales of shares were undertaken under private placement.

d. There has not been an uniform denomination for shares issued by different corporations.

e. Sales of shares to foreigners are being taken into consideration.

f. According to a number of market surveys, there are currently needs to resell shares but not any to repurchase them. Overall worsening economic and business conditions has resulted in decreasing corporations' values.

g. 1-year term government bonds were issued under private placement. There must be a plan on issuing them through large-scaled underwriting and organizing auctions at the trading centre, that is designed to unify bonds' maturity and interest rates. During the initial stages, government bonds will be the main type of securities to be traded but there still exist much difficulties in introducing them into the market.

3. Establishment of Securities Companies

a. There are 10 banks, corporations and financial companies who are capable of setting up their affiliate securities companies. Plan for setting up these companies are being drafted.

b. Given the unfavorable economic conditions and incomplete legal framework, these institutions are expecting a firm commitment from the government to establish the trading centre.

c. Commercial banks' decisions to contribute into securities firms are subject to approval from the State Bank.

d. These institutions have not grasped securities trading practice.

e. Unwillingness to participate due to the impact of financial crisis in the region, slowdown of economic growth, inefficient banking system and the collapse of a number of private enterprises.

f. Considerations of tax and securities to be traded in initial stages.

4. Establishment of Securities Trading Centre

a. The establishment of a trading system as scheduled may be difficult due to the lack of capital, technology, auction methods, etc.

b. Regulatory framework of the centre has been formed but the number of qualified executives who will be able to manage the market operations is insufficient

c. Difficulties in bringing securities into the market

d. Difficulties involved in the establishment of securities companies

5. Legal Environment

a. Decree 48 and its attached regulations were promulgated but have not been put in place.

b. Weak law enforcement system

6. Other Considerations

a. A new accounting system have newly been adopted at companies

b. Independent auditing firms have been present for only several years thus have not gained confidence

c. Automated settlement system is still a new concept to general public

7. Investors

a. Inefficient investment institutions

b. Low savings as a result of low income

II. Measures Recommended to Speed up Equitization

1. Arranging and Classifying SOEs:

- Making up a list of enterprises to be equitised: The plan for classifying and arranging SOEs under ministries, cities and provinces and corporations 91 was completed in 1998. The next step is to review and put it into place according to planned stages, and later on to supplement any shortcomings in related policies and what to be done in following stages.

  The ratification of plans for SOEs located in Hanoi and HCM City was completed at the end of the third quarter 1998. For enterprises under ministries, corporations 91 and other provinces, it is to be completed during the final quarter of 1998 and first quarter of 1999.

  In Hanoi: There remains 880 SOEs of which 310 have been equitised, 39 have been sold out and managed by contractors and 5 dissolved.

  In HCM city: There remains 709 SOEs of which 296 equitised, 36 sold out and managed by contractors and 17 dissolved.

Basically, the arrangement and classification of state-owned enterprises located in Hanoi and Ho Chi Minh city have already been completed. The development and implementation of equitisation program depends significantly upon the authorities in charge of those enterprises as well as the strict supervision over the transformation of the economic management mechanism as long as that conforms with the law and avoids leaking of state's assets.

+ Plan for the period from 1999 to 2000

At present, the government has set up plans and given out directives for the nationwide classification of state-owned enterprises including enterprises under both central and provincial levels from now on to the year 2000.

2. Settlement of Bad Debts

After a long time in a centrally-planned economy, state-owned enterprises have accumulated numerous bad debts that requires a lot of time and costs. This problem still remains unsolved.

3. Organization of Equitisation

a. The National Enterprises Reform Committee was established to:

- assist the government in doing research, giving instructions and co-ordinating with ministries, ministerial-level agencies, agencies attached to the Government, provincial peoples' committees directly under the Central Government that are concerned in SOEs reform.

- study and review then submit plans for mechanism and policy reform, management structure, classification, equitization and ownership diversification to the Government.

- evaluate and submit the equitization plans made by ministries, committees to the government for consideration.

b. Competence to select enterprises to be equitized:

- Ministers, Heads of ministerial-level agencies, Presidents People's Committees are responsible for selecting enterprises to be equitized.

- Boards of directors of Corporations 91 are responsible for making a list to be submitted to the government.

- Boards of directors of Corporations 90 are responsible for making a list to be submitted to the Ministries.

c. Competence to provide guidance and decide the value of enterprises;

- Minister of Finance establishes the guidance on how to value enterprises.

- Minister of Finance will make final decision on the value of enterprises possessing over 10 billion dong; for those possessing less than 10 billion dong: ministers and Presidents of People's Committees will do.

d. Competence to approve equitisation plans:

- Plans for those possessing over 10 billion dong will be ratified by Ministers, Presidents of People's Committees and Boards of directors of corporations 91 before being submitted to the Government.

- Plans for those possessing less than 10 billion dong will be ratified by Ministers, Presidents of People's Committees.

4. Policies to Promote Equitization

a. For enterprises

- May enjoy preferential treatment in accordance with the Law on Domestic Investment Promotion. Enterprises failing to meet conditions for enjoying this treatment will be entitled to the 50% profit tax reduction for two consecutive business years.

- May be exempt from registration fee

- May be entitled to continue getting loans from Commercial Banks, Financial companies, Credit Institutions according to the preferential policies applicable to State Enterprises.

- May continue the export & import activities in accordance with regulations applicable before equitisation.

- May distribute its reward & welfare funds to their employees for the purchase of shares;

- May deduct equitization expenses from the proceeds from the sale of shares, which belong to the State's capital.

b. For employees

- Employees are entitled to buy 10 shares for each year they have worked for their enterprises at 30% discount;

- Total value of preferential shares should not exceed 20% of the State's capital at the enterprise;

• For enterprises with self-accrued capital representing 40% of their value, the total value of preferential shares sold to employees must not exceed 30%;

• Poor employees, who are entitled to buy shares at preferential prices, may delay their payment for the first three years and pay installments without interest in ten years during which their shares will not be transferable.

• Employees loosing their jobs will be entitled to policies prescribed in the current regulations.

5. Introduction of Shares into Securities Trading Center

a. To make up lists of equitized enterprises eligible for being listed in the trading centre;
b. To file listing registration;
c. Preferential policies:

• Tax exemption or deduction in the first three years;
• Exemption of listing fee;

Ⅲ. Loans of Foreign Exchange from Commercial Banks will be Extended to Projects on Technology Investment

Ⅳ. Assessment of the Relationship between Measures Intended for the Development of Banking System, Securities Market and for the Encouragement of Equitisation in Vietnam

1. Relationship between Measures Taken to Develop Banking System and Securities Market

a. Strengthening and restructuring commercial banks may be undertaken via the securities market: i.e. via selling debts, issuing shares to increase banks equity

b. The improvement of banking system may encourage banks to set up their affiliate securities companies who are would be participants of the trading centre

c. Modernization may contribute to fast and safety settlement for securities transactions

d. The presence of the securities trading centre may help create competitiveness in mobilising capital between securities market and banks that will force banks to reduce costs and

interest rates

2. Relationship between Securities Market and Equitisation

a. Measures taken in equitisation process help create good quality securities for the market.

b. The presence of securities trading centre will support the transformation of SOEs into corporate governance structure and will lead to objective valuation of enterprises. That will also promote issues of shares to the public.

c. The presence of the centre will lead to the restructure of equities and liabilities, to the increase of equity and decrease of borrowings, thus leading to stable growth later on.

3. Relationship between Measures Intended for Banking System and Those for Equitisation

- Equitisation may make the settlements of bad debts easier for the banks
- Strict inspection and supervision will result in better auditing of enterprises' equity and correct valuation of their assets
- The settlement of commercial banks' bad debts will also facilitate the settlement of SOEs' debts.

II－1

A Note on Interest Rate Policy and Information Structure

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"Credits flow with information."

I. Introduction

Under the current interest rate regulation, there are ceilings on loan interest rates, but the upper bound of deposit interest rates are left free to the choice of individual banks. In the economy where information asymmetry is severe and prudential regulations are difficult to enforce,[1] 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.

This paper argues that the combination of the ceilings on loan interest rates and the free upper bound of deposit interest rates does not match the stage of economic development of Viet Nam, destabilizes the banking sector and is detrimental to its financial deepening.

Viet Nam is in the early stage of developing its financial infrastructure. There should be little disagreement on this fact. But the implication of this fact for the necessity of building information channels between banks, business firms, households and the government is not well acknowledged. This paper argues that the interest rate policy should be used with other related policy measures to induce banks to invest in developing their financial network and the associated information channels with borrowers and depositors. The interest rate policy should take into account the fact that building new information channels requires resources for many years of a large amount of investment.

Financial liberalization has been used in many developing economies as a strategy for financial deepening and economic growth. But the results were not quite successful. Demirguc-Kunt and Dtragiache (1998) finds that financial liberalization exerted a strong negative effect on the stability of the banking sector for the data of 53 countries over the period of 1980-1995. De Gregorio and Guidotti (1992) finds that financial deepening may not lead to higher economic growth under unregulated financial liberalization and expectations of government

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[1] These are defining characteristics of developing economies. Ray (1998, p.5) states: "Combining the complementary notions of incomplete information, a weak legal structure (so far as implementation goes), and the resulting strategic and economic considerations that emerge, we begin to have some idea of what it is that makes developing countries somehow "different".

bailouts. These evidences indicate the importance of the existence of effective prudential regulations as a prerequisite for successful financial liberalization.

The 1997 annual report of SBV states its interest rate policy as being "directed toward liberalization with the progress of commercialization of banking system and the strengthening of banking supervision." This position is perfectly consistent with both arguments in Paragraphs 3 and 4. What is argued in this paper is that the current interest rate policy neither enhances the progress of commercialization of banking system nor strengthens banking supervision, and thereby deter the emergence of the conditions necessary for liberalization.

Some anomalous phenomena continue to characterize the financial market of Viet Nam:

(1) The growth of credit has been slowing down markedly since 1998 and causing a concern over the possibility of a further decline in economic growth. But, at the same time, a large number of private enterprises are rationed out of the formal credit markets in spite of their strong demand for credit. This is partly because of a high probability of their defaults and partly because of the severity of information problems.[2]

(2) State owned commercial banks (SOCBs) triggered the price competition by cutting loan interest rates in 1999. Joint stock banks followed the cut of the lending rates and their earnings have been shrinking. Ceilings on lending rates were also reduced. But, some joint stock banks were found to be violating the ceilings on loan interest rates at the same time and the SBV issued stern warnings against such violations.

This paper examines interest rate policies that may serve as an alternative to the existing policy mix. It is based on a version of the financial restraint model developed by Hellman, Murdock & Stiglitz (1997). Section II describes how to apply the financial restraint model of HMS to the situation of Viet Nam. Section III examines alternative interest rate policies and other related financial policies and discusses their costs and benefits.

II. The Model

HMS has developed a model which incorporates the stage of economic development explicitly into formulating a strategy for financial deepening, in particular, an interest rate policy. The model is based on the recognition that information asymmetry and the difficulty of enforcing contracts and regulations are the central characteristics of an economy at an early stage of development and that a large amount of investment is necessary to build up

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[2] Out of 2600 private business established since 1996, more than 600 have been forced to close by the end of 1998. Furthermore, it is said that a large number of private firms which originally applied for credits for the purpose of low risk projects used them for riskier investment. (Viet Nam Investment Review, March 3-15, 1999, p.11).

financial institutions.

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

For an economy in a low state of deepening, financial restraint may embody both deposit and lending rate controls, entry restrictions, and limitations on competition from capital markets. As the economy develops, lending rate controls should be relaxed before those on deposits, and the government should develop a private bond market for government securities before introducing competition for the banking sector from corporate bond and stock markets. (T. Hellman, K. Murdock & J. Stiglitz (1997): "Financial restraint: towards a new paradigm," pp.198-199)

Such a dynamic strategy of financial deepening is supported by the recognition that reliable information on the financial states of business firms is very scarce at an early stage of economic development and that a large number of years of investment are necessary for building a nationwide financial network.

A financial system serves as a mechanism to transfer funds from economic units with financial surplus to those with financial deficit. The potential efficiency gain obtained by such transfers will be greater when the difference of investment opportunities is larger among individuals. For example, liberalization of external trade openes a wide range of business opportunities for different economic units, increasing the difference in investment opportunities available to individuals and creating a larger room for potential gain. It is the function of the financial system to turn the potential gain into the actual one by channeling the funds from individuals with inferior investment opportunities to those with better ones. How successful a financial system is in realizing the potential gain depends on several parameters. The degree of realization will be higher if:

(1) the financial system has higher capability to separate good investment projects from bad ones and to monitor the use of the funds by borrowers;
(2) the access of the public to the financial system is easier; and
(3) the public has higher confidence in the safety of their deposits.

The degree to which the potential efficiency gain is turned into the actual gain depends on the information channels that support the operation of the financial system. It is inversely related with the severity of information asymmetry among banks, borrowers, depositors and the government, and the costs of enforcing contracts and regulations. But mitigating these difficulties is bound to be long run issues, simply because overcoming information asymmetries is the economic development itself, requiring to build new information channels through which individuals exchange more reliable and a much larger amount of information each other.

Prudential regulation is an essential component of the financial system. But implementing effective prudential regulations is a time consuming and costly process. It is necessary to build an effective information channel between SBV and commercial banks. But it is not sufficient for the effective implementation. Banks should be able to evaluate their risks more accurately and to monitor the financial state of borrowers more closely. But, in order to do so, borrowing firms must be able to produce reliable information on their financial states and banks have to build reliable information channels with them. Effective prudential regulations require much more than the laws and regulations. It is necessary to build information channels among different economic units through which credible information about the financial states of banks and enterprises flows. This of course assumes the existence of reliable flows of information within each organization.

Horiuchi (1989) studies the information channels embedded in the main bank system of Japan. Corbett and Mayer (1991) compares a bank centered financial system of Japan and Germany with a market centered financial system of US and UK, and argues that the former model serves better for transition economies as a mechanism to support their financial deepening. Watanabe (1995) studies how a new financial network is emerging between banks and enterprises in Poland to support its economic growth. The emphasis on the informational infrastructure as a basis of market transactions is not unique to financial transactions. Simon (1991) argues that the market relationships "are not narrow tracks along which only money and goods flow, but broad highways to accommodate a vast flow of detailed information as well."

III. Alternative Interest Rate Policies for Financial Deepening

This section reexamines the current interest rate policy and studies alternative interest rate policies as a strategy for financial deepening. It discusses the costs and benefits of alternative policies.

A. The current interest rate policy

One of the central features of the interest rate policy in Viet Nam has been the existence

of ceilings on loan interest rates. In many developing countries the imposition of ceilings on nominal interest rates results in negative real interest rates and the transfer of the wealth from depositors to borrowers (and to the government through inflation tax). This is because the ceilings on nominal interest rates were accompanied by inflation caused by monetary finance of fiscal deficits. In case of Viet Nam, however, the effective control over budget deficits and the growth of domestic credit combined with the rapid monetization of the economy succeeded in stabilizing its inflation process. Thus, the ceilings on loan interest rates did not result in negative real interest rates. In fact, the real lending interest rates remained positive since 1993 and quite high for some periods.[3] For example, the real short-term loan interest rate was around 1.8%, 0.7%, 2.0%, 0.5%, 0.5% and 0.8% at the end of the year from 1993 to 1998.[4] Note that the real rate has been controlled in a narrow range between 0.5% and 0.8% since 1996.

The direct regulation on deposit interest rates was dropped in January 1996. It was replaced by the regulation on the maximum spread between the average lending rate and the average deposit rates.[5] Combined with the ceilings on lending rates, the regulation on the maximum spread effectively imposes minimum deposit rates, although deposit rates could be lower if lending rates were set lower than the ceiling rates. The real deposit interest rates took on positive values since 1993 except for some months in both 1995 and 1998. The real 3 month deposit interest rate was around 1.1%, 0.0%, 1.3%, 0.0%, 0.2% and 0.4% at the end of the year from 1993 to 1998. Its values were quite high for the periods when inflation decelerated rapidly.[6] Since 1996, the real deposit interest rate has been also controlled in a narrow range between 0.0% and 0.4%.

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

However, the combination of the maximum lending rate and the minimum deposit rate caused a serious problem for the financial state of the joint stock banks. Even under normal

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[3] The value of real interest rate quoted in the text is the nominal interest rate at the end of the year minus the average monthly inflation rate of the 4th quarter of the year.

[4] The real deposit interest rates in the first half of 1998 was slightly negative because of the surge of the inflation. But the inflation calmed down since the end of 1998. Monthly inflation rate was negative, -0.7%, -0.6%, -0.4% from March to May in 1999. If deflation continues, the real interest rate becomes very high. (Viet Nam Investment Review, June 7-13, 1999)

[5] More accurately, the spread is between the average lending rate and the average cost of funds which include bonds and foreign currency deposits. The maximum spread is 0.35% per month.

[6] The average inflation rate from March to May 1999 was -0.6%. Then, the real interest rate was 1.7% for short term loans.

business conditions, joint stock banks have to offer deposit interest rates higher than the rates of SOCBs, because an explicit deposit guarantee does not exist for joint stock banks.[7] But they have to follow the lead of SOCBs when SOCBs cut the lending rates below the ceilings because of the competitive pressure. Thus the financial base of joint stock banks is weaker than SOCBs in terms of interest rates.

But the more serious problem is the fragility of the banking sector as a whole. If a joint stock bank gets into a liquidity problem for one reason or another, there is a strong possibility that the bank is tempted to resolve its cash flow problem by attracting new depositors with the offer of higher deposit interest rates, further eroding its own profit basis.[8] If the number of such weak banks is not negligible, they could cause anxiety about the safety of the banking sector as a whole and eliminate the demand for deposits at good banks as well. This is a typical adverse selection problem.

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

Two quantitative regulations have further constrained banks from expanding their financial networks. The most powerful instrument is the credit ceiling imposed on each bank. This regulation was introduced in 1994 in order to control the growth of the aggregate domestic credit of the banking system and thereby the rate of inflation. To the extent that the regulation was binding, marginal profits for banks of finding new borrowers were small. This is especially true when it is costly for banks to evaluate the credit risks of new borrowers and when there is a strong demand for credit from their long-term borrowers.[9]

The other is the prudential regulation over the maximum amount of mobilized funds, that is, banks should not mobilize more than 20 times of their registered capital plus reserves.[10] The amount of capital and retained earnings of banks defined the limit to the growth of their deposits. Thus banks did not have strong incentive to develop its deposit base.

Taxes on banking activities also had negative effects on the expansion of financial networks.

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[7] Exceptional joint stock banks exist. For example, Asia Commercial Bank offered lower deposit interest rates than SOCBs in 1998.

[8] Nam Do Bank, for example, offered the deposit rate higher than its competitors in 1998.

[9] Credit ceilings were not used in 1998. The low growth of credit is a more serious problem.

[10] This regulation in the 1990 Banking Ordinance was replaced by a more comprehensive prudential regulation in the new Banking Law made effective October 1998.

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

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

B. Alternative interest rate policies for financial development

Now let us examine alternative interest rate policies and other related policy measures from the viewpoint of the development of the financial sector in Viet Nam.

Deposit interest rates

At present, no regulation exists on the upper bound of deposit interest rates. Banks are free to compete in deposit interest rates. It was argued, however, that such a policy environment resulted in the banking sector vulnerable to an adverse selection problem. The question is then what alternative policies exist and what their costs and benefits are.

Let us consider the policy to impose ceilings on deposit interest rates. Will ceilings on deposit interest rates have a large negative effect on the growth of deposits? This question is a part of a more general question on the characteristics of the demand function for deposits in Viet Nam.[11] The following specification of the demand function for VN dong deposits describes the major variables that determine the demand for the real balance of VN dong deposits for households:

$$D/P = L\,(\underset{(+)}{i},\ \underset{(-)}{I},\ \underset{(+)}{i-\pi^{e}},\ \underset{(-)}{(E^{e}-E)/E},\ \underset{(+)}{Y},\ \underset{(+)}{wealth/P};\ \underset{(+)}{confidence},\ \underset{(+)}{accessibility})$$

[11] We only consider term deposits or quasi money here. The demand for demand deposits will be discussed later when we take up the function of the banking system as a payment mechanism.

where D/P is the real balance of the VN dong deposits, i is the nominal interest rate of term deposits, I is the nominal interest rate in the informal credit market, π^e is the expected rate of inflation, $i-\pi^e$ is the real interest rate, E is the price of US dollar in terms of VN dong, $(E^e-E)/E$ is the expected rate of depreciation of VN dong which is the expected rate of return of holding US dollar notes in terms of VN dong, Y is the current income, wealth/P is the real wealth held by households, "confidence" is the confidence in the safety of deposits at banks, and "accessibility" is the ease of opening, adding and withdrawing deposits at banks. The demand function L embodies the hypothesis concerning the substitutability between deposits and other monetary assets (cash, loan in informal credit markets, gold, US dollar notes), the transaction demand, the wealth effect and the two dynamic state variables that represent the development of the banking sector. The sign conditions are straightforward and specified in the brackets under the variables.

It is the behavior of the last two state variables that determines the development of the banking sector in the long run. The state variable "confidence" is an increasing function of the stability of the banking sector, which depends further on the quality of assets held by individual banks. Its value is determined endogenously at equilibrium in a larger socioeconomic system consisting of SOCBs, joint stock banks, households, SOEs, non-SOEs, the government and the foreign sector. In the previous section A, it is noted that the price competition among banks to attract depositors with higher deposit interest rates could easily result in a very low value of the "confidence" at equilibrium, when the information on the financial states of banks and borrowing firms is extremely limited and the adverse selection problem is serious.

The value of the state variable "accessibility" depends on a large number of variables, including variables of social infrastructure such as transportation costs or communication costs and regulatory variables such as the two quantitative regulations on the sizes of loans and deposits. It is argued in the previous section A that the two quantitative regulations weakened the incentive of banks to invest in expanding its depositor base. The regulation over the deposits/capital ratio was absorbed into more comprehensive prudential regulations of banks in 1998.

Imposing ceilings on deposit interest rates will weaken the operation of the adverse selection problem caused by low quality banks, and raise the value of "confidence" and therefore the demand for the real VN dong deposits. But, will not ceilings on deposit interest rates cause the shift of the portfolio of financial assets held by households from deposits to other monetary assets, such as informal credits, gold or dollar? If the substitution effects are larger than the "confidence" effect, then the demand for the real VN dong deposit will decline because of the ceilings on deposit interest rates. The issue is an empirical one and will be discussed later.

The effects of removing the ceilings on loans and deposits are equally complicated. On the one hand, it will remove the restriction on expanding loans and deposits. Therefore, if the interest rate spread is large enough, banks will undertake investment necessary to improve the access of the public to deposit facilities of banks. Therefore, the value of "accessibility" will increase. On the other hand, removing ceilings may lead to the "excessive" expansion of loans and deposits relative to capital and reserves of banks. It will make the banking sector vulnerable to external shocks and thereby reduce the value of "confidence." Thus, when the ceilings on loans and deposits are removed, the sign of the net effect on the demand for real VN dong deposits is not determinate. The issue is again the empirical one. However, when the banking sector is unstable and the "confidence" is weak, we may better hypothesize that the negative effect on "confidence" dominates the positive effect on "accessibility." In such a case, it may be better to retain the ceilings on loans and deposits.

While a systematic empirical study does not exist on the nature of the demand function L, some evidence exists which allows us to make an inference on the characteristics of the function L. All the figures are taken from the tables in Watanabe and Ohno (1998).

("confidence" effect and "accessibility" effect) Table 1 shows the composition of the monetary assets held by the households in the 5th (highest) quintile of current expenditure from Region 1 to Region 7. Region numbers correspond to the standard division of the nation from Northern Mountainous Region (Region 1) to Mekong Delta Region (Region 7). Hanoi is in Region 2 (Red River Delta Region) and HCMC is in Region 6 (Southeast Region). Substantial difference exists in the composition of Cash, gold and deposits. Table 1 shows that it is possible to attribute the difference to the value of the two state variables in each region. The regions are divided into two groups in terms of "accessibility", rural agricultural area (Regions 1, 3, 5 & 7) with low "accessibility" and regions with large cities (Regions 2, 4 & 6) with high "accessibility." Within the area of high "accessibility," the fraction of deposits is highest in Region 2 and the lowest in Region 6. Since most of the joint stock banks are centered in HCMC (Region 6), we can attribute the difference in the deposit ratio between Regions 2, 4 and 6 to the "confidence" effect. That is, the figures of Table 1 can be interpreted as an evidence of the positive effect of "confidence" and "accessibility."

Table 1 Composition of monetary assets of households in the 5th quintile in current expenditure

unit =1000VND

	Region 1	Region 2	Region 3	Region 4	Region 5	Region 6	Region 7
dong & dollar	6,971.3	6,858.9	0.0	1,724.7	1,620.0	7,946.4	5,117.9
Gold	500.0	2,616.0	0.0	4,852.8	10,000.0	1,830.0	5,503.6
Deposits	0.0	10,074.8	0.0	2,905.5	0.0	1,786.7	365.5
				unit =%			
dong & dollar	93.3	35.1		18.2	13.9	68.7	46.6
Gold	6.7	13.4		51.2	86.1	15.8	50.1
Deposits	0.0	51.5		30.6	0.0	15.5	3.3

source: Table A21 of Watanabe and Ohno (1998, pp.192-195)

("substitution" effect by informal credit instruments) Table 2 describes the difference between the households with deposits and those without deposits in major economic variables. The fraction of households with positive deposits is only 4%. The income and expenditure of these households are 1.7 and 1.9 times higher than those of households without deposits. The most striking fact about Table 2 is the levels and composition of monetary assets (that is, VN dong cash, US dollar, gold, deposits). Households with deposits keep about 80% of their monetary assets in banks as deposits. And the level of their deposits is very large, larger than their current expenditure. Table 2 reveals one important fact about the substitution effects between bank deposits and the instruments of informal credit market. Households with deposits have only a marginal "Loans to ho/hui" and no "Personal loans with interest."[12] That is, the rate of return of deposits dominated the rates of return of traditional interest earning assets when the survey was conducted in 1997. It does not seem to be likely that imposing ceilings on deposit interest rates causes a noticeable shift from bank deposits to traditional credit instruments.

Teble 2 Households With/Without

Units:1,000VND

	with Deposits	without Deposits
Number of households (%)	71 (4.0)	1717 (96.0)
Current income	26.366	14.005
Current expenditure	17.431	10.055
Current savings	8.936	3.951
Investment in real assets	11.363	4.061
Investment in money and other fin. assets	−1.945	169
Currency (VND)	2.152	2.510
Dollar ($ 1 = VND 11.000)	310	46
Gold (1 Chi = VND 500.000)	2.595	1.856
Deposits in banks and other financial inst.	19.432	0
Loans to ho/hui	8	103
Personal loans without interest	90	157
Personal loans with interest	0	222
Accounts receivable	110	319
Durable consumption good	16.649	5.470
Durable equipment	1.330	2.213
House and land	195.349	74.062
Total assets	248.209	88.487
Debts to banks and other financial Inst.	35	736
Debts to ho/hui	0	50
Personal debts without interest	602	631
Personal debts with interest	1	232
Accounts payable	52	308
Debts to government	0	93
Debts to money lenders	0	153
Total liabilities	735	2.189
Net worth	247.474	86.298

(Source: Table 6 in Watanabe and Ohno (1998))

[12] An informal credit arrangement commonly important for both classes of households is borrowings and lending without interest. Personal loans without interest seem to be governed by social factors other than interest income.

("substitution" effect by gold) Substitution effect with gold may exist and significant. But the substitution effect is likely to be one way from gold to deposits as long as deposit rate ceilings are adjusted with inflation so that the real deposit interest rate remains around zero. Table 1 shows that high income households in Regions 4, 5 and 7 hold more than 50% of their monetary assets in gold, while they have no or negligible bank deposits in Regions 5 and 7. That is, if they gain the access to deposit facilities, their demand for gold will be substituted by the demand for deposits.

("substitution" effect by dollar) The amount of dollar is not large compared to gold. So the substitution effect is likely to be small if it exists at all. If deposit ceilings are adjusted with inflation and if the rate of depreciation of dong is not much larger than inflation, then the substitution effect should be small.

Thus, the empirical evidence supports the interest rate policy which imposes ceilings on deposit interest rates. It will be sufficient to keep the real deposit interest rates above zero in order not to reverse the historical process of the shift from gold to bank deposits or from informal credit instruments to bank deposits. The key variables are the "confidence" and "accessibility."

Loan interest rates

From the viewpoint of the development of the banking sector, ceilings on loan interest rates should be set to allow banks to earn sufficient interest income that will strengthen their capital base for the expansion of their financial network.

But, how are the values of the ceilings adjusted with the changes of economic conditions? When the actual market rates are at the ceilings, should the ceilings be revised upward? And, how much? The decision will depend on a large number of factors, including the financial needs of banks, borrowing firms and the government budget.

When actual market loan interest rates are below the ceilings, should the ceilings be adjusted downward? Actual loan interest rates will fall below the ceilings when the economy slips into recession. Output will decline and investment demand will decline.

The financial state of business firms will get worse and the overdue loans will increase. In such a situation, firms that are willing to pay higher interest rates than market rates are likely to be the firms with serious liquidity problems. Keeping high interest rate ceilings may simply worsen their liquidity problems. The real problem to be faced by banks is to separate firms with temporary liquidity problems from those with chronic liquidity problems. High interest rates cannot separate these two groups and may even attract the latter group with chronic liquidity problems, because they are more likely to have difficulties to obtain additional credits. In order to avoid such an adverse selection problem, it will be better to adjust the ceilings downward when actual market rates decline.

Is there a rule that can be used as a reference for adjusting ceiling rates? One possible rule of adjusting ceilings is to keep the real loan interest rate at the level consistent with the long run development of the real and financial sector of the economy. Given the target real loan interest rates, ceilings can be adjusted upward (downward respectively) when inflation is increasing (decreasing respectively).

VI. Concluding Remarks

This paper has examined the design of interest rate policies and other related policy measures for the development of the financial sector. Alternative policies are evaluated by employing a version of the HMS model which emphasizes the importance of information asymmetries at an early stage of economic development. The data of household survey are used to assess the importance of the two state variables, "confidence" and "accessibility" in designing interest rate policies.

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II－2

Lessons from the Financial Crisis in Asia for Viet Nam's Financial Sector

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Viet Nam is undergoing a process of economic transformation from a planned economy to a market economy, of which financial and capital liberalization is an integral part. In the midst of this transformation it watched neighboring ASEAN countries, which had gone through financial and capital liberalization much earlier, suffer heavily from the recent currency and financial crisis in East Asia while it was itself less affected because of its low degree of financial and capital liberalization.

This essay first examines the common features in the development patterns of East Asian financial systems and also the causes of the Asian financial and currency crisis to find implications for financial reform in the region. This review shows a need for sequential financial reform. Against this background, the implications for Viet Nam's financial reform are examined in each section.

I. Common Threads in the Evolution of East Asian Financial Systems and their Implications for Viet Nam's Financial System

1. East Asian experience

East Asian financial systems share the following six common characteristics with some exceptions:

1) They share a common history of financial repression.
2) Banks dominate them.
3) They enjoy high rates of domestic savings and their foreign savings focus on foreign direct investment.
4) They have been accelerating liberalization of the financial sector and capital movement while institution-building lagged behind.
5) Governance problems have been behind the slow progress of institution building.
6) East Asian financial institutions are generally inefficient and lack international competitiveness, in sharp contrast to their manufacturing firms.

A. Shared history of financial repression

Financial systems in East Asia generally share a history of financial repression, which in cluded limitations on interest rates and on entry and obligatory lending to policy-preferred sectors and projects. Financial repression relies on economic regulation and tends to neglect

the tools of prudential regulation such as capital requirements and limits on risky investments and the tools of information regulation such as disclosure requirements. In the planned economies of China and Viet Nam, the financial sector was totally repressed or subsumed in fiscal policy.

Financial repression may have made some constructive contribution, such as overcoming market failures, in the early period of development when information infrastructure was weak. However, the adverse effects of financial repression, such as misallocating resources and suppressing domestic savings are usually extremely strong even in the early period of industrialization, especially if bureaucracy is neither efficient nor clean. As most East Asian economies had a system of financial repression in the initial period of post-war development, the informal financial sector played a role to add necessary flexibility to the rigid official financial sector, particularly in financing small and medium-sized enterprises, which the official sector did not adequately cover. Some East Asian governments wisely allowed the informal sector to function.

Although financial repression was eased in subsequent years, the strong involvement of government in the financial sector has remained under development-oriented governments with the consequence of over-regulation.

B. Bank-dominated system

In East Asian economies, indirect finance, or intermediation by the banking system, developed first and direct finance, or finance through money and capital markets, was introduced gradually as a supplement to the banking system. Indeed, most financial systems in East A sia are still dominated by banks, although money and capital markets have become more important during the 1990s. This pattern of development can be explained by information asymmetry. In the early period of economic development, lenders (investors) posses relatively less information than borrowers (investee firms). Given this asymmetry of information, it makes sense for banks, which offer the capacity to process necessary information and diversify risk, to intermediate between lenders and borrowers.

A bank-dominated financial system lacks flexibility and long-term finance capability. Typically banks are reluctant to take on the additional risk of long-term lending where information is insufficient and enforcement infrastructure is inadequate. Since the region's equity and bond markets, particularly the latter, are underdeveloped, private businesses are forced to roll over short-term bank borrowings to meet their long-term financing needs. Since lenders retain more control with leasing than with collateral lending, leasing has emerged as a way to overcome information asymmetry and weak legal enforceability of normal commercial lending in developing countries (White 1995, p. 20).

Although equity markets started to expand rapidly in many East Asian economies in the late 1980s and early 1990s, bond markets are extremely underdeveloped. One reason is that the generally healthy budget balances in most countries prevented the development of government bond markets, which usually precedes the development of corporate bond

markets. In addition, the dominant position of banks in most financial systems stymied competing corporate bond markets. This has limited the financing alternatives for borrowers.

C. High rates of domestic savings and focus of foreign savings on foreign direct investment

East Asian economies had maintained fast economic growth until the crisis because of high domestic savings, and foreign capital flow focused on foreign direct investment (FDI). These financial systems generally enjoyed high and rising rates of domestic savings even under financial repression (Table 1). China, which has a transitional economy like Viet Nam's, has had a fairly constant savings ratio of more than 40%. Rising income levels in East Asia due to high rates of economic growth contributed to the propensity to save. The high rate of domestic savings in the region is also explained by the tendency of East Asian governments to adopt policies to maintain relatively high real interest rates even under financial repression. Furthermore, several countries in East Asia have implemented mandatory saving systems under public retirement fund schemes, although such systems by no means exist across the board. Singapore and Malaysia have implemented this scheme and Hong Kong is reportedly moving in this direction. Compulsory savings schemes are utilized as government-controlled financial institutions in order to develop securities markets and/or the regionalization of capital markets.

Notwithstanding the availability of domestic savings, East Asian developing economies depended relatively heavily on foreign savings to maintain their high rates of growth. The composition of foreign savings has changed over time as dependence on official sources gradually declined and foreign direct investment became the main source of foreign savings. Along with FDI came technology and management transfer, particularly in export-oriented manufacturing industries, which stimulated overall economic growth. With foreign savings going to export-oriented manufacturing industries, the large pools of domestic savings in these countries could be used for infrastructure building and for domestic market-oriented investments. Most countries in East Asia apparently absorbed the growing amounts of FDI without unduly straining their economies and financial systems. With FDI, borrowers do not cause a problem of information asymmetry as they can usually finance in their home market or in other overseas markets.

During the middle of the 1990s, the composition of foreign savings in East Asia changed dramatically. In addition to the build-up of internationally mobile investment funds along with the development of global financial markets, financial and capital liberalization in many countries and a relatively fixed exchange rate regime led to an increase in foreign borrowings and portfolio investments and a decline in the importance of FDI (Table 2). Many of these economies may not have been ready for the shift to non-FDI foreign capital. Because of the lower level of corporate development and inadequate institution-building in the financial sector, the capacity to absorb non-FDI capital flow was lower in the NIEs than in Japan when they began to implement liberalization and it was lower still when the developing economies of East Asia implemented liberalization.

D. Accelerating liberalization of the financial sector and capital movement with lagging institution-building

East Asian economies have found it necessary to proceed with financial liberalization as the traditional system of financial repression had negative effects such as misallocation of financial resources and could not meet the requirements of increasingly sophisticated economies. They lagged behind, however, in building the institutions necessary to accompany financial and capital liberalization, with some negative consequences such as misallocation of resources and financial instability

Financial liberalization was introduced gradually and it accelerated after the middle of the 1980s consonant with the general shift of economic policies towards deregulation and liberalization. Capital markets, particularly stock markets, have developed over time. Significantly, financial liberalization was accompanied by the liberalization of capital movement in a compressed time frame. East Asian governments have moved to phase out credit allocation, to liberalize interest rates, loan portfolios, business lines, and market entry including entry by foreign institutions, and to develop and reform securities markets.

Financial sector liberalization has contributed to the mobilization of domestic savings and the deepening of financial systems in East Asia. The ratio of M2 to GDP, a measure of financial deepening, increased steadily in East Asian economies (Table 3). On the other hand, the liberalization of the financial sector, particularly in combination with the liberalization of capital movement, has caused financial instability in some cases.

Institution-building, such as strengthening information disclosure, prudential regulation and financial supervision, is the necessary counterpart to financial liberalization in order to avoid market failure. Prudential regulations such as capital adequacy and limits on single-party exposure have been strengthened gradually as financial liberalization has proceeded. International pressure has been a major influence as the tendency in East Asia, as elsewhere, is for regulation and supervision to improve only after problems have surfaced. Lack of transparency has some structural basis in East Asian financial systems and bankruptcy laws and procedures are generally perceived as inadequate throughout most of the region. Another legacy of financial repression and government involvement in the financial sector is the relative absence of explicit safety nets.

However, the progress of institution-building in East Asia has generally lagged behind financial liberalization, a situation that has contributed to a number of financial crises in the region, including the recent ones. Inadequate regulation and supervision of non-banks have often resulted in uncontrolled lending that eventually brought substantial economic costs.

The rapid pace of financial liberalization, which was not backed by adequate institution-building in some economies, has undermined the health of the financial systems. For example, the aggressive financial liberalization in Indonesia in the 1980s resulted in over-lending. On the other hand, too slow liberalization and institution-building in Japan and Korea has prevented the growth of efficient financial institutions and has left these financial systems

vulnerable. The process faces added difficulties in transition economies such as Viet Nam and China, which had total financial repression and a mono-bank system and where there was no independence of financial regulators such as the central bank.

E. Governance problem

Behind this weakness of the institutional system including prudential regulation and its implementation lies inadequate governance in regulatory authorities, financial institutions, and non-financial corporations. These agents are not sufficiently independent of each other and they are not subject to adequate discipline from each other.

As a result, transparency of decision making by these agents is lacking. The lack of transparency is partly the legacy of financial repression when governments exercised a high degree of discretion over management of the financial sector and it is also partly attributable to the region's relationship-oriented business practices. In general central banks are not sufficiently independent. In some East Asian economies official corruption in organizations such as central banks resulted in inadequate supervision. Commercial banks that had strong government connections were often perceived to have implicit guarantees that they would not be allowed to fail. This perception caused a severe moral hazard problem and resulted in undisciplined lending activities. An element of the corporate governance problem in East Asian countries is the bank-domination and under-development of capital markets, which prevent the progress of information infrastructure and the proper execution of corporate governance by shareholders.

Transition economies have acute governance problems, as autonomous decision making has been alien in a planned economy. In China's transitional economy the independence of the Peoples Bank of China, the central bank, is limited by the Central Bank Law of 1995 which establishes its position under the authority of the State Council. Interference from China's line ministries and local governments for loans to SOEs has undermined commercial-based decision making by financial institutions. State-owned commercial banks inherited the traditional policy loan function when they were separated from the People's Bank of China, the mono-bank, and the Ministry of Finance in 1979 and 1984. The state-owned commercial banks continue to be forced to make policy loans even though specialized policy banks were created in 1994 to take over the policy loan function and allow the state-owned banks to lend on a purely commercial basis. Moreover, the state-owned commercial banks have found it difficult to make loans on a commercial basis because more than half of SOEs are loss-making and stringent collateral requirements constrain lending to non-SOEs. They are subject to strong pressure from central and local government agencies to make loans to enterprises on non-commercial terms (Wall). Unfortunately, pressure on state-owned commercial banks to extend non-commercial policy loans has increased recently in the context of government efforts to cope with the economic deterioration.

Another element of governance problems in China's transitional economy is the tension between the central government and local governments over the activities of local branches

of banks including the People's Bank of China. Local governments influence the local branches through the appointment of bank staff and political influence. This undermines the operational integrity of banks. The central government has tried to correct the situation by a variety of means such as a major restructuring of the provincial branch structure of state-owned commercial banks and the People's Bank of China.

F. Inefficiency and lack of international competitiveness

With the possible exception of Hong Kong and Singapore, East Asian financial systems are generally inefficient because they lack competition, effective governance, and managerial freedom, mainly due to excessive restrictions and inadequate regulation and supervision. Inefficiency in the financial system has kept domestic corporations from minimizing financial costs and pursuing optimum financial strategies. Financial inefficiency and lack of international competitiveness can destabilize the financial system and, indirectly, the economy as a whole when countries embark on financial and capital liberalization.

2. Situation in Viet Nam

Viet Nam's financial system shares most of the features of its East Asian counterparts with some exceptions as follows:

1) Viet Nam's financial system shares a history of financial repression with its East Asian counterparts.
2) Viet Nam's financial system is even more extremely dominated by banks.
3) Unlike most other East Asian economies, Viet Nam suffers from a low savings rate and, while its foreign savings focus on FDI, it has utilized FDI much less aggressively.
4) Viet Nam's pace of financial and capital liberalization has been much slower than other East Asian economies' and institution-building has been also slower.
5) Governance problems in Viet Nam are closely related to its economic transition and very severe.
6) Viet Nam's financial institutions are inefficient and totally lack international competitiveness.

A. History of financial repression

Viet Nam's financial system has been totally repressed or subsumed to the fiscal system under a planned economic system, as mentioned before.

B. Extremely bank-biased financial system

The extent of bank domination in Viet Nam has been more extreme than in other East Asian economies, as money and capital markets are virtually non-existent, reflecting the legacy from the planned economy and the slow pace of equitization. Bank domination not only limits the depth and flexibility of the financial system but also constrains the equitization of SOEs. Moreover, as the banking system is dominated by state-owned commercial banks

(SOCBs), which traditionally favor SOEs in their transactions, the allocation of scarce capital tends to be biased and therefore inefficient, and the development of the non-SOE sector is constrained.

C. Lower mobilization of domestic savings and less aggressive utilization of FDI

Viet Nam's savings rate has increased to 19%, but it is still low compared with other East Asian nations. One reason for the low level of domestic capital mobilization, as cited by Huong's paper (contributed from the Vietnamese side), is regulated interest rates. Moreover, as banking system weakness has undermined public confidence, the financial system has not deepened. The M0/M2 ratio has been high, indicating a preference for holding cash. Viet Nam stands in stark contrast with China, also a transition economy, where the saving rate has risen to over 40%. Mobilization of domestic savings is a high priority for Viet Nam.

The population's low confidence in the banking system lies at the heart of the difficulty in mobilizing domestic savings. Low regulated interest rates constrained the ability of the banking system to mobilize domestic capital in 1997 and 1998. (Huong) Moreover, the extremely strong expectation of dong (VND) devaluation and its possible inflationary consequence have discouraged domestic savings at financial institutions. Furthermore, dollar deposits were completely free, and extensive dollarization of the economy has taken place. The share of foreign currency deposits in the total deposits of the banking system, which was over 50 % at the beginning of the 1990s, declined to around 30% in 1996. The share of foreign currency lending in total loans was around 10% in 1991 and reached slightly less than 40% in 1996 (Phase II). Recently the ratio is said to be around one-third. Moreover, banks, particularly joint-stock banks, are highly leveraged in foreign currency lending, with the ratio of foreign currency loans to foreign currency deposits as high as 125% (World Bank [98] p.22-23). The effectiveness of a system of forced conversion to local currency, introduced recently to correct the dollarization of the economy, is uncertain.

With regard to foreign savings, Viet Nam has also relied mostly on FDI as other East Asian countries did. The problem is that Viet Nam has so far not been as successful as neighboring countries in attracting FDI. The combination of its low domestic saving rate and its relatively low level of FDI may constrain Viet Nam's future investment and economic growth.

D. Slow pace of financial liberalization and institution-building

Since Viet Nam lacks a market-oriented financial system, it needs to proceed with financial liberalization as well as institution-building. In Viet Nam, the pace of both financial liberalization and institution-building, particularly the latter, has been extremely slow. Under the New Banking Law of 1998, the national congress has ceased to determine interest rates, the central bank decides a basic rate, and commercial banks can decide rates freely. A restriction on interest rate margins was lifted in 1998. However, interest rate ceilings are still imposed on lending and this has distorting effects on the interest rate mechanism and

competition.

While Viet Nam is to be credited for not having liberalized capital control prematurely, it has not used the respite efficiently in order to build the necessary institutional infrastructure. The slow development of prudential regulations and supervision has had its cost in the deterioration of bank assets in general and the failures of joint-stock banks, which had been allowed to open too easily. Legal and accounting systems in Viet Nam are still underdeveloped although there have been significant improvements.

The information infrastructure is extremely lacking. SOCBs, private banks, and SOEs disclose extremely little information with regard to business condition. The government recognizes that reform of the accounting system is necessary and the MOF started its reform five years ago. International accounting standards are being introduced and they are planned to cover the SOE sector in 1999. However, the implementation appears to be slow.

The legal framework for collateral banking is underdeveloped and banks cannot dispose of collaterized properties freely (Phase 2 and Huong). More fundamentally, the legal framework of property ownership in general seems to be extremely underdeveloped, in reflection of Viet Nam's socialist tradition. It is pointed out that SOEs do not keep enough legal documents to support their ownership rights over collateralized properties (Sau p.19, contributed by the Vietnamese side).

The New Banking Laws, which became effective in October 1998, made strides in institution-building. Improved prudential regulations have been introduced, but they have not been implemented effectively. This is said to be because of a governance problem, or the non-arm's length relationship between SBV, state-owned commercial banks, and state-owned enterprises. This issue will be discussed later. The ineffectiveness of prudential regulations is due also to the lack of human resources at the central bank and commercial banks.

E. Governance problems unique to a transition economy

Behind this delay in institution-building, particularly the poor implementation of regulations, lies a very severe governance problem unique to transition economies. The central bank is not sufficiently independent even though there have been some improvements. The central bank of Viet Nam stopped underwriting government finance in 1992. The independence of the central bank was strengthened by the New Banking Act of October 1998, but it is still deemed insufficient. Decision-making authority on monetary policy still rests with National Congress (IMF). Moreover, the central bank has too many departments and too many branches (61), the latter of which have become the agents of local governments. The New Bank Law specifies that local governments should not influence the central bank. It remains to be seen whether this will happen.

State-owned commercial banks do not seem to have sufficient independence in making credit decisions. The central bank controls each bank's total credit. There are detailed guidelines for commercial bank lending (Phase 2). Lending to SOEs by state-owned commercial banks is affected by political intervention, and regulations are not implemented

effectively. Preferential credit policies exist for several priority areas and projects, and Viet Nam's SOCBs have the dual functions of commercial lending and policy lending, whose border is not clearly demarcated. This dual role has left SOCBs susceptible to political intervention. Moreover, joint-stock banks are influenced by shareholders and are said to have non-transparent relations with regulatory authorities. The development of a healthy banking system in Viet Nam requires reducing the system's exposure to the SOE sector, which is not subject to proper corporate governance.

F. Inefficiency of commercial banks

The lack of competition due to the domination of SOCBs and the slow development of prudential regulations have left Vietnamese domestic banks inefficient and uncompetitive internationally. Commercial banks in Viet Nam have excess employees and inefficient operations. There is not enough competition as the four state-owned commercial banks dominate the banking system, accounting for 80% of total deposits. Moreover, their managerial, professional, and technological capabilities are weak. Management and employees of state-owned commercial banks lack professional knowledge and credit analysis capability. Moreover, they lack managerial independence necessary for developing such capabilities. Over-regulation and over-intervention by the central bank, non-arm's length relationships with SOEs, and government interference have been undermining independent commercial decisions of state-owned commercial banks. As preferential loans to SOEs are still carried out under political direction, there is no incentive for commercial decision making. Managers of state-owned commercial banks are said to have no right to dismiss their employees.

Private joint-stock banks have often been founded to finance particular enterprises and their loan portfolios are not sufficiently diversified. Many of these joint-stock banks lack sufficient net worth. They also complain that the playing field for competition with SOCBs is not level. Moreover, foreign financial institutions have played a limited role in Viet Nam's financial sector although their entry has been allowed too indiscriminately. Constrained by the fact that governments and enterprises disclose virtually no information these institutions have difficulty expanding operations behond their extremely limited current state. Some foreign financial institutions have closed their offices due to the recent deterioration in the operating environment. The weak legal basis of collateral banking creates a problem in implementing project finance by foreign financial institutions. Furthermore, the restrictions on attracting VND deposits have constrained their entry to domestic lending businesses. The Vietnamese government has started gradually loosening restrictions on VND deposit taking by joint-venture banks since 1999.

II. Causes of the East Asian Currency and Financial Crisis and Their Implications for Financial Reform

1. Need for a healthy financial system and a cautious approach to capital liberalization

There are two schools of thought concerning the causes of the financial crisis. One blames weak domestic economic fundamentals, such as the unsound financial sector and the diminished international competitiveness of industry as a result of the relatively fixed exchange rate regime under the dollar-pegged exchange system widely adopted by East Asian economies. The other blames the international financial system, under which the volatility of international capital flow caused a contagious effect. Although the exchange rate regime and inefficient financial systems intensified the boom and bust cycles of East Asian economies and undermined financial stability, it is generally believed that economic fundamentals alone did not justify the speed and magnitude of the currency and economic adjustments. The volatility of international capital flow, particularly short-term capital and portfolio investment, due to herd behavior by international lenders and investors is believed to have played a major role in causing the crisis.

Still, unguarded capital account liberalization invited the crisis and the weakness of financial systems in East Asian countries aggravated it. Excessive foreign currency-denominated borrowing by the private sector, particularly for short-term maturities, in expectation of exchange rate stability under dollar-pegged exchange rate systems, resulted in extreme currency and maturity mismatches that, together with deteriorating asset quality, increased the vulnerability of financial systems to volatility in currency and asset prices. Inefficient financial systems in these countries allocated the inflow of capital to such unproductive uses as real estate, consumer durable goods, and mega-projects, inviting an economic bubble in Malaysia, Thailand, and Indonesia. What prudential regulations were in place were not adequately enforced, supervision was lax, and the management and staff of financial institutions lacked technical skills to carry out disciplined credit analysis. The widely held perception of an implicit government guarantee on debt obligations of politically connected borrowers is also believed to have contributed to the excessive borrowing.

The crisis has left the affected economies with significantly lower economic levels, full recovery from which will take years, and financial systems in disarray. The banking systems, which had dominated their financial systems, are caught with piles of non-performing loans. This has become a major constraint on economic recovery. Despite the pervasiveness of the crisis, individual countries' resistance to the contagion has varied with the health of economic fundamentals and financial systems, the convertibility of currencies, the flexibility of foreign exchange policies, monetary policies and factor markets, and the levels of foreign exchange reserves.

Moreover, it is important to note that China, which looks so far to have escaped from

contagion of the Asian crisis thanks to its capital controls and large pool of foreign exchange reserves, has similar symptoms such as a highly vulnerable banking system and over-valued currency. China, a transition economy like Viet Nam, also has a serious bad debt problem. A Western economist estimates that non-performing loans account for over 40% of total loans if western accounting methods are applied. This is due to the large pool of private savings intermediated by state-owned commercial banks to generally inefficient state-owned enterprises. Moreover, interest rate controls on deposits have also undermined commercial banks' profitability in China.

Thus, the health of the financial system is regarded as the key to short-term economic recovery as well as to long-run sustainable economic growth. In fact, the IMF rescue packages have addressed both short-term measures to restore the health of the banking systems and long-term measures to modernize the financial systems with liberalization and institution-building. Transparency has been emphasized in particular. The more liberal and more closely monitored reformed financial systems will serve as regional standards, although the pace and extent of such reform remains uncertain because the effective implementation of reforms requires systemic changes involving other sectors. Moreover, a more flexible exchange rate policy than a dollar-pegging seems to be necessary to prevent excessive speculation in foreign exchange by financial and non-financial institutions.

2. Impact on Viet Nam's financial sector

Since Viet Nam has not liberalized capital control, the financial system has escaped the impact of volatile international capital flows. Since Viet Nam's currency is not convertible, the country did not witness an inflow of hot money, which might have caused a bubble economy as it did in other ASEAN countries. However, the quality of bank assets in Viet Nam is believed to have been deteriorating because of the weakening financial condition of enterprises, which is in part a negative effect from the Asian crisis.

A. Indirect impact of the Asian financial crisis

As Viet Nam's SOEs depend fairly heavily on foreign capital, primarily FDI, their financial condition is believed to be affected by the deterioration of export markets and the slowdown of FDI as a result of the Asian crisis. As the bulk of Viet Nam's exports go to Japan and neighboring ASEAN countries and Viet Nam's top five FDI investors are East Asian economies, the weakening of those economies as a result of the crisis has negatively affected Viet Nam's exports and incoming FDI. The deterioration of the fiscal budget and the financial condition of SOEs increased the burdens on the financial system.

Moreover, the controlled devaluation of the dong (VND) has increased the debt burden of Vietnamese enterprises. Vietnamese enterprises had the habit, shared with other East Asian enterprises, of borrowing heavily in foreign currencies (12% of total SOE debt), mostly the US dollar, to take advantage of lower interest rates in a steady exchange rate

environment. Although the foreign currency exposure of the state-owned commercial banks is not particularly large, their indirect exposure is extremely high, as SOEs use foreign currency-denominated loans to finance their domestic businesses. The foreign-currency borrowing of SOEs was rather loosely controlled. Huong cites the prevalence of deferred L/C before control by the State Bank in 1998. Thu (contribution from the Vietnamese side) calculates that the 24.5% devaluation of VND against the US dollar from the beginning of 1997 to the end of 1998 increased enterprises' debt to banks by VND4,000 billion. This will in turn aggravate the already poor condition of the banking system and the recurring expectation of devaluation of the VND is likely to add to banks' difficulties. These difficulties should remind the government of the necessity of renewed efforts to reform the financial and other sectors of economy.

To cope with the problem, the Vietnamese government has increased the flexibility of its foreign exchange rate policy and has tightened the foreign currency exposure of commercial banks and enterprises. The central bank has devalued the dong-dollar exchange rate three times, for a total devaluation of about 20%, since the occurrence of the Asian currency and financial crisis. Management of the exchange rate has been made more flexible. The new foreign exchange trading system introduced on February 26 abolished the official rate and now allows gradual devaluation of VND up to 30% per annum through market fluctuations of 0.1% from the average rate of the previous trading day. It remains to be seen how effective this measure will be.

In 1997, a series of measures was introduced to tighten control of foreign currency borrowing by SOEs, both centrally and through individual bank exposure. In 1998, a system of mandatory conversion of enterprises' foreign currency holdings to foreign exchange banks was introduced. The government promulgated the Foreign Debt Management Law in January 1999 to try to control total offshore loans. Regulation of foreign exchange open exposure was also introduced.

Moreover, the Structural-adjusted Facility and Industrial Policy for the period 1999-2001 as agreed with the IMF calls for: flexible management of the exchange rate and enhanced efficiency of the foreign exchange market; liberalization of the current account; and amendment of foreign exchange management with regard to commercial banks.

B. Deterioration of the quality of bank assets

Viet Nam looks to be plagued with non-performing loans although the situation does not look very gloomy according to official statistics. Non-performing loans increased from less than 8% of total loans at the end of 1995 to 13% at the end of September 1997, partly due to stricter non-performing loan criteria implemented since the beginning of 1997. It is said that the situation improved as SOE-reform progressed during 1988-92, but that it worsened as reform stalled after 1994. The ratio improved to 9.5% at the end of 1998. These official data, however, may mask the actual quality of bank loans. According to the MOF's categorization, problem debts accounted for around 30% of total debt of SOEs and inadequate

criteria and deficiencies in the accounting system mean that the true extent is not clear.

Viet Nam's bad debt problems are inextricably tied to the relationships between state-owned commercial banks and SOEs, and depend on the performance of SOEs. Because of the non-arm's length relationship between state-owned commercial banks and state-owned enterprises, it is probable that loan rollover decisions have been made too easily. On the other hand, it is said that Viet Nam's bad loan problem is due to the substitution of bank loans for budgetary subsidies to SOEs. Since past improvements in SOEs were made possible by joint ventures with foreign firms that possessed management, marketing, and technological capabilities, the performance of SOEs is believed to have suffered from the recent down trend of inward FDI. Ha (a contributor from the Vietnamese side) points out that another factor in Viet Nam's bad debt problems is the inadequacy of collateral law that makes it difficult for banks to dispose of their collateral assets.

In addition to tightening control of foreign currency borrowing and increasing flexibility in the management of foreign exchange rate, Viet Nam's government has responded to these problems by taking ad hoc measures to favorably treat SOE borrowing from SOCBs, often at the expense of the financial condition of the SOCBs. In 1997 several measures were taken to protect SOEs in response to their deteriorating performance. These measures include abolishing the requirement for collateral on borrowing from state-owned commercial banks and permitting lending to loss-making enterprises that have sound business plans, rolling-over loans to enterprises in difficulty of repayment, and starting loan write-offs. Moreover, credit institutions have been allowed to reschedule loans to troubled SOEs from 1-3 year terms to 1-5 year terms. Lower interest rates are now applied to SOEs. The preferential treatment of SOEs seems to have been enhanced because of the recent deteriorating economic conditions. The apparent improvement in the non-performing loan ratio may reflect these ad hoc measures to help troubled SOEs. At the same time, they seem to be government intervention in the commercial conduct of SOCBs and they might have an adverse effect on the already significant deficiencies in governance involving the government, SOCBs, and SOEs.

To offset the increasingly heavy financial burden of SOCBs stemming from these ad hoc measures to relieve SOEs, the government has introduced a series of compensating measures. From the beginning of 1999, the income tax rate for the banking system was reduced from 45% to 32%. More government funds were allocated to SOCBs with a government decision in September 1998. In response to the worsening economic condition, the Vietnamese government lowered reserve requirement ratios by 3 to 5% in March 1999.

Ⅲ. Need for Sequenced Financial and Capital Liberalization

1. East Asian generalization

A. Need for sequenced financial and capital liberalization

According to the experience of East Asian countries, it is necessary and useful to liberalize the financial sector. Financial sector liberalization has contributed to the mobilization of domestic savings and the deepening of financial systems in East Asia. On the other hand, too hasty financial and capital liberalization unaccompanied by adequate institution-building causes financial instabilities as seen in Indonesia and many other East Asian countries that were affected by the recent currency and financial crisis. As portfolio investment is liberalized, the volatility of capital markets sometimes increases. For example, new players, such as hedge and pension funds, that can instantaneously transfer capital into investments at low cost increase the volatility of short-term capital flow and, hence, that of domestic asset prices as well as foreign exchange rates. Greater volatility in the capital market may destabilize the banking system if the prudential regulation on equity ownership by banks is inappropriate.

These potentially de-stabilizing effects of financial liberalization point to the importance of proper sequencing of reform. A rough framework of proper sequencing may be summarized as follows. In a broad macro-economic context the generally accepted principles of proper sequencing are, first, that price stability and fiscal balance are the preconditions for economic liberalization, second, that trade liberalization should precede capital liberalization, and third, that financial liberalization should precede capital liberalization. Short-term capital and international portfolio investment likewise, should be liberalized in a controlled manner to maintain the stability of the financial system.

With regard to financial sector liberalization, the general sequence may be as follows. First, the establishment of the health of the banking system is the precondition. Second, institution-building is the top priority. Institution-building should be backed up by the development of human resources and proper governance structure encompassing the public, financial, and corporate sectors. As the development of human resources and proper government structure takes time, institution-building should be started early and continually upgraded as financial liberalization proceeds. Third, a level playing field should be constructed by lowering entry barriers within each segment of the financial sector and by removing barriers segmenting domestic institutions, and by developing capital markets to compete with the banking system and, next, by allowing the entry of foreign financial institutions. The lowering of entry barriers should be done in a controlled manner so that surviving domestic financial institutions can build sufficient net worth to maintain the stability of the financial system.

B. Flawed process of financial and capital liberalization

Against the yardstick of ideal sequencing of reform, the progress of liberalization in most East Asian economies appears flawed. On the whole, East Asian economies had laid part of the groundwork for liberalization by achieving reasonably high levels of macroeconomic stabilization. The more significant deficiencies in the sequencing of financial liberalization in East Asian economies involve the structure of the financial sector and the timing of capital liberalization. However, the recent economic turmoil in the wake of the Asian financial and currency crisis has put some of these economies in need of re-establishing macro-economic stability for implementing their financial reform programs.

In East Asia, financial reforms have often been taken because of foreign pressure, influenced by liberalization ideology and the self-serving motives of foreign financial institutions, which did not take into account the issues of readiness and sequencing. East Asian governments did not put enough effort into institution-building as they implemented financial and capital liberalization. On the other hand, countries such as Japan and Korea prolonged liberalization unduly with negative consequences.

The IMF-led efforts to cope with the Asian crisis as well as Japan's financial "Big Bang" will have an effect of facilitating financial liberalization and institution-building. On the other hand, the crisis will probably make East Asian governments more cautious about capital liberalization as we have already seen in Malaysia's re-imposition of capital control.

(1) Implications for Viet Nam's financial sector

The implications of the experience of the Asian crisis for Viet Nam's financial sector are that financial liberalization accompanied by aggressive institution-building is necessary and that Viet Nam should be cautious about capital liberalization. In this respect, Viet Nam needs to study how to implement sequenced financial and capital liberalization. Moreover, financial reform in formerly planned economies such as China and Viet Nam involves issues of both a developing economy and a transition economy. Problems of these financial systems are inseparably tied to the other elements of planned economies, particularly problems associated with financial transactions with state-owned enterprises. Financial reform of transitional economies requires a unique conceptual framework and distinct policy measures.

2. Agenda for financial sector reform

(1) Agenda for East Asian financial reform

Taking into consideration the development pattern of East Asian financial systems and the recent Asian financial and currency crisis, I consider the agenda for financial reform in East Asian economies consists of the following six points:

1) The utmost priority should be placed on establishing a healthy banking system.
2) Financial liberalization should be pursued by being accompanied by aggressive institution-building.

3) Particular emphasis should be placed on strengthening governance structure.
4) The bias towards a bank-dominated financial system should be corrected.
5) The international competitiveness of financial institutions should be monitored carefully and strengthened.
6) Steps to liberalize capital movement should be taken in a controlled manner and a more flexible foreign exchange rate policy should be pursued.

A. Utmost priority on a healthy banking system

A healthy banking system is the absolute priority for any economy for maintaining financial stability, as the banking system functions as the payment system and other means of financing are still underdeveloped. When a banking system is plagued with non-performing loans and inadequate net worth, as is the case with many East Asian countries in the wake of the recent currency and financial crisis, this adds particularl urgency.

This bad loan problem has to be solved expeditiously, while maintaining the stability of banking systems. Prolonging the solution entails extremely high costs to the economy as testified by the recent experience of Japan. Korea seems to have heeded the lesson and is taking a more aggressive approach in resolving the bad loan problem in the wake of the Asian crisis. The region's non-performing loan problems should be solved by resorting to international best practices that have been established through experience accumulated from the U.S. savings and loan association failures, the Latin American debt crises, and the Nordic debt crises. The resolution should involve separating the non-viable part of the financial system-either the failing financial institutions or the non-performing loans-from the remaining healthy part, which should serve as the basis of a credible financial system with sufficient net worth. The quality of individual loans should be determined according to internationally accepted accounting principles and loan classification criteria in order to establish the transparency necessary for bank restructuring and to generate public confidence. Nonviable financial institutions should be ordered to close or encouraged to merge with stronger financial institutions after their non-performing assets are removed. Governments need to offer incentives to encourage mergers among viable financial institutions in order to facilitate this process. Although closure of financial institutions must be timely, it must also be done with caution. It is extremely difficult to achieve this delicate balance in East Asia where safety net mechanisms, such as deposit insurance, to absorb the shock and prevent bank runs have not been put in place. Surviving financial institutions may need to be re-capitalized in order to restore their net worth position. Governments may also nationalize some failing banks temporarily before re-capitalizing or closing them. Where infusion of fo reign capital is necessary, an effective approach is to open up financial institutions to foreign investors. This will also facilitate the transfer of technology and management.

While remaining banks strengthen their balance sheets by writing off bad loans and recapitalizing, they need to show that their profitability is established. This process requires many painful decisions such as reduction of employees and changes of management. It has

been the experience of East Asian countries that macro-economic stability is necessary to restore the health of the balance sheets of ailing banks. Particularly, a continuous economic decline worsens the asset qualities of borrowers, and the quality of bank loans continues to deteriorate. Thus, the tight fiscal and monetary policies initially advised by the IMF on the crisis countries have been questioned as counter-productive and they have been moderated since then as long as fiscal balance allows. Some East Asian countries have gained room to maneuver thanks to past sound fiscal policies.

B. Financial liberalization accompanied by aggressive institution-building

Financial liberalization itself is necessary as the experience in East Asian economies testifies. It is also more clearly recognized that it should be accompanied by aggressive efforts for institution-building to prevent financial instability. In order to create an environment conducive to further financial liberalization, East Asian countries must move as quickly as possible to strengthen prudential regulations and information disclosure and to establish adequate governance. Some of the necessary changes are taking place already, particularly in the countries most severely affected by the crisis under the auspices of IMF. Moreover, the WTO negotiations for service sector liberalization may press East Asian economies to accelerate liberalization further.

Institution-building includes prudential regulations such as capital adequacy and limits on single-party exposure, bankruptcy laws, and information infrastructure such as accounting systems. Not only adequate regulations but also their rule-based implementation are necessary. Institution building requires both making regulations and establishing governance structure for their effective implementation. It is particularly important to integrate non-banks into the formal regulatory and supervisory system. Regulators should also exert more control over the foreign currency exposure of financial institutions. Under its agreement with the IMF, Korea imposed prudential controls on short-term external borrowing by financial institutions. Thailand, Indonesia, and Korea are in the process of building modern institutions under the IMF-mandated reform programs in the wake of the crisis. Although the rush to carry out such reform programs in the very fragile economic and financial conditions in the crisis environment has been criticized, the reforms themselves are absolutely necessary and should be instrumental to the modernization of financial systems in those countries.

C. Strengthen governance structure

The efforts for institution-building mentioned above should place particular emphasis on strengthening governance structure. Behind the weak institutional structure of East Asian financial systems lies a lack of governance in regulatory authorities, financial institutions, and non-financial corporations. In essence, good corporate governance depends on good governance of financial institutions, and good governance of financial institutions depends on good public governance of regulatory authorities. The performance of governance depends,

among other things, on the legal infrastructure, the incentive systems, and the depth of human resources within the system. Supervising authorities need to be free from political pressure. The independence of regulatory institutions such as the central bank needs to be clearly established. In Korea, the central bank's independence was substantially reinforced after the crisis.

Financial institutions on their part need to make independent decisions subject to sufficient supervision. Bank ownership by individual corporations and by industrial groups needs to be limited in order to avoid conflict of interest.

D. Correct the bias toward a bank-dominated financial system

The shortcomings of a bank-dominated financial system such as inflexibility, the lack of financial choices, and the deficiency of long-term financing need to be addressed. One way to overcome the lack of long-term finance capability within a banking system is to develop specialized long-term banks as has been done in Japan and China. This approach is reasonable when information infrastructure is underdeveloped. However, this cannot be a long-term solution as it leaves a segmented financial system and does not add the necessary flexibility. Moreover, domination by the banking system eliminates competition from other forms of financial intermediation.

Therefore, it is preferable to develop securities markets as quickly as possible to achieve a more balanced financial system as an economy develops. The development of securities markets also serves to increase transparency of financial systems by developing information infrastructure and to strengthen corporate governance. As international portfolio investment added volatility to capital flow in East Asian economies and its economic benefit is uncertain, portfolio investment by international investors needs to be adequately monitored and controlled. However, the banking system still generally plays a dominant role for small and medium-sized firms even after securities markets develop. Securities markets mainly serve large corporations around which information infrastructure develops. The development of securities markets in East Asia is constrained by the underdevelopment of corporate organizations. There may be a significant role for venture capital to facilitate domestic corporate development in East Asia.

E. International competitiveness of financial institutions

It is not only desirable but also necessary to have internationally competitive financial institutions in order to have efficient allocation of financial resources and also to reduce the risk of financial instability. Thus, it seems to be crucial for a transitional economy to develop expertise in lending to the non-SOE sector without totally depending on collateral. Inefficient financial systems misallocate the increased inflow of capital attracted by financial and capital liberalization and uncompetitive domestic institutions succumb in the face of increased entry of foreign financial institutions, threatening financial stability. This poses a difficult policy question because, while financial liberalization is necessary in order to improve the efficiency

of the financial system, rapid liberalization may undermine the stability of that system.

Some governments have encouraged or forced mergers to create domestic financial institutions with economies of scale that can survive international competition. However, size alone is not the answer to making healthy financial systems. Managers in protected financial industries tend to lack the skills needed to function in a competitive environment and to effectively utilize the technological innovations of the information age. Most East Asian countries need to strengthen the management of their domestic financial institutions through deregulation, liberalization, and possibly deliberate human resource development programs. The key to strong financial institutions lies in competition, corporate governance, and human resource development rather than size.

Competition among domestic financial institutions needs to be enhanced with deregulatory measures such as the break up of market segmentation and the lifting of entry barriers. A level playing field needs to be established. In China, state entities are directly involved in financial businesses. For example, most securities companies are either owned by the People's Bank of China, the Ministry of Finance, or other state entities. This is not desirable for generating true competition.

The entry of foreign financial institutions needs to be gradually liberalized. Since East Asian financial institutions share a long history of tight regulation, it will be almost impossible to make them internationally competitive unless the entry of foreign financial institutions is permitted. Although China now has more than 100 foreign banks with branches and representative offices they are still subject to stringent geographical limits and tight restrictions on their business scope. (Wall)

A major problem in China is that the staffs of local banks and regulatory agencies are inadequately trained for the management of the complex financial system recently established (Wall). This suggests that developing economies, particularly transitional economies, should increase the complexity of the financial system gradually in parallel with human resource development.

F. Controlled capital liberalization with a flexible foreign exchange rate policy

Capital inflow other than FDI is not necessarily beneficial to developing economies that do not have adequate absorptive capacity, as amply proven in the Asian financial crisis. Such economies should liberalize their capital account cautiously, except for FDI. As portfolio investment is liberalized, the volatility of capital markets sometimes increases. Overall foreign currency exposure of an economy should be carefully controlled with a particular emphasis on short-term borrowing and portfolio investment. While domestic corporate organizations are underdeveloped, foreign savings should focus on FDI. A more flexible exchange rate regime appears advisable, although this issue is outside the scope of this paper.

(2) Implications for Viet Nam's financial reform

Viet Nam shares with other East Asian economies most points on the agenda for financial

reform. However, Viet Nam should place different emphasis on these points because of its low savings rate and transition economy status. Viet Nam should emphasize macroeconomic stability as a precondition for financial and capital liberalization. Moreover, its low savings rate compels Viet Nam to emphasize the mobilization of domestic savings and the utilization of FDI within foreign savings. Furthermore, Viet Nam should focus more on governance reform as its status as a transition economy adds particular difficulties in this regard. As a result, the agenda for Viet Nam's financial reform may be summarized follows:

1) Macro-economic stability is necessary as a precondition for financial liberalization.
2) The top priority should be to establish a healthy banking system.
3) Viet Nam should strengthen policy measures to mobilize domestic savings and invite FDI more aggressively.
4) Financial liberalization should continue with even more aggressive efforts in institution-building.
5) The core of financial reform should be strengthening the governance structure.
6) Capital markets should be developed to complement the banking system.
7) Government should take policy measures to strengthen the international competitiveness of financial institutions.
8) Viet Nam should take a cautious approach in capital liberalization other than FDI.

A. Macro-economic stability as a precondition for financial liberalization

In view of Viet Nam's economic deterioration indirectly brought about by the Asian financial crisis, financial liberalization should be undertaken by monitoring macro-economic stability.

B. The top priority on establishing the health of the banking system

In view of the seeming deterioration of bank assets, establishing a healthy banking system is the top priority in Viet Nam's financial reform. Viet Nam introduced an improved loan classification system in February 1999 and commercial banks have been allowed to make loan-loss provisions based on the loan classification. The Viet Nam government intends to freeze or write-off non-performing loans which commercial banks extended at the request of the government. In 1997, the central bank re-capitalized SOCBs to some extent. The government has committed to adopt a comprehensive strategy for restructuring all 51 joint-stock banks and all 4 state-owned banks. SBV has also audited SOCBs and large joint-stock commercial banks. SBV has started to restructure large joint-stock commercial banks and has forced ailing joint-stock banks to merge or close. According to the government plan, the restructuring of all joint-stock banks will be completed by 2000.

The more critical restructuring of SOCBs has been slow because of its complexity and political sensitivity. Debt-restructuring in Viet Nam is a highly sensitive political matter as it is likely to engender substantial failures of SOEs, half of which are said to be non-profitable. They currently perform valuable social safety net functions such as providing housing and

medical care. Thus, bank reform, particularly in the area of debt-restructuring, needs to be carefully coordinated with SOE reform and a construction of alternative safety net capabilities. The questions are how large a capital infusion is necessary and whether or not foreign investments are necessary for this purpose. It is also said that the fiscal cost of bank re-capitalization will be relatively small thanks to the extreme underdevelopment of Viet Nam's banking system. Total credit is less than US$6 billion or a little over 20% of GDP (World Bank p.26).

C. Mobilization of domestic savings and emphasis of foreign savings on FDI

Viet Nam's low savings rate, which has a variety of explanations, should be corrected, particularly because of the prospect of lower inflow of foreign capital into the region after the Asian currency crisis. The lack of confidence in the banking system and currency, which caused the dollarization of economy, should be on the list of reasons. Resolution of the agenda issues discussed above should serve to increase the population's confidence in the banking system. Viet Nam's government is reported to have decided to establish a postal saving system which might help to increase the savings rate. But, as such a system carries a risk of inefficient non-market-oriented allocation of funds, it should be carefully constructed and operated. This issue may need more extensive study.

As far as foreign savings are concerned, it seems desirable for Viet Nam to emphasize FDI until it builds adequate capacity to absorb inward portfolio investment and overseas borrowing. Since Viet Nam's current utilization of FDI is much lower than neighboring countries' and competition among recipient countries for FDI has intensified since the Asian currency crisis, Viet Nam may need a more aggressive and innovative approach to attracting FDI.

D. Continued liberalization with aggressive institution-building

By learning from the experiences of neighboring countries and also to catch up with the development in those countries, it is desirable for Viet Nam to continue to liberalize the financial sector accompanied by aggressive institution-building. It seems to be reasonable to concentrate initially on the development of a sound banking system. Particular emphasis should be placed on transparency and the development of a legal framework for bankruptcy and collateral lending. Before this development, leasing may play a role in providing necessary long-term finance. Reform of the governance structure is particularly relevant in Viet Nam in order to build and operate necessary institutional infrastructure.

E. Reform of the governance structure as the core

The reform of the governance structure should form the core of financial sector reform in a transition economy such as Viet Nam. As the bad debt problems of SOCBs are inextricably tied to their relationship with SOEs, the reform of the governance structure is crucial for the long-term health of the banking system.

First, strengthening SBV's independence from government intervention is important. More independence and restructuring seem necessary. Second, financial liberalization in a transitional economy such as Viet Nam includes the freeing of commercial banks to make their own economic decisions in such areas as interest rates and credit provision. Indeed, this is a critical element of bank reform in Viet Nam. The New Bank Law specifies that commercial banks should extend loans on their own responsibility and that nobody has a right to intervene. However, questions remain as to the actual implementation. Third, in a transition economy, it is crucial to level the playing field between for SOCBs and non-state-owned financial institutions and for SOEs and non-SOEs. The government has committed to eliminate all preferential lending by commercial banks in 1999. It is unclear how this will be implemented without the reform of governance structure. Equitization may be an option for SOCBs. Ha (p.9) mentions that some SOCBs will be equitized in the long run.

A sound governance structure surrounding financial institutions and SOEs can be established only by correcting the non-arm's length relationship between state-owned commercial banks and SOEs. Viet Nam expanded the transformation of SOE corporate structure to joint-stock corporations in 1998. Moreover, the government decided to sell up to 30% of equity capital in a number of SOEs to foreign investors in early 1999. The government has a plan to equitize a list of SOEs located mostly in the HCMC and Hanoi areas. However, the actual implementation of this plan is a big challenge. There seems to be general reluctance on the part of SOE executives because of their concern over losing such privileges as favorable tax treatments and easy access to bank loans and because of the lack of incentives. The SSC paper (contributed by the Vietnamese side) suggests a series of incentives, most of which are to provide the same privileges as SOEs enjoyed before equitization. This is tantamount to extending non-arm's length business transactions to the non-state sector. A market-oriented and internationally compatible approach to leveling a the playing field between SOEs and private firms should involve termination of SOE privileges. Moreover, equitization requires the settlement of bad debts which is also a challenge. Valuation of firms, on which the Ministry of Finance has the final say, is a very new and difficult task.

Questions still remain about how equitized firms are owned and behave. A World Bank paper states that equitized firms are still partially owned by the state and members of the local people's committee continue to have a say in management decisions. It also states that these firms still enjoy the benefits accorded SOEs (special treatment from state-owned banks and tax breaks). One solution under contemplation is to separate the policy loan function from SOCBs. The scope of policy banks needs to be clearly defined and their size should be limited so as not to crowd out commercial banks and to prevent their distorting effects on the financial system (World Bank). The Chinese experience shows that establishment of specialized banks alone cannot terminate the policy loan function of SOCBs. A more comprehensive reform is required.

It is often heard in Viet Nam that financial sector reform is much more advanced than reform in other sectors. However, it is difficult to see why it is possible, as the most crucial

problems in financial sector reform stem from problems involving other sectors such as SOEs.

F. Development of capital markets complementing the banking system

Since Viet Nam is a transition economy, the market-oriented banking system itself has had a very short history of development and capital markets need to be established from scratch. Moreover, because of Viet Nam's heritage of a planned economy, the general public is not familiar with securities markets (SSC, p.1), and there is a huge need to educate them.

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

Viet Nam needs to develop stock markets in order to absorb the stocks that will be issued for equitization of SOEs. Equitization is also absolutely necessary in order to establish the health of the banking system, which is the utmost priority. Since there are very few large firms eligible for listing in stock exchanges in Viet Nam, the stock markets will be very different from those in more advanced economies. It seems reasonable to expect that the stocks of most SOEs are not very attractive investment vehicles, as their operating efficiency is rather low and their size is small. Thus, Vietnamese stock markets will probably focus on relatively large and stable utility-type firms, which have investment value because of their natural monopoly position, and on SMEs. However, counter to economic logic, the current policy appears to keep those large stable firms from listing. It is likely that many smaller firms need to be equitized without listing on the stock market and it may be necessary to come up with innovative ideas by studying the experiences of other transitional economies. The banking system needs to focus more on providing financing for SMEs as equitization proceeds and it reduces its role in financing SOEs.

There are also obstacles to the development of bond markets. It is rightly recognized that bond markets should be developed initially by focusing on government bonds. One-year government bonds were issued under private placement. The Ministry of Finance is said to be planning a VND4,000 billion issue of National Treasury Bonds. Policies like this will contribute to the development of bond markets in Viet Nam. With regard to corporate bonds, large utilities can be candidates for issuers in the initial period. Preferential loans to SOEs are said to restrict the development of corporate bond markets by lowering the incentive for these firms to issue bonds. The policy option of leveling the playing field for competition between loan financing and bond financing requires the termination or restriction of preferential lending to SOEs.

The development of infrastructure for securities trading is a daunting task. Establishment of securities trading centers faces difficulties in securing capital, technologies, know-how,

and trained professional staff. The preparation of securities laws with foreign assistance is probably easier, but it will be a major challenge to establish supervisory agencies staffed with trained personnel to enforce. It is also difficult to establish enough securities trading firms with sufficient expertise. Foreign assistance may play a role in these areas.

G. Need for an improved efficiency of financial institutions

Apart from the resolution of bad debt problems, the generation of a regulatory and governance structure that is conducive to independent commercial decision-making by financial institutions is necessary to improve their efficiency and international competitiveness. In a market economy, competition is the key for improved efficiency and competitiveness. Allowing entry of more foreign financial institutions is a policy option to improve efficiency and raise the international competitiveness of Vietnamese financial institutions. A level playing field should be established between SOCBs and non-state-owned banks. As yet, foreign financial institutions have played a limited role in training, and there is scope for them to take on a much greater role in this area with an expanded presence. They can bring in sorely needed expertise and generate demonstration effects. However, there are some obstacles to a larger presence of foreign financial institutions such as the lack of transparency and the restrictions on taking dong deposits. On the other hand, too rapid entry of foreign financial institutions may pose too severe a competitive threat to domestic financial institutions and undermine financial stability. Policy on entry of foreign institutions should be designed to ensure that it occurs in a controlled manner.

There is also a need for massive training of bank employees. The Vietnamese side, as discussed in Huong's paper, emphasizes the country's lack of technology. However, the introduction of new technologies will not be effective unless it is accompanied by improved management and governance structure.

H. Cautious approach to capital liberalization

Viet Nam should maintain a cautious approach to capital liberalization other than FDI.

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TABLE 1

Rates of Domestic Savings and Capital Formation in East Asia, 1980-1997

Percent of GDP

	Domestic Savings Rate			Rate of Capital Formation		
	1980	1990	1997	1980	1990	1997
China	34.1	38.7	41.4	35.2	34.7	39.2
Hong Kong	33.5	36.6	30.6	35.4	27.1	34.5
Indonesia	29.2	32.3	31.0	20.9	30.7	31.6
Japan	18.3	18.9	15.7	31.6	31.7	29.7
Korea	23.8	36.2	35.2	31.7	36.9	35.0
Malaysia	32.9	33.4	44.4	30.4	31.2	42.8
Philippines	26.6	18.7	15.5	29.1	24.2	25.0
Singapore	38.8	45.6	50.0	46.3	36.0	37.4
Taipei	32.6	28.1	24.9	33.8	23.1	22.2
Thailand	22.3	34.0	34.9	29.1	41.4	35.0

Notes: Latest data for China are 1996.
Source: Asia Development Bank. Statistical Database System. Regional Tables. Table 15. http://internotes.asiandevbank.org/notes/regional/rt15ki98.htm. Japan figures calculated from OECD *Quarterly National Accounts.*, various issues.

TABLE 2

Net Capital Inflows to Selected East Asian Economies, 1980-1997

US$ millions

	1980	1985	1990	1995	1996	1997
Thailand						
Official Transfers	141	119	187	42	30	14
Direct investment	187	159	2,402	1,169	1,455	2,354
Portfolio investment	96	141	457	3,485	4,351	4,451
Other long-term capital	1,824	1,326	793	3,718	5,935	2,625
Other short-term capital	-64	227	4,489	2,310	2,760	-9,306
Deposit Money Banks	N/A	-533	1,603	11,239	5,003	-5,340
Net errors and omissions	-180	133	1,182	-1,479	-2,985	235
Malaysia						
Official transfers	23	40	51	N/A	N/A	N/A
Direct investment	935	695	2,332	6,632[a]	5,377[a]	6,649[a]
Portfolio investment	-11	335	-1,048[b]			
Other long-term capital	489	673				
Other short-term capital	414	350	501	1,010	4,101	-5,058
Net errors and omissions	-682	-148	1,115	-686	-2,125	
Philippines						
Official transfers	134	207	357	449	399	378e
Direct investment	-2	49	528	1,361	1,338	1,117e
Portfolio investment	-100	-32	-48	248	2,142	-1,027e
Other long-term capital	1,032	2,787	674	1,276	2,841	4,688e
Other short-term capital	324	-1,731	19	-56	540	495e
Net errors and omissions	140	1,110	480	358	-3,210	-5,629e
Indonesia						
Official transfers	201	27	252	330	141	109
Direct investment	180	310	1,903	3,742	5,594	4,525
Portfolio investment	46	-35	-93	4,100	5,005	-2,509
Other long-term capital	1,927	1,605	3,724	2,298	190	1,267
Other short-term capital	-820	-98	-229	117	58	76
Net errors and omissions	-1,738	651	744	-2310	1264	-2091
Korea						
Direct investment	-20	-358	-263	-1,776	-2,345	-1,948
Portfolio investment	134	1,737	84	11,591	15,185	14,763
Other investments	6,405	345	3,075	7,459	11,085	-6,789
Net errors and omissions	-369	-878	-1,747	-1,233	1,067	-8,739

Notes: [a] Includes portfolio and other long-term capital from 1995 on. [b] Includes other long-term capital. e designates estimate.

Source: Economics and Development Resource Center. Asian Development Bank. *Key Indicators of Developing Asian and Pacific Countries 1998.* Vol. XXIX. Manila: Oxford University Press.

TABLE 3

Ratio of M2 to GDP in East Asia, 1980-1997

	1980	1985	1990	1993	1994	1995	1996	1997
Hong Kong	0.69	1.47	2.05	1.97	1.97	2.12	2.12	2.07
Indonesia	0.16	0.24	0.40	0.44	0.46	0.49	0.54	0.57
Japan	0.95	0.96	1.15	1.09	1.11	1.14	1.12	1.14
Korea	0.32	0.35	0.38	0.42	0.44	0.44	0.46	0.48
Malaysia	0.53	0.65	0.73	0.85	0.84	0.91	0.96	1.05
Philippines	0.23	0.22	0.28	0.32	0.36	0.40	0.40	0.43
Singapore	0.64	0.52	0.91	0.87	0.87	0.84	0.86	0.86
Taiwan	0.64	1.06	1.45	1.73	1.84	1.86	1.87	1.86
Thailand	0.38	0.56	0.70	0.79	0.78	0.79	0.81	0.90

Source: Calculated by Nomura Research Institute based on Economics and Development Resource Center, Asian Development Bank. *Key Indicators of Developing Asian and Pacific Countries 1998.* Vol. XXIX. Manila: Oxford University Press. Japan data from International Monetary Fund, *International Financial Statistics Yearbook 1998.*

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