Study on the Economic Development Policy in The Transition toward a Market-Oriented Economy in The Socialist Republic of Viet Nam (Phase 3)

Final Report

Vol. 3 Fiscal and Monetary Policy

March 2001

Ministry of Planning and Investment
The Socialist Republic of Viet Nam

Japan International
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Foreword

This study entitled "Study on the Economic Development Policy in the Transition toward a Market-Oriented Economy in Viet Nam (Phase 3)" was conducted within the framework of the technical cooperation program of the Government of Japan, in response to the request from the Government of the Socialist Republic of Viet Nam.

This study was carried out as a joint research by professionals specializing in economic policy from both Japan and Viet Nam. The research groups headed by Shigeru Ishikawa, Professor Emeritus of Hitotsubashi University for the Japanese side, and by Dr. Nguyen Quang Thai, Vice president, Development Strategy Institute, Ministry of Planning and Investment, for the Vietnamese side were set up in each country, assisted by consultant teams from leading institutes in both countries.

The research groups and consultant teams held a series of discussions, and conducted several field surveys. This report was prepared jointly by Japanese and Vietnamese research groups based on a mutual understanding.

I hope that the useful suggestions presented in this report will contribute to the formulation of policies for economic transition and sustainable development of Viet Nam, and it would be my great pleasure if the report would be used practically by concerned organizations, officials and experts.

I wish to express my sincere appreciation to Professor Ishikawa, Dr. Thai and each research member for their close cooperation extended to the study, and to the officials concerned for their valuable opinions.

March 2001

Kunihiko SAITO
President
Japan International Cooperation Agency

Preface

The joint Viet Nam Japan Project of the Study on Economic Development Policy in the Transition toward a Market-oriented Economy in the Socialist Republic of Viet Nam, which we called in short Joint Vietnamese-Japanese Research (JVJR), has just terminated its 6-year activities of an undertaking for "intellectual cooperation" with the aim of advising various issues in designing and implementing the Five-year Social-Economic Plans in Viet Nam. JVJR was agreed upon in the consultations between the Governments of Japan and Viet Nam in 1994 and 1995 and was inaugurated in August 1995. The project was formally implemented under the Japan International Cooperation Agency (JICA)'s Social Development Studies Program as well as Technical Assistance Program.

Under the agreement, the research was to be conducted jointly by Japanese and Vietnamese study groups each consisting respectively of an average 20 academic scholars and high-ranking experts of a similar number.[1] Japanese study group was supported by professional consultants. In fact, these research members were regrouped into a small number of Study Group organized by different academic disciplines, and the joint studies were carried on mainly through these Study Groups. Moreover, the whole studies were conducted in three Phases and one Follow-up, and the Study Groups were specified for each Phase or Follow-up.

Below, the names of the Study Groups with their main study topics are shown according to this phasing.

Phase 1 (August 1995 - June 1996)

Main topic: Issues relating to the draft documents about the 6th Five-Year Plan

(1) Macro-economy Group

(2) Fiscal and Monetary Group

(3) Industrial Policy Group

(4) Agricultural and Rural Development Group

Phase 2 (July 1996 - March 1998)

Main topic: Issues relating to the participation to AFTA/APEC/WTO, and Industrial policy

(1) Agricultural and Rural Development Group

(2) Participation for AFTA/APEC/WTO and Industrial Policy Group

(3) Fiscal and Monetary Policy Group

(4) State Enterprise Reform Group

[1] By the end of Phase 2, the Vietnamese-side members of JVJR Study Group consisted solely of the high-level officials and experts of Ministry of Planning and Investment, but thereafter the high-level officials and experts of other Ministries: Ministry of Finance, State Bank of Viet Nam, Ministry of Trade, Ministry of Industry, and Ministry of Agriculture and Rural Development and Ministry of Labor, War Invalids and Social Affairs were permitted to participate in the JVJR Study Group as fullfledged members.

Follow-up Phase (July 1998 - July 1999)

Main topic: Issues arising from the impacts of the East Asian Economic Crises on the Vietnamese economy

(1) General Commentary Group

(2) Industry and Trade Group

(3) Fiscal and Monetary Matters Group

(4) Agricultural and Rural Development Group

Phase 3 (September 1999 - March 2001)

Main topic: Issues relating to the draft documents about the 7th Five-Year Plan

(1) General Commentary Group

(2) Trade and Industry Group

(3) Fiscal and Financial Reform Group

(4) Agricultural and Rural Development Group

(5) State-owned Enterprise Reform and Private Sector Promotion Group

While conducting these studies, we held a large number of workshop either on the Study Group level or the overall project level, and either in Tokyo or Hanoi. Workshop on overall project level numbered 12.[2]

The results of these studies and the policy options derived therefrom were published in official reports jointly by JICA and MPI.[3] In addition, we have attempted the commercial publication of a book on overall results of JVJR at the stage of the Phase 2 end.[4]

In retrospect, JVJR started at the period of Vietnamese economic development in which long years of Indo-Chinese War ended and the recovery from war-torn productive facilities and economic system minimumly completed, and therefore, it became possible for the government to think over Vietnamese economic development plans from a long-term perspective. We recognized on the other hand, that the Vietnamese economy was still at the embryonic stage of industrialization and market economy development. Hence, the

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[2] Phase 1

Hanoi Preparatory Meeting (May 29, 1995); First Hanoi Workshop (August 28-29, 1995); Consultations on the work plan for joint research (November 27-28, 1995, Tokyo); Tokyo Workshop (January 28-29, 1996); Second Hanoi Workshop (March 1-2, 1996)

Phase 2

Tokyo Workshop (March 22-23, 1997); Consultations on the progress of joint research and announcement of results (May 22-23, 1997, Tokyo); Hanoi Workshop (June 6-7, 1997);

Follow-up

Hanoi Workshop (July 20-21, 1999)

Phase 3

Tokyo Preliminary Meeting (May 30-31, 2000); Tokyo Workshop (July 26-27, 2000); Hanoi Workshop (December 8-9, 2000) challenging task before us was, in a sense, how to combine the existing theories of development and other disciplines with the practical knowledge of the Vietnamese economy to obtain the really useful prescriptions for triggering the development process in such an early-stage developing country. In the more-recent years when Vietnamese economy encountered a series of difficult issues from the international economic aspects, the task was again quite new and challenging. It was to discover for a country of embryonic industrializations those development policies that enable her to industrialize herself without resorting to conventional policy of "infant-industry protection."

The results of the study have not yet been very satisfactory. But the progress achieved in the method of the joint study has been satisfactory in that the relationship of mutual trust between the Vietnamese and Japanese study groups and among all research members, and even deep friendship, have begun to take root while tackling with these challenging tasks jointly. We both sides believe this mutual trust and friendship would continue to alive even after this round of the joint research ended.

The Japanese side members of JVJR feel extremely fortunate that throughout these six years they have been given many opportunities to meet with the former Secretary General Do Moui, the present Secretary-General Le Kha Phieu and other Vietnamese leaders and seek their opinions. These opportunities were

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[3] Phase 1

MPI/JICA(1996): *Opinions of the Five-Year Plan for Social and Economic Development 1996-2000 in Viet Nam: Vol.1 General Comments*, JICA, Tokyo.

MPI/JICA(1996): *Opinions of the Five-Year Plan for Social and Economic Development 1996-2000 in Viet Nam: Vol.2 Macro Economy*, JICA, Tokyo.

MPI/JICA(1996): *Opinions of the Five-Year Plan for Social and Economic Development 1996-2000 in Viet Nam: Vol.3 Fiscal and Monetary Policy*, JICA, Tokyo.

MPI/JICA(1996): *Opinions of the Five-Year Plan for Social and Economic Development 1996-2000 in Viet Nam: Vol.4 Industrial Policy*, JICA, Tokyo.

MPI/JICA(1996): *Opinions of the Five-Year Plan for Social and Economic Development 1996-2000 in Viet Nam: Vol.5 Agricultural and Rural Development*, JICA, Tokyo.

Phase 2

MPI/JICA(1998): *Study on the Economic Development Policy in the Transition Toward a Market-Oriented Economy in Viet Nam. Vo.1. General Comments/Agricultural and Rural Development*, JICA, Tokyo.

MPI/JICA(1998): *Study on the Economic Development Policy in the Transition Toward a Market-Oriented Economy in Viet Nam. Vol.2. Participation in AFTA /APEC/WTO and Industrial Policy*, JICA, Tokyo.

MPI/JICA(1998): *Study on the Economic Development Policy in the Transition Toward a Market-Oriented Economy in Viet Nam. Vol.3. Fiscal and Monetary Policy*, JICA, Tokyo.

MPI/JICA(1998): *Study on the Economic Development Policy in the Transition Toward a Market-Oriented Economy in Viet Nam. Vol.4. State Enterprise Reform*, JICA Tokyo.

Follow-up

MPI/JICA(1999): *General Commentary / Industry and Trade*, JICA, Tokyo.

MPI/JICA(1999): *Financial and Monetary Matters*, JICA, Tokyo.

MPI/JICA(1999): *Agricultural and Rural Development*, JICA, Tokyo.

[4] Ishikawa Shigeru and Hara Yonosuke (1999): *Viet Nam no Shijo Keizai ka* (Marketization of the Vietnamese Economy), Toyo Keizai Shinpo-sha, Tokyo.

instrumental in bringing depth and strength to our study and findings.

The Vietnamese side members of the project express sincere thanks to JICA and its Viet Nam Office for supporting its research activities particularly in Japan.

This Final Report is submitted herewith to the leaders of Viet Nam Government as well as to other government agencies concerned. Also, we shall be presenting it to the interested parties in order to seek comments and opinions that would be useful for the possible future joint Vietnamese Japanese Research along the similar lines of the present work.

In addition, we have presented an Executive Summary in March 2001. This was prepared even before the Final Report, as it was required that the research outcome of Phase 3 could be available even briefly before the 9th National Party Congress. It is hoped that this Executive Summary will also be referred to by the readers.

March 31, 2001, Hanoi/Tokyo

Thai

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Acronyms & Abbreviations

ADB:	Asian Development Bank
AFTA:	ASEAN Free Trade Area
AICO:	ASEAN Industrial Cooperation
APEC:	Asia-Pacific Economic Cooperation
ASEAN:	Association of South East Asian Nations
CEPT:	Common Effective Preferential Tariff
CGE:	Computable General Equilibrium
CIEM:	Central Institute for Economic Management
CIS:	Commonwealth of Independent States
CKD:	Completely Knocked Down
CMT:	Cut, Make and Trim
CONCETTI:	Consulting and Research Company for Technology Transfer and Investment
CPI:	Consumer Price Index
DSI:	Development Strategy Institute
EAF:	Electrical Arc Furnaces
FDI:	Foreign Direct Investment
FOB:	Free on Board
FYP:	Five-Year Plan
GC:	General Corporation
GDP:	Gross Domestic Product
GRIPS:	National Graduate Institute for Policy Studies
GSO:	General Statistics Office
HNU:	Viet Nam National University, Hanoi
ICT:	Information and Communication Technology
IMF:	International Monetary Fund
IT:	Information Technology
JICA:	Japan International Cooperation Agency
JVJR :	Joint Vietnamese-Japanese Research (officially "the Study on the Economic Development Policy in the Transition toward a Market-oriented Economy in the Socialist Republic of Viet Nam")
LLDC:	Least Less Developing Country
MARD:	Ministry of Agriculture and Rural Development
MITI:	Ministry of International Trade and Industry (currently "the Ministry of Economy, Trade and Industry")

MNC:	Multi-National Corporation
MOF:	Ministry of Finance
MOI:	Ministry of Industry
MOSTE:	Ministry of Science, Technology and Environment
MOT:	Ministry of Trade
MPI:	Ministry of Planning and Investment
NEU:	National Economic University
NISTPASS:	National Institute for Science and Technology Policy and Strategy Studies
NPL:	Non-Performing Loan
NTB:	Non-Tariff Barrier
ODA:	Official Development Assistance
OOG:	Office of Government
PCF:	People's Credit Fund
PE:	Polyethylene
PP:	Polypropylene
PPH:	National Political Publish House
PRSP:	Poverty Reduction Strategy Papers
PVC:	Polyvinyl Chloride
SBV :	State Bank of Viet Nam
SI:	Supporting Industry
SME:	Small and Medium Enterprise
SOCB:	State-Owned Commercial Bank
SOE:	State-Owned Enterprise
SSC:	Southern Steel Corporation
SSC:	State Securities Committee
TISCO:	Thai Nguyen Iron and Steel Corporation
TVE:	Township and Village Enterprise
UNDP:	United Nations Development Programme
VASI:	Viet Nam Agricultural Science Institute
VAT:	Value-Added Tax
VBA:	Viet Nam Bank for Agriculture and Rural Development
VBP:	Viet Nam Bank for Poor
VNCC:	Viet Nam Cement Corporation
VSC:	Viet Nam Steel Corporation
WEI:	World Economic Institute
WTO:	World Trade Organization

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Chapter 1 Reforms of the Monetary/Financial System and the Fiscal Management

1 − 1

An Overview of the Financial System and Monetary Policy in Viet Nam

Akiyoshi Horiuchi

University of Tokyo

Shinichi Watanabe

International University of Japan

The Vietnamese economy suffered from a sharp economic downturn in 1998 and 1999. The real growth rate dropped from 8.2 % per year in 1997 to 5.5% per year in 1998, and further declined to 4.7 % in 1999. It recovered to 6.7% in 2000 but is expected to remain below 7%, a couple of points lower than the average growth rate before 1997. The annual inflation rate in terms of CPI reached almost 10% in 1998 but was stabilized quickly by active monetary policy to 0.1% in 1999 after consecutive months of deflation from March 1999 to October 1999. The trend of deflation continued and the price declined further by 0.6% in 2000. The Asian economic crisis that erupted in the middle 1997 certainly accounts for a significant part of the economic decline in Viet Nam. Slowdowns in exports to South East Asian countries exerted negative influence on Viet Nam's economic growth. Decreases in FDI to Viet Nam lowered domestic capital formation.

However, the Asian economic crisis cannot explain the whole of the economic stagnation that Viet Nam experienced in 1998 and 1999, the continued deflationary pressure and the significant increase in the risk and uncertainty of its future growth prospect. Another possibly more important factor for the uncertainty is the fragility of the financial system that was already visible in Viet Nam before the Asian economic crisis. The amount of non-performing loans (NPLs) did increase sharply in 1997. But the ratio of NPLs per total loans for the banking sector had already reached a serious level in 1995. It was 7.9% and 9.3% per total loans in 1995 and in 1996 respectively, and then jumped to 12.3% in 1997.[1] In particular, the fragility of the joint stock banks was very serious.

The fact that the performance of the banking sector was worsening before the Asian economic crisis suggests that the weakness of the financial system is deeply rooted in the weakness of the economic system of Viet Nam and that it would have surfaced sooner or later even without the Asian crisis in 1997.

The worst time of the Asian crisis was over. Although some countries (including Japan) are still suffering from the aftermath of the crisis, many have recovered from the worst situations. Nevertheless, all the countries including Viet Nam are still coping with the task of building up efficient financial mechanisms that are robust

[1] Masahisa Koyama and Toshiyuki Katagiri, "Achievement of financial system reform and issues of non-performing loans."

to external shocks.

This paper addresses this fundamental issue from a few different perspectives which Vietnamese colleagues present in their research papers. In the first half of this paper, from section 1 to 3, we discuss how dangerous the *ad hoc* policy measures the Vietnamese government has (perhaps temporally) adopted in order to help the banking and SOE's sectors overcome their financial difficulties. In section 4, we shortly comment on the difficulty of implementing active monetary policy for the SBV when it pursues two conflicting policy goals at the same time. We take up the issues concerning the development of securities markets in section 5. In section 6 and 7, we discuss the limitations and risks of the SOE-led industrialization process and emphasize the importance of interactions among SOE reforms, development of the private sector and establishing an efficient and stable financial system in Viet Nam.

Then, in the second half of this paper, we investigate the tension between developing countries' domestic financial systems and global capital mobility, which is widely believed to be an important cause of financial instability revealed in Asian countries in 1997. We agree with the conventional view that the rapid capital inflow into developing countries is destabilizing. We point out that distortions in the domestic financial system induce rapid capital inflows and that the distortions may provide the rationale of capital control policy in developing country. However, in the end of this paper, we argue that in some cases free capital movement would be instrumental in promoting efficient financial inter-mediation in developing countries and that Viet Nam needs to examine various options how to benefit most from free capital flows.

1. *Ad Hoc* measures to deal with fragile SOEs

Since 1997, the Vietnamese government adopted *ad hoc* measures to mitigate the financial difficulty of the sector of state enterprises. The purpose of those measures was to bail out state owned enterprises (SOEs) whose debt soured.[2] If the SOE's managerial difficulty were solely due to the unanticipated shocks caused by the 1997 Asian crisis, the *ad hoc* policy would be justifiable. Happenings that were not anticipated when reform plans were introduced would force the government to modify time-schedules of the reforms. The hardships brought forth by the happenings might lead to economic and even political instability in the transiting countries without more or less modification of reform implementation. If the occurrence of unexpected events is likely to destroy the basis of reform plans, the government should delay the speed of the reform to regain the stability of the economy.

As has already been explained, however, the inefficiency of SOE's management had already existed before 1997. Probably the Asian crisis was not a true cause of SOE's managerial difficulties in Viet Nam. It just revealed the potential fragility of the SOE sector.[3] Thus, the reforms of SOEs' management have been half-finished. If these *ad hoc* measures are maintained for a long time, they would make the direction of the reform

[2] Nguyen Ngoc Bao, "*Ad hoc* measures to deal with the banking debts."

plans diverge from the original objective: i.e., the objective of transforming the economy of Viet Nam to a market based economy.

We should recognize that some *ad hoc* measures are effective either in strengthening Viet Nam's financial system or stabilizing functions of its financial markets. For example, the government's decision to supplement registered capital to SOCBs at September 1998 was rational from the long-term viewpoints of enhancing financial capacity of the banking sector.[4] As we will discuss in section 8 of this paper, the policy introduced in 1996 in order to control banks' activities related to the deferred letter of credits (L/Cs) was also effective in protecting the domestic financial system from financial shocks from abroad. However, generally speaking, the *ad hoc* policy measures adopted by the government seem counter-productive in the sense that they will seriously undermine the Vietnamese ability of transferring its economy to a market-based one.

One of the problematic *ad hoc* policy measures was to require the commercial banks to be lenient with borrowers. For example, SOEs have been allowed to borrow without collateral. The limit of borrowing imposed on SOEs in terms of their charter capital was removed. SOE were allowed to transform their short-term borrowings into long-term ones. Some SOEs have enjoyed debt relief. These measures have helped inefficient SOEs continue their operations regardless of their bad performance.[5] It implies a policy of "the soft budget constraint," which undermines SOE's incentives for efficient management. The countries transiting from a central planning to a market-based system must eliminate features of the soft budget constraint in order to attain a successful transition.

In his interesting and valuable paper, Mr. Ngyen Ngoc Bao discusses the benefits of the *ad hoc* measure that allows SOEs to borrow from SOCBs without collateral and without limitation by their charter capital.[6] He concludes that this policy is productive in the sense that the measure obliges SOCBs to monitor borrower SOEs more precisely. His conclusion is based on the presumption that the existence of collateral decreases banks' incentives to carefully examine and monitor borrower firms' quality.

His argument could be persuasive if the SOCBs were sufficiently equipped with monitoring capacity, which would be instrumental in avoiding bad loans related to SOEs. However, the recent increase in commercial banks' bad loans suggests that the banks have not yet fully developed capacity of monitoring and that the reliable information on financial states of borrowing firms are quite limited. Mr. Bao himself admits the shortcoming of the *ad hoc* measures:

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[3] The government's decision at August 1996 to allow banks to restructure the debt of some important SOEs suggests that the magerial fragility of the SOE sector was recognized before the 1997 Asian crisis. Tran Van Son claims that the managerial difficulties of the SOEs such as weak management, cumbersome organization, limited capital, and outdated technology had already existed for a long time before the Asian crisis.

[4] Tran Van Son, "Positive and negative effects of the measures on financial situations of state-owned enterprises."

[5] Debt relief is highly concentrated on a small number of SOEs. Watanabe Shinichi, "Debt concentration among SOEs and their leverage ratios."

[6] See also Tran Van Son, "Positive and negative effects of the measures on financial situations of state-owned enterprises."

These measures cause SOEs and farmers to depend on bank loans when they meet the difficulty in doing business due to objectives reasons. On the side of SOCBs, because lending conditions and procedures are made easy, they lack caution when they evaluate the risk of loans to farmers and SOEs. This makes the credit risk tend to increase.

We should note that the collateral is instrumental in mitigating asymmetric information between banks and borrower firms. For example, banks could utilize the collateral system to differentiate good borrowers from bad ones under the asymmetric information.[7] The policy of removing collateral from bank lending process is, thus, counter-productive in the sense that the policy deprives banks of an instrument usable in practical credit businesses. Obviously the *ad hoc* measure suggests the retrogression of the prudential regulation that is indispensable to financial stability. We are concerned that the retrogression will hihnder the accumulation of intermediation capacity in the banking sector if it is kept in place for a long time. Moreover, the policy measure intensifies political influence in the process of financial intermediation because the *ad hoc* measure allows leaders of ministries or provincial people committees to approve efficiency and feasibility of the SOEs that are to be financially bailed out.[8] The intervention of politicians into financial allocation processes is fundamentally inconsistent with the objective of establishing the market-oriented financial system.

Furthermore, the *ad hoc* policy in itself could disseminate the misleading signal that the government will keep adopting the similar policy measures to rescue inefficient firms in the future. This signal would be a serious hindrance to the Vietnamese policy of transferring to a market economy. Thus, the *ad hoc* policy is inconsistent with the objective of establishing a robust market economy in Viet Nam. The government should not keep the *ad hoc* policy for a long time. Or the government should add some policy measures to discipline SOEs for efficient management.

2. Difficulties of expanding private enterprises

In order to enhance the function of the market mechanism in Viet Nam, the inefficiently managed SOEs should be liquidated, releasing both human and non-human resources held by them to private enterprises. The government commitment to liquidate inefficiently managed SOEs would be effective in disciplining those enterprises for efficient management. On the other hand, the government needs to prepare some enterprises, i.e., private ones, that can absorb labor and other resources dismissed from SOEs in order to make the commitment credible. Private enterprises would be required to absorb resources, particularly labor forces, freed from liquidated SOEs. The success of the Viet Nam's transition to a market economy hinges on how smoothly private enterprises will be able to take over the SOEs. Without the preparation of private enterprises taking over inefficient SOEs, the government is politically unable to make the commitment to

[7] For example, see Bester, H., "Screening vs. rationing in credit markets with imperfect information," *American Economic Review* 57 (1985), 850-855.

[8] See Tran Van Son, ibid.

expel inefficient SOEs credible. Lack of the credible commitment hinders the government from disciplining SOEs for efficient management. Thus, the development of non-state enterprises is in itself important for the economy transiting to a market-oriented economy.

There are some institutional reasons that make it difficult for private enterprises to gain access to credit. Ms. Hguyen Thi Hong provides a careful overview of the difficulty which banks and private enterprises have to overcome in order to creat reliable credit relationships between them.[9] Besides their capital being small, most private enterprises were established only recently and their business is risky and quite unstable. Furthermore they cannot supply credible financial statements on the financial conditions of their business. It is also extremely difficult and costly for private enterprises to obtain legal documents such as certificates of land use rights or asset ownership that can be used as collateral for bank loans. In order to get the necessary legal documents, they not only have to go through a number of cumbersome bureaucratic procedures but also "have to pay a lot of fee that costs about 25% of total real estate value."[10]

The limited access to bank credits caused by complicated administrative procedures and high transactions costs creates a number of opportunities for bankers, private enterprises and government officials to earn hidden rents or profits. If they collude successfully, they can gain substantial profits to share among themselves by circumventing costly procedures and requirements. The scandal of Minh Phung and EPCO is a vivid testament of the existence of such rent seeking opportunities created by high transactions costs (including institutional barriers) for financial inter-mediation.

In a very comprehensive and thoughtful paper that analyses the changes in domestic investment, Dr. Le Viet Duc, Dr. Ha Xuan Tu and Dr. Le Quoc Ly find that the amount of private sector investment remained flat at around VND20.0 trillion in current prices since 1995.[11] This is in sharp contrast with the change of the investment financed by the government budget, which increased from VND13.6 trillion in 1995 to VND 20.6 trillion in 1997, exceeding the level of the private sector investment. Stagnation of the private sector investment can be seen more clearly in the change of the ratio of investment of the private sector to total domestic investment: it declined continuously from 29.4% in 1995 to 20.7% in 1997. Dr. Duc et al. Observe:

> Despite a lot of improvement in policies and mechanism for capital mobilization from the private sector, private investors have been facing difficulties regarding environment for production and trade, import and export activities, credit terms, market information and transparency. Difficulties facing the agricultural sector as well as the non-agricultural private sector are normally related to legal framework, land use right, incentives for investment in unfavorable areas, direct access to foreign market for inputs and out puts.

These observations indicate strongly that the institutional development of Viet Nam toward a market based economy has not yet succeeded in creating an environment that supports the private sectors' growth. In this

[9] Nguyen Thi Hong, "Flow of funds between the banking system and enterprises in Viet Nam 1995 –1999."

[10] Nguyen Thi Hong, ibid.

[11] Le Viet Duc, Ha Xuan Tu and Le Quoc Ly, "Overview of investment situation and policy in Viet Nam in the 1990s."

regard, we are concerned about negative influences of the *ad hoc* policy measures on the private sectors. As Dr. Nguyen Ngoc Bao suggests, the *ad hoc* measures are mainly directed to the purpose of rescuing the SOCBs and the SOEs in financial distress.[12] The measures do not create a "fair playing field" for all banks and enterprises, particularly for joint-stock banks and private enterprises.

3. Danger of financial repression

It is a conventional view that developing countries should avoid policy to repress financial system. The financial repression, which implies an effective taxation imposed on activities of intermediating in the financial system, will reduce the capacity of banks and other financial intermediaries to efficiently supply financial services.[13] The repressed financial system is an obstacle to development of the market economy. A typical policy of the financial repression is to impose ceilings on lending interest rates, because it undermines profitability of banks' lending business.

The government of Viet Nam has adopted the policy of imposing ceilings on lending interest rates. Since 1996, the interest rate on bank deposit has been liberalized, but the State Bank of Viet Nam has stipulated the ceiling on the lending rate for commercial banks. In particular, the government reduced the ceilings on lending rates in rapid succession in order to counter with the recession since the beginning of 1999. Thus, the "commercial banks only earned a margin of 0.35% per month, including fees, taxes and interests."[14]

Since August 2000, the Sate Bank changed the regime of interest rate control from the ceiling system to the basic interest rate system where commercial banks can determine lending interest rates based on the basic rate stipulated by the Sate Bank. However, under the new regime, the State Bank continues to stipulate the maximum margin that commercial banks are allowed to add to the basic rate. Thus, there remains a feature of financial repression in the system of basic interest rate management. Mr. Nguyen Ngoc Bao points out low profitability of the Vietnamese banking sector: "the reason of low profitability is mainly due to low quality of credit, which is further attributable to low productivity, backward technology, weak management, and the practice of mixing commercial credit and directed credit."

The government's policy to rescue SOEs in financial distress seems to have exerted negative influence on banks' profitability. As Tran Van Son argues, "most of the frozen debts were exempted from interest payments in waiting time for complete treatment while banks had to mobilize fund sources from people and of course they had to pay interests. That means the income of banks fell."[15] If the banking system with autonomous capacity to decide credit allocation is to be established in Veit Nam, the government should refrain from

[12] Nguyen Ngoc Bao, ibid.

[13] McKinnon, Ronald, *Money, and Capital in Economic Development*, The Brookings Institute 1973, and Shaw, Edward S., *Financial Deepening in Economic Development*, Oxford University Press 1973.

[14] See Nguyen Thus Ha, "Money supply control by the State Bank".

[15] Tran Van Son, ibid.

imposing burden associated with the policy of bailing out inefficient SOEs on commercial banks. The national budget should bear the costs. It is important to demarcate commercial banks' role of credit allocation from the function of the public policy implemented by the government.

As Hellman et al. (1997) argue, the policy of restricting full-scale competition in the financial system, and thereby of conferring excess profits on existing financial institutions, particularly banks, would give them incentives for prudential management.[16] The financial institutions would be motivated for efficient risk management in order not to loose excess profit opportunities created by restricted competition. Hellman et al. (1997) call the policy of conferring excess profits on banks and other financial institutions as the policy of financial restraint to differentiate it from the financial repression. It is controversial whether or not the financial restraint policy is effective in enhancing the capacity of financial intermediaries as Hellman et al. (1997) claim.[17] But the SBV should avoid the regime of interest rate control that is likely to make the banking sector more fragile than otherwise by reducing bank profits.

Some may argue that deregulation of lending rates is dangerous because it would cause reckless lending competition and induce banks to take excessive risk.[18] Their argument seems corresponding to what Hellman et al. (1997) claim. However, banks could take excessive risk even under the regime of ceilings on lending interest rates. The rather serious non-performing loan problem in the banking sector suggests that this actually happened in Viet Nam during the last decade.

If the control on interest rates is effective, it is a *de facto* taxation on the banking business, and should be regarded as a policy of financial repression. On the other hand, if the ceiling on lending rate is sufficiently high so that the control does not give any pressures on profitability of commercial banks, then there is no reason for the government to keep this policy. The Vietnamese government should reconsider the regime of interest rate control as soon as possible.

Box 1 Is the "financial restraint" policy effective in enhancing inter-mediation capacity of the financial system?

It is not an easy issue for developing countries how to build up efficient financial systems. The efficient financial system should not only actively mobilize domestic saving and channeling it to capital formation, but also effectively monitor borrower firms and disciplining them for efficient management. In particular, it is

[16] Hellmann, Thomas F., Kevin C. Murdock, and Joseph E. Stiglitz, "Financial Restraint: Toward a New Paradigm," in M. Aoki, M. Okuno-Fujiwara, and H. Kim (eds.), *The Role of Government in East Asian Economic Development: Comparative Institutional Analysis*. Oxford: Clarendon 1997, pp. 163-207.

[17] As the authors recognize, this is not a sufficient condition for the efficient banking.

[18] See, for instance, Mr. Nguyen Thu Ha's paper.

widely conceived that banks can be important. The intimate relationship with borrower firms through loan contract is the great advantage to banks as monitors. Thus, some economists advocate developing countries to construct the bank-centered financial system.[19] But the bank-centered financial system would not be sufficient for developing countries to attain the efficient financial inter-mediation. Banks must be disciplined for efficient monitoring. How can we motivate banks to effectively monitor borrower firms? In practice, this is an important policy issue.

Hellman et al. (1997) give an answer to this issue. Their answer is that the government should protect banks from fierce competition in the financial system, and thereby giving them excess profits. The existence of excess profits will be effective in motivating banks to prudently monitor borrower firms because to shirk monitoring would increase bad loans for banks and would endanger their favorable status to enjoy excess profits. If they desire to stay the current position, they must be prudent in effectively monitor borrowers. This is an essence of the "financial restraint theory" advocated by Hellman and others. According to this theory, the regulation to suppress full-scale competition in the financial industry is productive to ensure efficient monitoring on the side of existing banks. Thus, the regulation of controlling new entry into the banking industry, for instance, is advisable because the regulation ensures excess profits to existing banks. This argument is in a sharp contrast to the neoclassical economics' view that denies positive effects from the counter-competition regulations.

Unfortunately, it is not an end of the story. It would be not so easy for the government to give a true motivation of efficiently monitoring borrowers to the banks that are heavily protected by counter-competition regulations as Hellman and other may suppose. The regulation to protect existing banks tends to weaken the market penalty imposed on inefficiently managed banks. Thus, in place of market competition, the government must stringently penalize inefficiently managed banks in order to attain banks' efficient monitoring. However, it is not easy to induce the government to play an effective monitor of bank management. For example, Hellman and others consider the Japan's experience after World War II as a successful example of the financial restraint. Japan appears to have achieved a remarkable economic development under the heavily regulated bank-centered financial system. The Japan's bank crisis occurred in the 1990s, however, throws doubt on validity of this argument. The Japanese government did not succeed in disciplining banks for efficient monitoring borrower firms under the policy of protecting existing banks.[20]

In short, in order for the financial restraint policy to be effective in enhancing inter-mediation capacity of banks, the government must be a truly stringent monitor that penalizes inefficiently managed banks in a credible way.

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[19] Aoki, Masahiko and Hugh Patrick (eds.), *The Japanese Main Bank System: Its Relevance for Developing and Transforming Economies*, Oxford University Press 1994.

[20] Hanazaki, Masaharu, and Akiyoshi Horiuchi, "Is Japan's Financial System Efficient?" *Oxford Review of Economic Policy* 16 (2), 2000, 61-73.

4. An issue of the SBV's monetary control

Ms. Nguyen Thu Ha provides us with an well-organized overview of the monetary control by the State Bank of Viet Nam.[21] Both Ms. Chu Hong Minh and Ms. Le Phuong Lan explain the recent development of the foreign exchange market and rationalization of policy instruments related to foreign exchange rate management.[22] According to Ms. Ha's paper, the SBV has succeeded in making the Vietnamese system of monetary control amenable to market mechanisms. Ms. Minh and Ms. Lan show how neatly the Vietnamese government has integrated the exchange rate policy into its macroeconomic policy framework. We appreciate the government's strategy of rationalizing the monetary policy framework. However, there seems remain a rather ambiguous idea of interest rate control as a monetary policy measure. In the following, we take up this point to criticize the current SBV's idea.

In the previous section, we discussed influence of the interest rates control on the financial mechanisms. In this section we investigate effectiveness of the interest rates control as a monetary policy instrument. Could control of ceilings on bank lending rates be an effective measure of monetary policy? The State Bank seems to believe that reduction in the ceiling rate will increase bank credit, stimulating capital investment by borrower firms. But, is there definite evidence to support this belief? Theoretically, reduction in lending rate ceilings is likely to stimulate "demand" for bank loans. However, it is uncertain whether commercial banks are stimulated to increase their credit "supply" when ceilings on lending rates are reduced. The reduction of lending rate ceilings would widen the excess demand for bank credit and make it more difficult for potential borrowers to get credits rather than make it easier. It remains ambiguous whether the reduction of lending rate ceilings will stimulate macroeconomic activities.

Ms. Nguyen Thu Ha describes how interest rates and bank reserves were controlled in 1999.[23] It illustrates the difficulty of choosing the right monetary policy under the condition of limited information, especially when the monetary authority pursues two mutually inconsistent goals.

Worrying the prospect of further acceleration of inflation, the SBV tried to tighten money supply by absorbing "excess reserve" from the banking sector by issuing 3-months SBV bill of VND 600 billion in January 1999. Having found that monthly inflation rate was quite high in February, the SBV decided to issue the SBV bills with the total value of VND 700 billions in April. The nature of the price process, however, had radically changed since March, that is, the price level began to decline in March. Ms. Ha says that "the SBV has shifted its policy from a "tightening" to a "prudent loosening" policy since the second quarter of 1999." The SBV cut the required reserve ratio in June and July to increase the money supply and to stop further deflation.

[21] Nguyen Thu Ha, ibid.

[22] Chu Hong Minh, "Foreign exchange and exchange rate management," and Le Phuong Lan, "The relationships between credit markets, foreign exchange markets, and securities markets."

[23] Nguyen Thu Ha, ibid.

On the other hand, when the SBV took the measure to tighten the money supply in January 1999, it reduced the ceiling on lending interest rates at the same time. While Ms. Ha argues that its purpose was "to push up economic growth" or "to stimulate investment demand," it was more likely to have reduced the availability of credits as is argued at the beginning of this section, especially when it was combined with monetary tightening. The SBV cut the ceilings on lending interest rates four times since March to the end of 1999. The actual effect of the SBV's policy was to ease the financial burden of troubled SOEs for interest payment and mitigated their cash flow problems temporarily. But it should have worsened the credit crunch against private firms and new borrowings.

The attempt to pursue two goals, controlling inflation and rescuing SOEs in financial troubles, might have weakened the working of the credit channel by reducing the availability of credits and resulted in the unexpectedly lengthy deflation process.

5. Development of securities markets

The Securities Trading Center (STC) started its operation in HCM City in June 2000. Developing an adequate legal and institutional foundations of its operation is crucial for its success as a center of capital markets in Viet Nam. Dr. Dao Le Minh provides an excellent survey of the evolution of the legal and regulatory framework for securities trading in Viet Nam.[24] The issuance of new securities to be traded in the STC is regulated by Decree No. 48/1998/ND-CP dated 11/7/1998. One of the most important mechanisms introduced by Decree No. 48 is the requirement of information disclosure. Regulations issued earlier for the issue of shares had no requirement for disclosing information on the financial states of issuers. Decree No. 48 has set the standard for information disclosure for the first time: what information must be provided to investors and how issuers can establish credibility of the information they provide. Reliable information on the financial states of business firms is extremely scarce in Viet Nam. Much of the financial information of each SOE has been enclosed within a group of its narrowly defined stake holders, such as managers, regulators and tax authorities. The development of the STC may be able to break such a state. Equitization of SOEs and trading their shares in the STC will create the demand for reliable financial information on the listed firms among investors and the supply will follow the demand as the condition is strengthened to enhance the credibility of the financial statements of issuers. If the STC functions as a public mechanism to evaluate the value of firms on rich financial information, it will be able to allocate capital more efficiently than the administrative mechanism of the State.

However, the actual development of the STC has been quite limited, which is not unexpected. In the first place private firms are all small and they do not satisfy the requirement for the listing at the STC. Establishing a legal framework for an OTC market will allow small joint stock companies to raise their funds by issuing

[24] Dao Le Minh, "Legal and regulatory framework of securities trading in Viet Nam."

shares and will help expand the basis for share transactions in general. In the second place the progress of equitization of SOEs has been quite limited and the number of listed shares has not increased. Various privileges of SOEs in comparison with private firms such as an easy access to bank credits and State credits have deterred even efficient SOEs from changing their legal status as SOEs. The solution to this problem is closely associated with the progress of eliminating the soft budget constraint of SOEs. Finally even equitized-SOEs eligible for the listing at the STC do not want their shares to be traded publicly at the STC, worrying the leakage of important managerial information to their competitors and the criticism of investors on their management. This problem is likely to disappear quickly, however, once the merit of listing their shares becomes clear for the growth of companies.

Box 2 Transactions at the Securities Trading Center (STC)

The shares of two firms (REE and Sacom) were traded in the first transaction at the STC in July 28, 2000. Two more firms (Hapaco and Transimex) were added to the list from August 4, 2000. A stark imbalance existed between supply and demand at the beginning and persisted for a long time. The number of shares ordered to buy and sell at the first three transactions were: 335,500 (buy) against 4,200 (sell) on July 28, 561,000 (buy) against 10,300 (sell) on July 31 and 461,800 (buy) against 300 (sell) on Auguest 2. This was largely attributable to the price ceiling and the bound of price change imposed by the State Securities Commission (SSC). The SSC worried about the fever at the beginning and the subsequent collapse of inflated prices.

Dr. Nguyen Son has pointed out that the transactions in the Securities Trading Center have been often dominated by rumors and irrational investor sentiment.[25] In a sense this is inevitable when only a small number of shares (five shares as of January 2001) are listed in the market in which firm-specific factors exert dominant effects on market prices.

However, the prospect of a rapid increase in the number of listed firms seems to be rather limited in spite of the fact that about one tenths of 500 equitized SOEs are eligible for the listing at the Securities Trading Center. The managers of equitized firms are said to worry that "their business information is exposed to the public." They believe that this would benefit their competition rivals and put them in a disadvantageous position. Besides, there still exists an attitude of "wait and see."[26]

Given a limited progress of share trading, the role of Government bond market is extremely important for developing securities markets. Dr. Minh proposes a number of measures to enhance the liquidity of Government

[25] Dr. Son's paper "Financial markets and relationship between its components" is included in Part II. His comments, however, are not taken from his paper. They were made in the final meeting for this project.

[26] An article from VNS-08/11/2000, "VN bourse hunts for new stocks."

bond such as standardizing the conditions of coupon payments and maturities.

6. The composition of domestic investment and the SOE-led industrialization

The paper by Dr. Le Viet Duc, Dr. Ha Xuan Tu and Dr. Le Quoc Ly analyses the changes in the composition of domestic investment, consisting of (1) investment from the state budget, (2) state credit, (3) investment of SOEs, (4) investment of the private sector and (5) FDI.[27] When we compare the composition of investment in the early 1990s with that of the end of 1990s, the most significant changes are the declines in investment from the state budget from around 35% to 23% and private investment from around 40% to 20%. They were roughly matched by the increase in state credit from around 5% to 17% and investment of SOEs from around 5% to 18%. FDI increased from 14.7% in 1990 to 32.3% in 1995, but then declined to 18.0% in 2000. Investment of the private sector includes investment of farmers and households as well as private enterprises. We can find in these figures the evidence of the key characteristics of the transition process of Viet Nam during 1990s. Firstly the investment of the state budget was separated from SOEs and was concentrated on building infrastructure of the economy. Secondly it was the SOE sector that served as a vehicle for industrialization of the Vietnamese economy during 1990s but that the development of the SOE sector was assisted by state credit. Finally Viet Nam has not succeeded in creating the pure private sector that can serve as the basis of industrialization.

Box 3 SOEs as a vehicle of industrialization in Viet Nam[28]

Table 1 shows the share of value added produced by SOEs (the state sector excluding state management) as against the non-state sector. The share of SOEs increased from 22.7% in 1990 to 36.9% in 1998.

Table 1 The share of value added of SOEs (%)

	1990	1998
Total/GDP	22.7	36.9
Agriculture/GDP	1.6	1.2
Industry & construction/GDP	10.3	15.6
Services/GDP	10.7	20.1

Source: IMF(July 1999), Viet Nam: Statistical Appendix, p.4.

This is in sharp contrast to the experience observed in Central and Eastern Europe, in which the share of

[27] Le Viet Duc, Ha Xuan Tu and Le Quoc Ly, " Overview of investment situation and policy in Viet Nam in the 1990s."

[28] This box is taken from Watanabe Shinichi, "Benchmarking the stage of economic development of Viet Nam."

the state sector fell precipitously in the 1990s. According to WB (1996, p.15), among about 30 transition economies Viet Nam was the only country in which the state sector increased its share of GDP from 1990 to 1995.[29]

However, the share of the non-state sector of Viet Nam in 1990 was already as high as 70.7% which was far higher than those of transition economies in 1990 and even in 1995 after the implementation of various privatization programs. The shares of the non-state sectors of most transition economies did not exceed 10% in 1990. Only Poland and Georgia had more than 20% and China more than 40% as of 1990.

The large share of the non-state sector in Viet Nam in 1990 reflected the fact that Viet Nam was still at an early stage of industrialization and the non-state agriculture sector had a dominant share of output, 39.1% of GDP,[30] as is shown in Table 2.

Table 2 The share of value added of the three broad sectors (%)

	Viet Nam		Average low-income economies		China	
	1990	1998	1980	1998	1980	1998
Agriculture/GDP	41	26	29	25	30	18
Industry/GDP	23	33	32	33	49	49
Services/GDP	36	41	39	42	21	33

Source: IMF(July 1999), Viet Nam: Statistical Appendix, p.4.; WB (1999), Entering the 21st Century, World Development Report 1999/2000, p.252.

The dominant share of agriculture at the beginning of the 1990s indicate that it is not proper to understand the transformation process of Viet Nam within the same context of transition in East and Central European economies that were at much higher levels of industrialization at the beginning of the 1990s. The central characteristics of the transformation process of Viet Nam during the 1990s was that an agrarian economy at an early stage of industrialization rapidly overcame its economic crisis and restored its macroeconomic balances and output structure comparable to those of average low-income economies by the end of the 1990s.

If that is the case, it is not surprising to find that the state sector expanded its role as an organization vehicle of industrialization during the 1990s. Even if millions of small household enterprises existed, it is rather obvious that it would have been impossible for them to play the central role in the industrialization process that exploits the benefits of scale economies.[31]

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[29] World Bank (1996): World Development Report 1996, From Plan to Market. Joint ventures between SOEs and FDI are counted as a part of the state sector.

[30] The share of the state agriculture sector was only 1.6% of GDP. The agriculture sector as a whole was 40.8% of GDP in 1990.

[31] From the mid-1990s Viet Nam accepted FDI larger than any other low-income economies except for China and India. Many FDI firms established joint venture firms with SOEs. The joint venture firms thus formed are classified as a part of the state sector. Thus the increase in the share of value added of the state sector might be a "statistical fact" which reflected the contribution of the joint ventures. Therefore, the increase in the share of the state sector should not be interpreted as the lack of progress toward a market economy.

Both the success and limitation of the industrialization of Vietnamese economy have been closely related to the success and limitation of the SOE sector. Dr. Duc et. al show why the development of the SOE sector in the 1990s should be interpreted cautiously. First of all, its development has been assisted by state credits, that is, loans provided by the state to priority projects included in the government development plan with preferential repayment conditions. In particular, the ratio of investment financed by state preferential credit to total domestic investment increased markedly after the Asian crisis from 13.7% in 1997 to 16.7% in 1998 to 18.3% in 1999. The increase indicates the financial weakness of the SOE sector. Dr. Duc et al. express a concern:

> Even though the economy has been transformed towards market based economy for many years, it is recently in a tendency of returning to the old mechanism, i.e., soliciting - giving mechanism (co che xing cho), subsidization of credit as it was in the period of central planning. Such a mechanism is actually a subsidization in terms of credit for non-competitive products and prolongs the lives of ineffective enterprises.

Dr. Duc et al. show another evidence which indicates the limitation of the industrialization based on the SOE sector. They report that ICOR of Viet Nam increased from 1.76 in 1992 to 5.3 in 1998, that is, the marginal product of investment in 1998 was three times smaller than in 1992. They argue that in spite of the rapid accumulation of capital in Viet Nam in the 1990s its allocation became increasingly inefficient as "they (policies and mechanism) turned investment to industries that met domestic demand or industries that were still under the protection of the state and reduced the competitiveness of the overall economy."

7. SOE reform, private sector development and the financial system reform

The analysis and evidence reviewed in the previous sections have shown various ways of interdependence among SOE reforms, private sector development and the financial system reform. Whichever path Viet Nam may follow in its transition process to a market based economy, it cannot be a monotonous linear process. A downside risk always exists that its reform process stops in the middle, getting stuck at an inefficient and unstable equilibrium with SOEs dependent on state subsidies and protection, an underdeveloped private sector, and an unstable financial system vulnerable to external shocks. In order to sustain the reform process in motion, a continuous effort is necessary to restructure the SOE sector, to eliminate institutional barriers for private sector development and to strengthen the function of the financial system. What conditions are necessary to avoid the trap of inefficient and unstable equilibrium and to sustain the momentum of reform processes?

Three papers by Mr. Nguyen Van Tan, Dr. Le Quoc Ly and Watanabe Shinichi address this question,[32] and they all emphasize the importance of sustaining institutional innovations. Mr. Tan points out six areas as being particularly important in order to avoid the risk of economic stagnation: (1) restructuring joint stock banks, (2) strengthening the capacity of financial institutions to manage their exposure to various risks, including foreign exchange risk, (3) solving over-employment problems of SOEs without sacrificing the worker's interest, (4) reorganizing or liquidating potentially bankrupt firms, (5) establishing effective regulatory mechanism of financial institutions and markets, and (6) solving the problem of non-performing loans of SOEs.

We want to add another area as being extremely important: establishing transparent institutional framework that enhances the development of the private sector. But as has been observed by many authors, it may be most difficult to make a progress in this area.

8. Distortions in the domestic financial system and capital mobility

The economic development in Viet Nam crucially depended on imported capital for the last decade.[33] According to Mr. Phung Xuan Nha, for example, "foreign capital accounted for around 45% of total investment capital in 1900-1999." Viet Nam is expected to continue heavy dependence on foreign capital. Mr. Nha estimates that the dependence on the foreign capital has been increasing since the latter half of the 1980s in Viet Nam.

The major portion of imported capital is occupied by the FDI. In contrast, commercial credits and foreign loans do not play any significant roles in this respect. The FDI is substantially less mobile than commercial credits, particularly short-term loans. In this sense Viet Nam is not so exposed to ever-changing global capital markets as the other Asian countries that experienced serious capital flight in 1997. But we cannot expect that FDI will continue to grow without significant fluctuations. Furthermore, the commercial credit will undeniably become more and more important as Viet Nam's economy develops. Thus, it is not meaningless to consider the issue how to prevent the domestic financial system from being vulnerable to variations in global capital markets. We can learn some lessons from the experience of the Asian crisis in 1997.

<u>Sources of domestic distortions</u>: In an economy without control on capital movements, distortions in the domestic financial system tend to induce rapid capital inflow. For example, suppose banks that are covered by the comprehensive financial safety net implemented by the government. Foreign investors perceive no credit risk in their lending to the banks as far as the financial system of the country looks stable. The banks could aggressively expand their business by borrowing short-term capital in international money markets without paying high premiums. This is a case that a domestic distortion of a too comprehensive safety net in

[32] Nguyen Van Tan, "Evaluating the interaction among the reform steps of various sectors of Vietnamese financial system." Le Quoc Ly, "Coordination of the reforms of the financial system and the business sector (in particular, state-owned enterprises)." Watanabe Shinichi, "The analysis of the effects of long-term reform policies and the *ad hoc* measures."

[33] Phung Xuan Nha, "Foreign capital in Viet Nam: Current situation and policy recommendations."

the financial system induces the rapid capital inflow into a developing country via a tremendous increase in banks' borrowing in international money markets.

We might refer to the case of a rapid increase in deferred L/Cs in 1996 as a Vietnamese example of capital inflow induced by the domestic distortion. Obviously, the L/Cs increase led to rapid capital inflow into Viet Nam. The domestic credit expansion supported by heavy borrowing of foreign currencies in international money markets makes borrowing countries vulnerable to the web and flow of capital. However, individual banks do not pay sufficient attention to the fact that an increase in their borrowing of foreign currencies from abroad not only reduces their own credit worthiness in international market, but also down-grades credit worthiness of their peers from the viewpoint of foreign lenders. In other words, the social cost of foreign currencies borrowing exceeds its private cost in developing countries under severe limitation of foreign reserves. This is a problem of externality and another source of the domestic distortions.

In August 1996 the Vietnamese government introduced the quota system for commercial banks' foreign short-term borrowing in order to suppress the expansion of the deferred L/Cs. The SBV strengthened control on banks' activities related to deferred L/Cs in 1997. We can appreciate this policy as rational in dealing with the externality associated with increase in the deferred L/Cs.[34] Similarly, we can justify the 1998 policy of strengthening the regulation on US dollar positions taken by credit institutions, because individual agents do not take the externality of their foreign currencies positions into account.[35]

Real exchange appreciation induced by capital inflows: Many tend to pay too much attention to the causal relationship from changes in the foreign exchange to balance of payments. However, as Chu Hong Minh suggests, the relationship is not so clear cut.[36] Rather, we should note influence of changes in the real exchange rate on the industrial structure. The rapid capital inflow induced by the domestic distortions into a developing is often destabilizing. The rapid capital inflow leads to a sharp appreciation of the real exchange rate of the recipient country.[37] The real exchange rate appreciation induces expansion of the non-traded good industries, such as real estate industry and some domestic service industries, of the recipient country. Generally speaking, the management of non-traded good industries is less disciplined than traded good industries because former industries are less exposed to global competition than the latter industries.

A rapid capital inflow into this sector is nutritious to inefficient management of the firms belonging to non-

[34] According to Tran Van Son, the Vietnamese short-term foreign debt decreased by 42% during 1996. The introduction of quota on banks' foreign borrowing partially account for this decrease. Tran Van Son, ibid.

[35] See Chu Hong Minh, "Foreign exchange and exchange rate management," and Box 4 in this paper.

[36] Chu Hong Minh describes, "it is possible to note that exchange rate adjustments towards increasing value of the US dollar in comparison with Vietnamese Dong affected export promoting and import controlling to some extent" with the reservation that "these effects on net export, or in other words on trade balance, were not so noticeable." Chu Hong Minh, ibid.

[37] The recipient country is most likely to have the system of exchange rate pegged to a key currency. Then the appreciation of real exchange rate will be realized in a form of domestic inflation in non-traded goods.

traded good industries such as the real estate and land development. The rapid expansion of those industries induced by appreciation of real exchange rate, thus, undermines efficiency of the recipient country's industry. Foreign investors find the recipient is becoming more fragile and less efficient due to rapid expansion of the non-traded good industries, and suddenly they try to withdraw their capital all together. This story describes what the Asian countries experienced during a few years immediately before the 1997 crisis.

Thus, we may justify the government intervention in capital movements when the recipient country suffers from serious distortions in the domestic financial system. Of course, this is a second-best argument. If distortions in the domestic markets induced a large scale of short-term capital inflow, the first best policy is to remove the distortions.

Box 4 A simple analysis of externality associated with foreign short-term borrowing

It is not difficult to show how domestic banks' short-term borrowings from abroad cause negative externality on the domestic financial system. Suppose there are N domestic banks in a developing country. Each bank can borrow the foreign currency from the international money market. The amount of foreign short-term borrowing of the k bank is denoted by b_k. The borrowing interest rate for every bank of this country is assumed to be common. This assumption implies that international investors regard all of the banks located in this country are equally protected by the domestic government. However, it does not necessarily mean that the credit risk of the domestic banks is zero from the foreign investors.

Needless to say, the foreign currency is a scarce resource in the developing country. The government cannot produce it freely. Then, the more the domestic banks borrow foreign currency in total, the more vulnerable becomes the domestic financial system to abrupt collections of the short-term loan by foreign lenders. In other words, the credit rate of each bank is assumed to negatively depend on the total amount of borrowing $\Sigma_k b_k$ of the country's banks in the international money market. Thus, the borrowing interest rate r is an increasing function of the total amount of the banks' borrowing: i.e., $r = r(\Sigma_k b_k)$, and $r'(\Sigma_k b_k)>0$.

For simplicity, we can assume that the k-th bank's profit F_k is an increasing function of the bank's foreign currency borrowing b_k: $F_k = F_k(b_k)$, and $F_k'(b_k)<0$. The net profit for the k-th bank R_k is

$$R_k = F_k(b_k) - r(\Sigma_k b_k)\, b_k.$$

On the other hand, the social net profit for the whole banking system is

$$\Sigma_k R_k = \Sigma_k F_k(b_k) - r(\Sigma_k b_k)\, \Sigma_k b_k.$$

The optimal borrowing for an individual bank is determined by the following condition:

$$F_k'(b_k^*) = r(\Sigma_k b_k^*) + r'(\Sigma_k b_k^*)\, b_k^*. \qquad (1)$$

The social optimality, on the other hand, is determined by the following condition:

$$F_k'(b_k^\circ) = r(\Sigma_k b_k^\circ) + r'(\Sigma_k b_k^\circ)\, \Sigma_k b_k^\circ. \qquad (2)$$

The right hand sides of (1) and (2) respectively represent the private and the social cost of foreign currency borrowing for an individual bank. Obviously, the private cost is underrated compared with the social cost. Thus, if they are allowed to freely borrow, banks will borrow excessive amount from the international money market, making the domestic financial system fragile. The government is justified to intervene in individual banks' borrowing to fill the divergence between the private and social costs.

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9. Short-term measures to deal with domestic distortions

It is not realistic to require the recipient country to remove domestic distortions at once. In the short-run, the distortion is not removable. Then, the second best policy is to mitigate distorted incentives for capital movements produced by the domestic distortion. The followings are examples of the second best policy:

(1) The recipient country should abolish any *de facto* taxation systems that favor short-term borrowing from abroad, because it distorts residents' incentive to import short-term capital.

(2) The recipient country should allow wide fluctuations in the exchange rate. The flexible fluctuation in the exchange rate will be effective in preventing excessive capital inflows. The excessive borrowing could happen under the flexible exchange rate regime. But the regime will suppress the one-way speculation that is likely to be formed under the pegged exchange rate regime.

(3) It is indispensable for the capital importing country to build up a combination of well-functioning safety net and effective regulations for prudent bank management. The comprehensive financial safety net is not only a cause for the domestic distortion. It often causes the problem of moral hazard in the financial system. But it is practically impossible for a developing country to drastically narrow the financial safety net, or to abolish it totally. Thus, the government's policy of prudential regulation in the financial system is all the more important.

(4) The recipient country should internalize the externality of foreign borrowing. This externality leads to excessive borrowing and makes the country vulnerable to withdrawal of the accumulated short-term liabilities. Both the absence of a lender of the last resort in international money markets and imperfect information regarding borrowers increase the social costs of the externality. Establishing the system of disclosing and disseminating important information on capital flows will be effective in mitigating this externality problem. It may be advisable for the BIS either to give a higher risk weight to short-term loans to banks than the current level or to require banks to have a specific capital for their short-term foreign exchange risk.

<u>How to remove distortions</u>: It is impossible for a developing country to remove distortions in the domestic economy in a short time. But the government can raise the private costs of short-term borrowing from abroad

to the level corresponding to the social costs. This policy is more efficient than the policy of uniformly restricting short-term capital import because the latter would exclude short-term capital inflows with socially positive net present value. Specifically, to strengthen capital adequacy requirements is desirable. We also recommend an introduction of a prudential regulation to induce banks to decrease their uncovered foreign debt. Multilateral organizations have already started to consider the possibility of introducing prudential regulations responding to foreign exchange risk. We think it meaningful to increase a higher risk weight assigned to foreign currency loans to banks in the framework of the BIS capital adequacy rules.

10. The sequential problem related to capital control

Under the imperfect financial system, not only private agents but also the government has only limited capacity of monitoring and supervising. It would be very costly for them to indirectly control movements of short-term capital, because the precise information regarding gaps between the private and the social costs of capital import is not available.[38] In contrast to the indirect policy, the policy of directly restricting capital movements needs no detail information regarding the gaps between the private and the social costs. Thus, it would be much easier for the government to implement the policy of directly restricting capital movements. This seems to suggest that before abolishing the policy of directly controlling capital movement, both the domestic capital markets and government's capacity of monitoring should be developed. Thus, this is related to the issue of a policy sequence.

The argument for direct restrictions on capital movements is applicable to those countries whose financial systems are extremely under-developed and fragile. Thus, it cannot be applicable to most countries in South East Asia where the financial systems have relatively developed. On the other hand, in those countries in a transition to the market economy, the financial systems are under-developed and distorted so as to justify the policy of directly controlling capital movements. Before fully liberalizing capital movement, those countries should reform domestic financial systems in order to remove remaining distortions. This argument seems quite sensible.[39]

However, we would like to add some reservations to this argument. First, in practice, it is difficult to implement effective capital control. It would be easier for the government of a transition economy to implement the direct restriction policy than the policy of indirectly controlling capital movements. However, it does not mean that the former policy is effective. The direct restriction leaves the gap between the private and the social costs of capital import unfilled. Thus, the policy tends to induce private agents to circumvent the direct

[38] See Box 2 in this paper.

[39] Box 1 in Koyama and Katagiri paper shows an example of a policy sequence for transitional economies faithfully following the World Bank's agenda. According to this agenda, the liberalization of capital is located at the final stage of the policy sequence.

restriction policy. The circumventing behavior undermines the effectiveness of the policy. Moreover, the development of international trading widens the scope for agents to circumvent capital control. The capital restrictions lead to political corruption and heighten economic inequality in developing countries as any other regulations are likely to do. We cannot be optimistic about this issue.

Second, we should recognize that it is not easy to remove domestic distortions even if we are allowed to take rather long time. For example, monitoring by banks is essential to an efficient market economy. However, it is difficult to build up banks' incentives to efficiently monitor borrower firms in a moment when banks have functioned as an organization to distribute funds under the comprehensive central planning. Enterprises are not well disciplined for being prudent borrowers. The government sometimes forces banks to rescue major borrowers in financial distress for any reason other than economic efficiency.[40] The government in itself must be motivated to strictly supervise bank management in order to construct the market-oriented financial system. How could a developing country like Viet Nam build up a robust financial system in a short time period, starting from such a historical precondition?

It would be advisable for some countries to "import" banks' monitoring capacity and the government's supervision ability from abroad. For example, a joint venture of a domestic bank with foreign banks located in the money center such as HCM City or Hanoi could be a specific method of "importing" banks' monitoring capacity. The joint venture will activate domestic financial inter-mediation in a developing country. Moreover, when the foreign banks are well disciplined by rigorous supervision by the government in their mother countries, we can interpret the joint venture as a form of "importing" the supervision capability from the developed countries. We think it important for developing countries to "import" banks' intermediation capacity and public supervision on financial institutions. But to import those services will require free capital movements at least to some extent. If so, we need to reconsider rationality of the reform sequence that gives priority to building up a stable domestic financial system over liberalizing international capital movements.

Of course, this is a complicated issue. When its financial system is fully opened to international capital movements, the developing country will become furthermore vulnerable to external shocks such as the contagion effect of the Asian financial crisis in 1997. However, the external shocks are sometimes effective in exerting disciplinary impact on the domestic economy. The disciplinary impact may be useful for promotion of quick construction of the market-based financial system in a transition economy. The transition economy may utilize the policy of liberalizing capital movements as a catalyst to quickly improving efficiency of its financial intermediation capacity.

[40] As we have emphasized in this paper. The various *ad hoc* policy measures to bail out the SOEs in financial distress weaken both the firms' incentives and lending banks' incentive for efficient management.

11. Concluding remarks

This paper overviewed the current situation of the Vietnamese financial system and the SVB's monetary control by commenting the papers submitted by Vietnamese experts to our research investigation. All of them are quite informative, and we have been able to learn a lot from reading them. Their reports gave us both optimistic and pessimistic views on the Vietnamese financial system. The optimistic view is that the Vietnamese government continues to hold firm belief in the financial development strategy fundamentally based on market mechanisms in spite of the economic slowdown since the mid 1990s. The government has introduced financial reforms to realize the market-based financial system step by step. The well-organized analyses by Vietnamese experts also clearly show that people responsible for the financial policies in Viet Nam understand the government targets of constructing the market-based financial system. We agree with this attitude of the Vietnamese government.

On the other hand, the papers submitted by experts of Viet Nam inform us that the Vietnamese financial system has not been transformed into a truly market-oriented one. In particular, the intricate and sometimes very ambiguous relationships between SOEs and SOCBs have prevented full-scale market mechanisms in the Vietnamese financial system. The government policy of protecting inefficiently managed SOEs not only undermines corporate managers' incentives for efficient management, but also deprives SOCBs of motivation to effectively monitor borrower firms. The lack of incentives for efficiency on both sides of lenders and borrowers will delay development of the financial inter-mediation and thereby will delay the process of Vietnamese transition to the market economy.

We regard the *ad hoc* policy measures the Vietnamese government has adopted in order to mitigate the financial problems that emerged in the later half of the 1990s as problematic because they tend to exacerbate the remaining weak point of the financial system. Viet Nam needs a sort of new deal to revitalize the process of transition to the market economy. We believe that our colleagues in Viet Nam share this opinion with us.

1 − 2

Economic Reform and Fiscal Management of Viet Nam: A Re-examination

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Abstract

The purpose of this study is to look at the public finance of Viet Nam as a mirror of its reform toward a market economy. In addition to a usual function of the government to construct infrastructure and to provide public services, the government of Viet Nam has to mobilize savings to invest in order to mitigate a sever shortage of capital for growth. Tax system has also to be compatible with its reform so that more revenues can be generated along with deepening of a market economy. Incentives to offer better environment for investment cannot be guaranteed without strong initiatives and commitment of local governments to accommodate investments, both domestic and foreign. All these necessary reform point to the importance of improving fiscal management of the government. This study aims at offering as much empirical and on-site information as possible to prescribe the better and more solid foundation for growth in Viet Nam.

1. Purpose of study

The purpose of this note is to update the development of public finance in Viet Nam after our phase-two study conducted jointly with the JICA and Vietnamese counterparts. It seeks to look at the public finance of Viet Nam as a mirror of its economy. Emphasis is placed on tracing the development by facts and numbers.

2. The state-owned enterprise (SOE) sector

Tables 1.A through 1.D show the economic size of the SOEs. Questions that we are asking ourselves are the following:

- Is it getting smaller and giving more room to the rest of agents of the economy?
- Is the private sector developing to take over the state sector?

The answers to them is rather in the negative; SOEs of Viet Nam have been retaining its strength over its economic reform period toward a market economy. The following remarks of Prime Minister Phan Van Khai at the eighth session of the National Assembly, November in the year 2000, point out the direction of SOEs.

"The prime-minister said the restructuring of SOEs will aim to maintain their dominant role in the national economy. The first step in restructuring would be to continue solving problems in the ongoing equitization process so that small-and-medium-sized SOEs would be either equitized, leased, hired or sold" (Vietnam News, November 15, 2000)

3. The dual role of the tax system

One of the most difficult problems of Viet Nam is mobilizing savings. That is, under a chronic shortage of investment funds, the government has to assume the role of raising savings and to support various kinds of investment on top of its usual function of raising taxes and providing necessary public goods and services. Accordingly, the examination of Vietnamese tax structure is to look into the following questions:

- Is it strong and efficient enough to raise revenue along the development of the economy?
- Is the tax system flexible enough to come up with the development of the market economy?

Table 2 shows the GDP of Vietnam by expenditure. The nation's (gross) saving rate has persistently been small and seems to have stagnated at around 20% of GDP. On the investment side, public investment has been very small and the country has been facing the vagaries of the foreign direct investment. Import propensity, too, is very high and the foreign exchange ceiling drags the growth of economy.

Tables 3, 4 and 5 illustrate the tax structure. There are a couple of salient features:

- Total revenue as a proportion to GDP seems to have peaked out at the middle of the 1990s and it is now smaller than 20%.
- Transfers from SOEs are declining, but the dependence on a couple of revenue sources continues. In fact, when revenues from SOEs, oil-related non-tax revenue and import-export taxes are combined, almost 80% of the total revenue is collected.
- Tax liabilities of SOEs as a proportion of its value added are declining, but still are far larger than in the non-state sector.

4. Local public finance

One of the most remarkable fiscal development in Viet Nam since it started a reform toward a market economy is centralizing fiscal management. The General Tax Department functions as a nation-wide organization, with its local branches over the country; and the same applies to the Treasury, which deals with managing budgets. While this centralization helped to strengthen revenue collection, local governments have been pressed under the "ask and grants" situation. This is like a trapped situation where poor provinces have lost their incentives to help themselves out of fiscally dependent , i.e., "ask", conditions. On the other hand, a handful of richer provinces and the cities under the government control feel themselves fiscally squeezed, and have lost incentives to raise more revenues to improve their local infrastructure and other public services.

The Budget Law was enacted in the year 1996 to clarify the functions and responsibilities of each level of governments, i.e., the central government, the people's councils of provinces, districts and communes. It also aimed at stabilizing revenues of local governments over a three-to-five-year period.

Tables 6, 7, 8 and 9 seek to capture local public finance at work. Using them, questions that we would like to pose as to the central and local fiscal relations would be as follows:

- To what extent has fiscal centralization occurred? Has it been a significant change?
- Have local budgets been stabilized by the Budget Law?
- Are the revenue sources assigned to local governments big enough to encourage provincial governments to raise revenues?
- Can it be possible to make both the central and local governments better off? That is, are fiscal incentives of local governments still distorted?

The observations of the tables and the interviews that I had with directors of provincial financial departments provide us with the following answers to the above questions.

- The establishment of the General Tax Department contributed very much to strengthening the revenue-raising capacity of the central government. A sizable difference in this capacity can be witnessed in the year 1991.
- The Budget Law stabilized the supplements from the central government to grant-receiving provinces. However, provinces and the cities that are fiscally better endowed have to negotiate with the central government as to the rate of revenue sharing, say from the VAT and other taxes. Thus, the "ask and grants" system still is very much far from being corrected.
- Limited tax sources of provinces have given distorted incentives to local governments. Revenue-raising efforts tend to be concentrated on their own revenues like land-development taxes and land leases.
- One of the very important consequences of these distorted efforts is that taxes suitable in a market economy have not developed enough. The VAT is exactly the type of tax that can raise huge revenue in a market economy, but local governments do not cooperate with Tax Department to improve administration for the tax.
- A clearer assignment of revenue sources to local governments with stabilized rates of sharing between

the central and local governments will improve fiscal incentives of local governments, and would lead to making both the central and local governments better off than now.

- A comparison of Chinese and Vietnamese tax assignment systems would reveal that local governments of Viet Nam have been allocated much smaller tax sources. However, a caveat is due here; a separation of roles of local governments as a provider of public services and the owners and managers of state enterprises have to be carried out in order to assess their appropriate sizes.

5. Policy issues

Our examination of fiscal management in Viet Nam has left us with several key issues to make it compatible with the development of market economy. The following is their overview.

5.1 Revenue issues

Reforming the current tax system that has relied overwhelmingly on the SOEs and international-trade calls for those taxes with broader tax bases with smaller disincentives on the side of tax payers. The VAT and personal income taxes would be the candidates for the next major taxes in Viet Nam. They are taxes in a market economy and have capacities to raise revenue as fast as the economy grows.

In this respect, Viet Nam has to implement them in a very well organized manner, otherwise it would fail to lose revenue. The VAT was introduced on January 1 of the year 1999 and saw many problems. Deflationary economic situation during the year was one of the reasons for its difficulties, but more thoughts have to be paid as to why the VAT in Viet Nam has raised so many problems. Several noteworthy aspects of the tax are as follows.

- Four rates, i.e., 0, 5, 10 and 20%, were too many to administer.
- The number of tax exempted commodities was too many to raise enough revenue.
- The existence of too many rates and too many exemptions has triggered endless rate cuttings on various commodities, and rates are now converging to 5%.
- Treatment of traders and businesses that do not issue invoices has raised confusions and finally ended up with allowing deductions from the purchases from them. A serious examination of direct-calculation method applied to small businesses is due. A better treatment of them would be much simplified "deemed value-added tax" by which tax base is the total sale instead of the value added.
- Besides these technicalities, a more fundamental issue behind the introduction of the VAT is that a consensus has not developed as to the nature of the tax. The VAT in Viet Nam replaced turnover taxes, hence it was conceived more as a tax on business than as a tax on consumption. Thus, those industries that bear more tax than before have made complaints; and once a special treatment was

applied to one industry, there was no way to stop it.

- The VAT as a consumption tax would have facilitated more forward shifting of the tax to consumers. Since the cascading tax was repealed and the reform was considered to be revenue neutral, the effects on prices would not be significant, if any. If the tax has been more market-friendly designed, it would have been accepted better by businesses and traders.

Personal income tax is now under the process of reform with higher thresholds. In a longer time horizon, this is the tax Viet Nam needs to stabilize its revenues. However, a desirable sequence of reform would be to make the current VAT better. Viet Nam has to avoid the confusions after introducing a new tax as it experienced by the VAT.

5.2 Expenditure and other issues

Expenditure issues cannot be separated from fiscal decentralization. Here, unleashing fiscal capacities of local governments and accelerating economic growth is intrinsically related with improving public expenditure system. Here, investments of local government still need approval from the Ministry of Investment and Planning. The red tape stemming from the central government has to be minimized so that local initiatives can be enhances as much as possible. In this respect, we have seen above that more reform of the Budget Law is necessary.

Tables

Table 1.A Share of state sector in GDP

%

	1989 prices					1994 prices				
Year	1990	1991	1992	1993	1994	1994	1995	1996	1997	1998
State share	32.5	34.2	35.2	36.4	38.0	41.3	40	40.8	41.4	41.2
Non-state share	67.5	65.8	64.8	63.6	62.0	58.7	60	59.2	58.6	58.8
Agriculture	40.7	39.2	38.6	37.1	35.4	28.7	26.2	25.1	24.2	23.7
- state share	3.9	4.3	4.4	4.7	4.9	4.5	.	.	.	.
Manufacturing	22.5	23.1	24.2	25.4	26.6	29.6	29.9	31.3	32.6	33.5
- state share	64.7	67.2	69.7	70.5	71.8	66.5	.	.	.	.
Services	36.9	37.7	37.1	37.5	38	41.6	43.8	43.6	43.2	42.8
- state share	44.5	45.1	44.6	44.7	45.1	48.7	.	.	.	.

Source: World Bank (1999), Table 2.2

Table 1.B GDP shares: state and non-state sectors, and industries

%

	1989 prices					1994 prices				
Year	1990	1991	1992	1993	1994	1994	1995	1996	1997	1998
State share	32.5	34.2	35.2	36.4	38.0	41.3	40.0	40.8	41.4	41.2
Non-state share	67.5	65.8	64.8	63.6	62.0	58.7	60.0	59.2	58.6	58.8
Agriculture	40.7	39.2	38.6	37.1	35.4	28.7	26.2	25.1	24.2	23.7
Industry	22.5	23.1	24.2	25.4	26.6	29.6	29.9	31.3	32.6	33.5
Services	36.9	37.7	37.1	37.5	38.0	41.6	43.8	43.6	43.2	42.8

Source: World Bank (1999), Table 2.2

Table 1.C Shares of state sector and sub-industries

%

Year	1989 prices					1994 prices				
	1990	1991	1992	1993	1994	1994	1995	1996	1997	1998
Agriculture:										
-state share	3.9	4.3	4.4	4.7	4.9	4.5	.	.	.	.
Industry:										
- state share	64.7	67.2	69.7	70.5	71.8	66.5	.	.	.	.
Manufacturing	83.0	83.6	84.0	83.3	82.5	74.4	75.1	74.7	75.0	77.2
- state share	66.0	67.1	69.8	71.4	71.9	73.6	.	.	.	.
Construction	17.0	16.4	16.0	16.7	17.5	25.6	24.9	25.3	25.0	22.8
- state share	58.4	67.5	69.1	66.4	71.2	45.9	.	.	.	.
Services:										
- state share	44.5	45.1	44.6	44.7	45.1	48.7	.	.	.	.
Transportation/communication	6.8	6.7	6.7	6.5	6.3	9.8	9.2	9.0	9.2	9.1
-share of state	60.1	61.0	61.8	62.8	63.0	68.3	.	.	.	.
Trade	32.0	31.0	30.7	29.8	29.5	32.5	39.2	39.5	39.5	39.3
-share of sate	32.0	31.9	31.9	31.4	30.3	25.6	.	.	.	.
Banking	3.5	3.8	3.9	4.2	4.7	4.9	4.6	4.7	4.6	4.6
-share of state	98.4	99.6	99.4	99.3	99.3	99.7	.	.	.	.
Public services (1)	24.6	24.1	24.1	24.1	24.8	25.8	19.9	19.6	19.3	19.4
-state shares	99.4	99.4	99.4	99.3	99.2	99.4	.	.	.	.
Others (2)	33.1	34.4	34.6	35.4	34.7	27.1	27.2	27.1	27.5	27.7
-state shares	6.9	9.8	8.1	8.9	8.6	11.8	.	.	.	.

Notes: (1) Public services are public administration, medical services and education.

(2) Other services consist of real estates, tourism and others.

Source: World Bank (1999), Table 2.2

Table 1.D Construction of investment by economic sector

%

Econ. sector	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
State budget	33.1	19.5	35.6	36.7	24.0	20.0	20.8	21.2	21.5	25.0	23.8
State credits	4.5	9.2	3.2	7.0	7.4	4.5	10.4	13.1	15.3	18.3	17.0
SOE's	6.2	11.2	2.9	7.1	13.8	13.8	14.0	13.7	16.7	18.3	17.9
Private sector	41.5	43.4	35.4	23.4	33.4	29.4	26.1	20.6	21.3	20.2	23.7
FDI	14.7	16.7	22.8	25.8	30.6	32.3	28.6	31.3	25.2	18.2	18.0

Source: MPI

Table 2 Gross domestic product by expenditure as percent of GDP

Year	1990	1991	1992	1993	1994	1995	1996	1997	1998
GDP	100	100	100	100	100	100	100	100	100
Domestic demand	111.5	104.9	103.9	107.6	108.4	108.9	110.9	108.2	107.3
Gross capital formation	14.4	15.0	17.6	24.3	25.5	27.1	28.1	28.3	28.7
State (1)	7.3	6.7	7.9	13.2	11.6	11.4	13.2	14.8	14.0
of which government (2)	5.1	2.8	5.8	6.9	6.6	5.3	5.7	6.2	5.4
Foreign direct investment	1.5	2.6	3.9	7.8	11.2	11.3	7.7	8.1	3.2
Other investment	5.6	5.7	5.9	3.2	2.6	4.5	7.2	5.4	11.5
Consumption	97.1	89.9	86.2	83.3	82.9	81.8	82.8	79.9	78.6
Private	89.6	83.3	79.3	76.0	74.7	73.6	74.4	71.8	71.1
Government	7.5	6.6	6.9	7.3	8.3	8.2	8.4	8.1	7.5
Net export	-9.2	-5.1	-4.1	-8.8	-9.4	-9.1	-11	-8.1	-7.3
Export	26.4	30.9	34.7	28.8	34.0	32.8	40.9	43.1	42.0
Import	35.7	36.0	38.8	37.5	43.5	41.9	51.8	51.2	49.3

Notes: (1) State investment data are from Statistical Publishing House, *Statistical Yearbook 1998*.

(2) Government investment data are from various reports of IMF and World Bank.

Sources: Calculated by the author, using the Statistical Yearbook and IMF/World Bank reports.

Table 3 Budget operations as percent of GDP

Year	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Revenue and Grants	13.9	13.2	11.3	13.9	14.7	13.5	19.0	22.5	24.7	23.9	23.0	21.1	19.0	17.8
- Tax revenue	3.0	2.4	2.9	3.9	4.0	3.7	5.0	8.3	9.9	10.5	10.3	9.0	8.9	8.7
- Transfers from the SOE's	10.0	9.9	7.2	8.0	8.6	8.1	10.8	11.2	12.1	9.8	9.5	8.8	7.5	7.0
- Other non-tax revenue	0.8	0.9	1.2	2.0	2.0	1.4	2.5	2.2	2.1	2.9	2.6	2.6	2.0	1.6
- Grants	.	.	.	.	.	0.4	0.8	0.7	0.7	0.7	0.6	0.8	0.5	0.5
Expenditure-Total	20.0	17.9	18.2	21.2	19.7	14.2	19.8	25.8	25.2	23.2	22.1	21.9	19.2	18.3
- Current expenditure	13.7	13.7	13.9	15.4	14.7	11.4	14.0	18.8	18.3	17.8	16.4	15.7	13.7	12.4
- Capital expenditure	6.3	4.2	4.4	5.8	5.1	2.8	5.8	7.0	6.9	5.4	5.7	6.2	5.5	5.9
Budget balances														
- Primary balance	-6.2	-4.6	-7.0	-7.4	-5.1	-0.7	-0.8	-3.3	-0.4	0.8	0.8	-0.8	-0.2	-0.5
- Interest due	0.2	0.1	0.2	2.9	3.0	3.0	2.9	2.7	2.6	1.9	1.5	0.7	.	.
- Balance: accrual basis	-6.3	-4.7	-7.1	-10	-8.0	-3.7	-3.7	-6.0	-3.0	-1.1	-0.7	-1.5	-0.2	-0.5
- Interest paid	.	.	.	0.2	0.7	0.8	0.9	1.3	0.6	1.3	1.0	0.6	0.6	0.6
- Interest arrears	0.2	0.1	0.2	2.7	2.2	2.2	2.0	1.4	2.0	0.6	0.5	0.1	-0.6	-0.6
- Balance cash basis	-6.2	-4.6	-7.0	-7.5	-5.8	-1.5	-1.7	-4.6	-1.1	-0.5	-0.1	-1.4	-0.8	-1.1

Notes: The numbers of years 1998 and 1999 are preliminary and estimates respectively.

Sources: World Bank (1995, 1999) Table 5.1

Table 4 Structure of revenue as percentage of total revenue

Year	1986	1987	1988	1989	1990	1991	1992	1993	1995	1996	1997	1998	1999
(a) Tranfers from SOEs	71.4	75.2	63.8	57.6	58.8	59.8	56.7	49.9	41.1	41.5	41.6	39.7	39.3
(b) Other non-tax revenue	6.0	7.1	10.3	14.3	13.6	10.4	13.2	9.8	12.1	11.1	12.1	10.7	9.2
(c) Grants	.	.	.	.	.	2.6	4.0	3.3	3.0	2.5	3.9	2.8	2.7
(d) Import and export tax	7.1	4.5	7.5	9.3	11.9	10.6	10.4	20.8	24.9	24.2	20.4	24.1	22.4
Aggregates													
(e) a+b	77.4	82.3	74.1	71.8	72.4	70.2	69.9	59.8	53.2	52.6	53.7	50.4	48.5
(f) a+b+c	77.4	82.3	74.1	71.8	72.4	72.8	73.9	63.1	56.2	55.1	57.6	53.3	51.2
(g) a+b+c+d	84.5	86.8	81.6	81.1	84.3	83.4	84.4	83.9	81.1	79.3	78.1	77.4	73.6

Notes: The numbers of the year 1998 are estimates, and those of the year 1999 are plan.

Sources: World Bank (1995, 1996, 1999), Table 5.1 and Table 5.2A

Table 5 Tax liabilities as percentage of value-added

Year	1990	1991	1992	1993	1994	1995	1996	1997	1998
State enterprises	26.2	23.7	29.8	27.5	29.3	23.9	23.8	21.7	18.8
Non-state sector	3.4	3.4	4.7	5.8	5.6	5.8	6.1	5.7	5.1

Note: Tax paid by each of the above sector is divided by its respective value-added.

Source: World Bank (1999), Table 2.1 and Table 5.2A.

Table 6 Central and local fiscal relations

Billion Dong

		1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999 est.	2000 est.
Localities													
Total revenue	(a)	2836	4146	4116	7189	10169	13110	13450		18593	19519	14896	16195
Transfer to center	(b)	1066	.	194	955	447	1390	0		.	.	.	.
Receipt from center	(c)	244	.	1023	2170	3619	2900	4255		.	.	.	.
Net revenue	(d)	2014	3435	4945	8404	13341	14620	17705		.	.	.	.
Expenditure	(e)	2014	3435	4945	8404	13341	14620	17705		29673	31808	30472	33153
Center													
Total revenue	(g)	1063	2226	6237	13834	20331	29150	39924		46759	53446	54604	58340
Receipt from the localities	(h)	1066	.	194	955	447	1390	0		.	.	.	.
Transfer to the localities	(i)	244	.	1023	2170	3619	2900	4255		.	.	.	.
Net Revenue	(j)	1885	.	5408	12619	17159	27640	35669		.	.	.	.
Expenditure	(k)	4091	5850	7136	15306	23669	30035	38265		48384	50187	52028	63382
Total (National budget)													
Revenue	(l)	3899	6372	10353	21023	30500	42260	53374		65352	72965	69500	74535
Expenditure	(m)	6105	9285	12081	23710	37010	44655	55970		78057	81995	82500	96535
Indexes													
Local to central Total revenue: (a)/(g)		2.66	1.86	0.65	0.52	0.50	0.45	0.34		0.40	0.37	0.27	0.28
Local to central Net revenue: (d)/(j)		1.06	.	0.91	0.66	0.77	0.52	0.49		.	.	.	.
Local to central Expenditure: (e)/(k)		0.49	0.58	0.69	0.54	0.56	0.48	0.46		0.61	0.63	0.59	0.52
Local revenue to Expenditure: (a)/(e)		1.40	1.20	0.83	0.85	0.76	0.89	0.75		0.63	0.61	0.49	0.49

Note: The rows (b) and (h), and (c) and (i) are same.

Source: Calculated by the author, using the data provided by the World Bank (92) for 1989 and The Ministry of Finance, Viet Nam, for the rest of years. The data of the year 1996 were not available.

Table 7

(A) Share of GDP by region

Percent

Region	1990	1991	1992	1993	1994	**1997**
North Upland	11.9	11.7	11.7	11.6	11.5	**9.8**
Red River Delta	19.1	18.6	18.9	19.3	19.0	**18.9**
North Central	9.2	8.8	8.5	8.6	8.5	**7.9**
Central Coast	8.4	8.4	8.1	7.9	7.8	**7.7**
Central Highland	3.2	3.3	3.1	3.0	3.0	**3.3**
South East	24.4	25.4	26.1	26.8	28.5	**32.6**
Mekong River Delta	23.8	23.9	23.6	22.8	21.8	**19.8**

(B) Growth rates of GDP by region not updated

Percent

Region	1991	1992	1993	1994
North Upland	4.3	8.5	6.8	7.8
Red River Delta	2.9	10.7	10.3	7.0
North Central	1.6	4.6	9.8	7.2
Central Coast	6.1	3.8	4.7	8.9
Central Highland	6.5	3.8	4.7	8.9
South East	10.3	11.8	11.0	15.5
Mekong River Delta	6.4	7.3	4.4	4.1

Note: per-capita GDP: thousand VND

Region	1997
North Upland	2072
Red River Delta	3538
North Central	2136
Central Coast	2656
Central Highland	2773
South East	9101
Mekong River Delta	3278

Table 8 Expenditure to revenue ratio by region

Percent

Regions	1990	1991	1992	1993	1994	1995	1996	**1997**
1. North Upland	190.2	162.8	129.4	126.9	110.9	115.3	100	**138.2**
2. Red River Delta	58.3	50.3	34.1	38.1	32.7	38.1	37.1	**40.2**
3. North Central	146.5	127.2	132.1	137.0	144.4	120.9	113.5	**141.4**
4. Central Coast	127.7	99.1	83.7	68.6	76.2	69.9	67.5	**91.1**
5. Central Highlands	136.7	140.9	158.2	153.7	147.6	126.2	105.3	**134.5**
6. South East	31.7	32.8	31.5	35.1	25.1	15.6	14.1	**22.6**
7. Mekong River Delta	74.1	81.8	87.7	80.5	79.2	79.9	82.4	**95.6**

Source: Japan International Cooperation Agency (1997), Statistical Publishing House (1999)

Table 9

(A) Total public expenditure as percent of regional GDP

percent

Regions	1990	1991	1992	1993	1994	1997
1. North Upland	11.3	104.	11.7	13.5	13.5	**19.3**
2. Red River Delta	7.8	7.2	7.8	10.0	9.2	**9.8**
3. North Central	8.6	6.9	8.7	11.4	12.6	**14.1**
4. Central Coast	13.6	10.6	11.1	12.7	13.0	**14.7**
5. Central Highlands	10.6	9.6	10.4	13.0	15.5	**18.4**
6. South East	5.5	5.1	6.7	8.8	7.4	**6.6**
7. Mekong River Delta	7.1	5.9	6.1	7.2	7.4	**10.2**

(B) Total revenue as percent of regional GDP

percent

Regions	1990	1991	1992	1993	1994	1997
1. North Upland	602	6.7	9.6	11.2	12.7	**14.0**
2. Red River Delta	13.4	14.4	22.0	26.2	28.2	**24.4**
3. North Central	5.3	4.9	6.6	8.3	8.7	**10.0**
4. Central Coast	10.6	10.7	13.3	18.5	17.0	**16.1**
5. Central Highlands	7.8	6.8	6.6	8.4	10.5	**13.7**
6. South East	17.4	15.4	21.2	25.0	29.5	**29.3**
7. Mekong River Delta	9.5	7.3	6.9	8.9	9.4	**10.6**

(C) Capital expenditure (provincial budget) as percent of regional GDP

percent

Regions	1990	1991	1992	1993	1994	1997
1. North Upland	2.7	2.7	2.6	2.8	2.7	**5.2**
2. Red River Delta	1.9	1.4	1.5	1.9	1.5	**2.3**
3. North Central	1.9	1.1	1.9	1.7	1.8	**3.4**
4. Central Coast	2.8	2.4	2.1	2.4	2.7	**5.0**
5. Central Highlands	2.7	2.1	1.9	2.6	2.7	**5.5**
6. South East	1.0	1.0	1.3	1.8	1.3	**2.1**
7. Mekong River Delta	1.6	1.2	1.3	1.5	1.4	**3.4**

(D) Total state investment as percent of regional GDP: the aggregate of central and local investment

percent

Regions	1990	1991	1992	1993	1994	1995	1996
1. North Upland	4.8	5.5	6.3				
2. Red River Delta	5.4	5.0	4.1				
3. North Central	6.5	5.1	4.9				
4. Central Coast	5.3	4.4	4.1				
5. Central Highlands	4.7	4.9	5.7				
6. South East	2.0	2.1	2.4				
7. Mekong River Delta	2.5	2.2	2.3				

(D') Total investment as percent of regional GDP: state, foreign and other investment

percent

Regions	1997
1. North Upland	**24.9**
2. Red River Delta	**44.0**
3. North Central	**20.8**
4. Central Coast	**21.0**
5. Central Highlands	**31.0**
6. South East	**36.6**
7. Mekong River Delta	**18.4**

(E) Education expenses as percent of regional GDP

Regions	1990	1991	1992	1993	1994	1997
1. North Upland	2.0	1.8	2.2	3.0	3.3	**4.8**
2. Red River Delta	1.3	1.2	1.3	1.7	2.0	**2.5**
3. North Central	1.7	1.6	1.8	2.4	3.1	**4.1**
4. Central Coast	2.5	1.8	2.0	2.5	2.6	**3.2**
5. Central Highlands	2.1	1.9	2.0	2.4	3.2	**4.2**
6. South East	0.9	0.7	0.8	1.0	1.2	**1.1**
7. Mekong River Delta	1.4	1.1	1.1	1.5	1.8	**2.2**

(F) Health-care expenditure as percent of regional GDP

Regions	1990	1991	1992	1993	1994	1997
1. North Upland	0.8	0.6	0.8	0.9	0.9	**1.2**
2. Red River Delta	0.5	0.5	0.5	0.7	0.7	**0.7**
3. North Central	0.8	0.5	0.6	0.9	1.0	**0.8**
4. Central Coast	1.1	0.8	1.1	1.0	1.1	**1.1**
5. Central Highlands	0.9	0.9	0.7	0.9	0.8	**1.1**
6. South East	0.7	0.6	0.7	0.7	0.7	**0.7**
7. Mekong River Delta	0.6	0.5	0.5	0.6	0.6	**0.8**

Sources: General Statistical Office (1994, 1996), JICA (1996) for years 1990 through 1994.
Statistical Publishing House (1999) for the year 1997.

Chapter 2-1 Reforms of the Financial System in Viet Nam

A. Banking Reforms

A－1

Flow of Funds between the Banking System and Enterprises in Viet Nam, 1995-1999

Nguyen Thi Hong

State Bank of Viet Nam

In order to accelerate the economic growth rate, Viet Nam has relied on foreign capital to fill its saving gap. However, Viet Nam was a country with relatively high external debt-to-GDP ratio (60% of GDP in 1998), so mobilizing domestic financing sources is an urgent requirement. In the 5 year socio-economic plan, total investments required for the five years 1996-2000 is USD41-42 billion. Of which, a half is expected from foreign sources and the rest is from domestic sources. Whether the domestic sources can be raised depends mostly on the banking system's intermediate role because it can be said that the banking system is a life blood of the economy in the sense that it raises funds from savers and provides to investors in the economy. In addition, an increase in investment is not necessary to bring high economic growth because this depends on the efficiency of capital utilization. With such significance, analysis on the flow of funds between the banking system and the enterprise sector is very important. From that, comprehensive policy implications can be suggested in order to strengthen the banking system to become a strong link of an market oriented economy.

In the centrally planning economy, the Vietnamese banking system is one-tiered banking system that channeled profit and tax of the state owned enterprises to the state budget, and vice versa, transferred investment funds from the state budget to the state owned enterprises. In such mechanism, the business and production of enterprises had not been financed by bank credits. Since 1989, together with reforms in agriculture, industry, trade.., the banking system has had strong shift in line with transformation requirements of the economy and the banking reform has been considered as key reform in the economic renovation.

By transforming from one-tiered to two-tiered system, the Vietnamese banking system has developed rapidly in terms of scale and scope. Therefore, it has set up a wide network offering diversified services to every economic sector, so the intermediate role of the banking system has been confirmed day by day. It is more clear to see the increasing amount of rising funds, approximately accounted for 15% of GDP in the period of 1991-1995.

Since 1995, the flow of funds between the banking system and the enterprise sector, particularly the deposits of enterprises at the banking system and the credits of the banking system to enterprises have changed remarkably, both changes in the trend and the structure. The main reasons can be explained by different aspects such as policies, reasons from enterprises, reasons from banks as well as external economic environments. Following paragraphs mention changes in the flow of funds between the Vietnamese banking system and the enterprises sector since 1995.

1. Deposits of enterprises sector with the banking system

(1) The general trend

Macro-economy can be divided into 4 sectors such as the private sector, the government, the banking sector and the rest of the world. Transactions on income and expenditure of one sector will result in changes in assets and liabilities of other sectors. Under the planned economy, transactions between the government and other sectors are dominated while under the market economy, transactions between the banking system and other sectors are dominated.

The fact shows that, the Vietnamese banking system has played an increasingly important role in mobilizing funds from domestic sources to support the national investment. It could be seen through the upward trend of deposits at the banking system as illustrated in Table 1.

In general, deposits at the banking system have upward trend in term of absolute value, firstly because the banking system has been developing day by day both in scale and scope to build up a wide network for mobilizing funds throughout the economy. Secondly, the monetary policy reform since "Doimoi" has rebuilt confidence in the financial intermediate role of the Vietnamese banking system. Thirdly, the commercial banks continue to diversify forms of fund mobilizing such as certificates of deposit, commercial bank bonds, housing savings, personal checks for current payments and further modernize the banking system.

Table 1 The deposits of enterprises at the banking system, 1994-1999

Unit: VND 1.000 billion

	94	95	96	97	98	99
Total deposits	24,379	33,043	41,451	56,270	74,151	101,327
Of which						
1. VND deposits	14,850	21,981	28,292	37,579	49,223	63,901
a. Economic entities		8,981	12,498	18,767	23,077	32,760
Demand deposits		6,870	10,213	14,682	18,241	25,600
Time deposits		2,111	2,285	4,085	4,836	7,160
b. Savings		13,000	15,794	18,812	26,146	31,141
Demand deposits		1,133	2,273	2,047	2,069	1,475
Time deposits		11,867	13,521	16,765	24,077	29,983
2. Foreign curr. deposits	9,529	11,062	13,159	18,691	24,928	37,198
a. Economic entities		9,697	10,219	11,793	8,910	15,497
Demand deposits		6,768	6,347	7,549	6,001	11,876
Time deposits		2,929	3,672	4,244	2,909	3,621
b. Savings		1,365	2,940	6,898	16,018	21,701
Demand deposits		272	423	629	560	519
Time deposits		1,093	2,517	6,269	15,458	21,182
* Total deposits of economic entities		16,678	22,717	30,560	31,987	48,257

Sources: The State Bank of Viet Nam (the data is consolidated from 4 SOCBs and 24 non-state own commercial banks.

The Table 1 shows that, the deposits of commercial banks rise at high growth rate of 30% per year, bring the total deposits from VND 24,379 billion in 1994 to VND 101,327 billion in 1999. The growth rate of deposits was highest in 1995 because the Bank for Agriculture and Rural Development expanded its branches resulting in rapid increase in deposits (208%) compared to the amount of VND 6,309 billion in 1994 at this Bank (the Bank has largest deposit share of the banking system). Since 1995, the inflation has declined, the confidence on VND has been gradually recovered that leads to increase in VND savings. Moreover, the foreign exchange regulations are relaxed to encourage idle foreign currencies in circulation, especially foreign currencies stored by households.

Increase in total deposits at the banking system have improved the deposit-to-GDP ratio, from 14% in 1994 to 27% in 1999 (Table 3), reflecting a significant improvement in the financial deepening ratio, in other words, an improvement in the monetization level of the economy as a result of the banking reform efforts. In this period, it can be said that cash preferred phenomenon in transactions due to lack of confidence in the banking system was not popular in this period.

Table 2 Deposit structure at the deposit monetary banks

Unit: Percent

	94	95	96	97	98	99
Total deposits		**100%**	**100%**	**100%**	**100%**	**100%**
Of which						
1. VND deposits	**61%**	**67%**	**68%**	**67%**	**66%**	**63%**
a. Economic entities		27%	30%	33%	31%	32%
Demand deposits		21%	25%	26%	25%	25%
Time deposits		6%	6%	7%	7%	7%
b. Savings		39%	38%	33%	35%	31%
Demand deposits		3%	5%	4%	3%	1%
Time deposits		36%	33%	30%	32%	30%
2. Foreign curr. deposits	**39%**	**33%**	**32%**	**33%**	**34%**	**37%**
a. Economic entities		29%	25%	21%	12%	15%
Demand deposits		20%	15%	13%	8%	12%
Time deposits		9%	9%	8%	4%	4%
b. Savings		4%	7%	12%	22%	21%
Demand deposits		1%	1%	1%	1%	1%
Time deposits		3%	6%	11%	21%	21%

Sources: Calculation from Table 1

However, the deposit-to-GDP ratio of Viet Nam is low as compared to that of other countries in the region and in the world. The main reason is that the settlement system through banking system is poor, the financial market has not been developed and in fact, strengthening the Vietnamese banking system is still required to bring its financial intermediate role into full play in a market oriented economy, especially, in the condition that Viet Nam is in shortage of capital.

Table 3 The deposit-to-GDP ratio, 1994-1999

Unit: Billion VND and %

	94	95	96	97	98	99
Total deposits	24.379	33.043	41.451	56.270	74.151	101.327
GDP	170.258	222.840	258.609	295.696	335.876	380.000
Total deposit/GDP	14%	15%	16%	19%	22%	27%

Source: The State Bank and GSO

(2) Changes in deposit structures

Since 1995, total deposits have had upward trend. Although the deposits of individuals have increasing tendency, changes in deposits classified by depositors are not significant. Classified by maturity (demand and time) and by type of currencies, the deposits change remarkably. The main factors that lead to these changes are inflation, interest rate and exchange rate. It can be seen from each period as follows:

- *Deposits in Vietnamese Dong*

  In 1995, because the inflation was stable and the time deposit interest rate was higher than that of demand deposits, the time deposits (including time deposits and time savings) increased and accounted for larger share as compared to that of demand deposits, facilitating to medium and long-term loan expansion by credit institutions.

  - During 1996-1997, when the inflation had declining trend, the share of demand deposits in total deposits increased. Of which the demand deposits of economic entities rose sharply because in the second half of 1997, many enterprises hesitated in investments resulting in a huge amount deposits of the economic entities at the credit institutions.
  - In 1998, the economic growth rate was at record low level and an expectation of VND devaluation due to the impact of regional crisis. As a result, the growth rate of deposits dropped to 22% in 1998 from 38% in 1997.

- *Foreign currency deposits*

  - Like to VND deposits, the foreign currency deposits of economic entities and individuals at credit institutions also increase rapidly, especially in recent years. In terms of absolute value, the total foreign currency deposits rose from VND 11,062 billion in 1995 to VND 37,198 billion in 1999. The growth rate increased from 19% in 1995 to 49% in 1999.

    + The foreign currency deposits of the economic entities have increasing trend except for decreasing trend in 1998. The reason deposits dropped in 1998 is the decrease in foreign currency revenue. It is possible to explain that: Firstly, the Government promulgated the Decision No 173/1998/QDD-TTg on the selling obligation and buying rights of residential organizations under which there is a stipulation that residential organizations have to sell at least 80% of foreign currencies revenue from current transactions to the commercial banks who are allowed to deal with foreign exchange; Secondly, due to negative impacts of regional crisis, the export growth rate dropped to 1% from