A－7

Financial System Reform Achievement and Non-Performing Loan Issues

Masahisa Koyama

The Japan Economic Research Institute

Toshiyuki Katagiri

The Japan Economic Research Institute

The following report is based on interviews with numerous financial institutions (including the State Bank of Viet Nam, state-owned commercial banks, joint-venture banks, and foreign bank branches), state-owned enterprises, and private companies, as well as information and data obtained by the counterpart to this study. Also we referred to many publications and statistical data of WB, IMF and ADB.

1. Macroeconomic performance in the 1990s

Since the commencement of the economic reform in the late 1980s, Viet Nam has achieved remarkable economic growth. Hyperinflation, caused by the monetization of debt in the latter half of the 1980s, had been contained by balanced budget policy and tight monetary policy by the early 1990s. This has also contributed to the stabilization of VND value, which has resulted in attracting foreign direct investment (FDI). Active FDI was another factor for sustaining Vietnamese high economic growth in the 1990s.

The Asian financial crisis, which was triggered by the sudden devaluation of the Thai Baht in the middle of 1997, which was caused by the change of currency control into floatation, has indirectly influenced the Vietnamese economy. The export to the neighboring countries shrunk, and the inflow of FDI was also weakened. Thus, the Vietnamese economy has been stagnant since 1998. Its real GDP growth rate has declined to four to five percent from eight to nine percent in former periods. In 2000, the economy in Viet Nam is slowly recovering, led by expansion of export. The State Bank of Viet Nam (SBV) has continued to ease its monetary policy by easing interest rates and the reserve requirement, in order to stimulate domestic demand. However, the lending interest rates in the real term do not seem sufficiently low to stimulate domestic demand in the current deflationary economic environment.

Table 1 Macroeconomic indicators

(Unit: %, except GDP - VND trillion)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Real GDP Growth rate	5.1	6.0	8.7	8.1	8.8	9.5	9.3	8.2	5.8	4.8
GDP				140	178	229	272	314	361	399
CPI	67.5	67.5	17.4	5.2	14.4	12.7	4.5	3.6	9.2	0.1
Budget deficit/GDP	-8.0	-3.7	-3.7	-6.2	-2.6	-0.8	-0.7	-3.9	-2.0	-3.8
Current A/C deficit/GDP	-	-	-	-	-	-12.8	-9.9	-6.2	-3.9	4.4
M2/GDP	0.27	0.27	0.25	0.24	0.25	0.24	0.23	0.26	0.28	0.36
Real savings rate	-	-	-	-	-	3.5	5.2	4.1	0.4	3.9
Real lending rate	-	-	-	-	-	12.4	11.8	8.6	4.9	11.7

(Sources: SBV and IME data)

2. Achievement of the financial system reform toward the market-oriented economy

2-1 Sequence of the financial reform

In the previous joint study (Phase 2) in 1998, we touched on the sequence of the banking system reform in Viet Nam (see appendix 2 on central bank reform and appendix 3 on commercial bank reform). Regarding this topic, the World Bank reported on the steps of financial sector reform in its World Development Report in 1989. WB's team implemented a comparative study by countries and drew lessons from a variety of experiences.

According to this report, financial reform comprises three stages. First, reform should be started by getting the fiscal deficit under control and establishing macroeconomic stability, and the government should also try to improve the foundations of finance— that is, the accounting and legal systems, procedures for the enforcement of contracts, disclosure requirements, and the structure of prudential regulation (see box 2 for Viet Nam's current prudential regulation) and supervision. In the second stage, financial reform should be intended to promote the development of a greater variety of markets and institutions and to foster competition. On the external side, foreign entry into domestic financial markets should be encouraged to increase proper competition and efficiency after domestic financial institutions are ready to compete fully. In the final stage, the government can completely liberalize interest rates, minimize directed credit programs, relax capital controls, and remove restrictions on foreign institutions. The report concludes that when macroeconomic stability has been established and the domestic financial system has been liberalized and deepened, it will be safe to allow greater freedom for foreign institutions and capital flows to integrate into the domestic and international financial markets (see box 1 for details).

Box 1 Lessons of financial reform in transition economies

—steps in moving from regulated to liberalized financial system—

(World Development Report 1989 by the World Bank)

1st Stage

- Reform shoulded be started by getting the fiscal deficit under control.
  - Borrowing from the central bank causes high inflation.
  - Borrowing from domestic banks through high reserve and liquidity requirements is less inflationary, but it weakens bank profitability, distorts interest rates, and crowds out private sector borrowers.
  - Borrowing from a securities market is preferable: establishing a short-term government securities market, which makes it possible for the government to engage in open market operations.
- Establish macroeconomic stability.
- Scale down and prioritize directed credit programs as a means of decreasing the subsidy from the government.
- Adjust interest rates in line with inflation and other market forces.
- Improve the foundations of finance.
  - the accounting and legal system
  - procedure for the enforcement of contracts
  - disclosure requirements
  - structure of prudential regulation and supervision
- Encourage managerial autonomy in financial institutions.
- If institutional insolvency is widespread, the government may need to restructure some financial institutions in the early stages of reform.

2nd Stage

- Promote the development of a greater variety of markets and institutions to foster competition.
- Introduce broader ranges for deposit and lending rates.
- Encourage foreign entry to domestic financial markets to increase competition and efficiency with necessary restrictions until domestic institutions can compete fully.

Final Stage

- Completely liberalize interest rates.
- Limit the remaining directed credit programs.
- Remove restrictions on foreign institutions.
- Liberalize trade transactions first, then relax capital movements.
- Link the domestic and international financial markets.

A gradual liberalization will impose losses, but it will allow firms time to adjust and financial institutions time to develop the new skills they will need. The appropriate balance must be judged in each case.

Box 2 Prudential regulations in Viet Nam

After the Asian financial crisis, many Asian countries changed their prudential regulations and supervision for building a robust banking sector. An efficient and sound banking system is prerequisite in order to promote economic development. In Viet Nam many regulations and decrees have been introduced since 1998. Some regulations for banks in Viet Nam are at the same standard as those introduced in other Asian countries after the financial crisis. Although major items have been covered by these regulations, there still remain some issues for which new regulations need to be introduced. Strict and transparent regulations and supervision will contribute to maintaining a sound and stable banking system.

Comparison of major regulations for banks

Items	Viet Nam	Indonesia	Korea	Malaysia	Thailand
Capital adequacy ratio target	8%	4% (End of 2001 8%)	Mar 2000 8% (End of 2000 10%)	8%	Commercial banks 8.5% Financial companies 8%
Loan classification (days elapsed before considered past due)	Lowered from 360 to 90 days	No change 180 days	Lowered from 180 to 90 days	No change 180 days	Lowered from 360 to 90 days
Loan loss provisioning (substandard/ doubtful/loss)	20 / 50/ 100	0 /50/ 100 to 10-15 /50 / 100	20/75/100 (backward looking) to 20/50/100 (forward looking)	No change 0/50/100	0/50/100 to 20/75/100
Interest accrual	Lowered from up to 6 months to up to 3 months; no claw-back	Lowered from up to 6 months to up to 3 months; no claw-back	Lowered from up to 6 months to up to 3 months; no claw-back	No change - up to 6 months; with claw-back	Lowered from up to 6 months to up to 3 months; no claw-back
Single customer limit	Loans: 15% of the equity capital	20% of the equity capital (10% for related parties)	Loans: 15% of the equity capital Guarantees: 30%	25% of a bank's shareholder's fund	25% of Tier 1 capital
Lending for stock purchase	None	Prohibited from underwriting commercial paper	No lending for speculative purposes	Out of total outstanding loans: commercial banks and finance companies 20%, merchant banks 30%	Margin loans are classified as a non-priority sector

Sources: WB (1999) "The East Asia Recovery and Beyond", ADB (1999) "Banking Sector Reforms: Recovery"

To what extent has Viet Nam achieved financial reform? And what are the remaining problems? These questions are considered in the following summaries.

2-2 Commercial banking system reform

Financial reform in Viet Nam has been cautiously achieved step by step in line with the reform sequence mentioned above. As for commercial banking system reform, the Vietnamese government and SBV have succeeded in stabilizing inflation and macroeconomic conditions by restoring strict fiscal and monetary discipline. And now SBV is making efforts to restructure the commercial banking system and to reinforce the established money and securities markets in order to construct a more market-based, sound and robust domestic financial system for further integration with the international financial market. One example is the improvement of the settlement system through the modern inter-bank network system and inter-bank money market. Another example is the deposit insurance system, which was established in March 1999 as a safety net instrument. Introduction of these new systems and improvement in such financial foundations as the legal system, accounting system and supervision are expected to attract depositors (the banks' customers) and investors in terms of reliability and convenience, and to contribute to the financial deepening.

2-3 Reform of the monetary control instruments

As for the monetary control instruments, SBV's policy is now shifting from direct control to more market-based indirect control, as shown below.

(1) Liberalizing interest rates
- Removed the deposit interest ceiling in 1996
- Liberalized deposit interest and inter-bank interest in 1996
- Introduced the basic lending interest rate with risk spread instead of the former ceiling rate in August 2000

(2) Changing the reserve requirement policy from a rigid regime to a flexible one

(3) Applying open market operation instruments since August 2000 (T-bills, SB bills)

(4) Canceling the credit ceiling, which had been used as direct intervention in the commercial banks' lending activities from 1994 to 1998

(5) Maintaining refinancing instruments for such specific purposes as short-term financing with collateral, short-term loans (for clearing) to offset temporary shortages in payment, and directed lending based on the government policies

(6) Adjusting the foreign exchange rate to be based more upon the inter-bank FOREX market

Interest rates in Viet Nam have been gradually liberalized by SBV; however, they are still restricted. The current local currency base rate (similar to the prime rate) is 0.75 percent per month and the risk margin is 0.3 percent (short term) to 0.5 percent (medium term and long term). SBV adjusts the base interest rates monthly and announces them publicly after evaluating the market data and information. Though the profit margin for the commercial banks, which are suffering with the non-performing loans (NPLs) problem, needs to be wider, the financial market reflects the weak loan demand. Taking account of the sluggish market condition and the fact that the government and SBV have a responsibility to manage the restructuring of state-owned enterprises (SOEs), the current interest rate levels are understandable. However, for the enterprises, the current interest rates in real terms still seem too high to make active investments. Interest rates and risk margins seem to have been determined to meet the financial market under the influence of both the commercial bank reform from the lenders' side and the SOE reform from the borrowers' side.

Table 2 Trends in short-term deposit and lending interest rates

(Unit: % / month)

		90.12	91.12	92.12	93.12	94.12	95.12	96.12
Deposit	(A)	4.0	3.5	2.0	1.4	1.4	1.4	0.8
Lending	(B)	4.0	3.5	2.7	2.1	2.1	2.1	1.25
Spread	(B-A)	0.0	0.0	0.7	0.7	0.7	0.7	0.45

	97/3	6	9	12	98/3	6	9	12	99/3	6	9	12
(A)	0.8	0.8	0.75	0.75	0.85	0.9	0.8	0.85	0.8	0.71	0.41	0.33
(B)	1.25	1.25	1.0	1.0	1.2	1.2	1.2	1.2	1.1	1.0	0.95	0.85
(B-A)	0.45	0.45	0.25	0.25	0.35	0.3	0.4	0.35	0.3	0.29	0.54	0.52

(Sources: Phase 2 Final Report and SBV data)

2-4 Restructuring of the commercial banks

The restructuring of the commercial banks has been implemented slowly. Each SOCB's restructuring plan, which includes the separation of NPLs and the re-capitalization, has already been submitted to the relevant authority, but none have been fully approved yet. As for the separation of the function of policy-based finance, the Development Assistance Fund (DAF), which was established in the beginning of 2000, provides long-term policy-based financing for important industrial and infrastructure development projects under sound banking principles. DAF integrated the same function that had been provided by the Bank for Investment and Development of Viet Nam (BIDV) since its commencement. And the Bank for the Poor is planned to be independent from the Viet Nam Bank for Agriculture and Rural Development (VBARD), aiming for concentrating policy-based financing for the poor. As long as those policy-based financial institutions play a banking function, they need sound banking operation and management under strict discipline. For achieving this, autonomous status for the decision making and professional skills for the credit appraisal will be needed. It is also necessary for policy-based financial institutions to focus on their own lending targets and complement the commercial banking activities.

The restructuring of joint-stock banks (JSBs) is also proceeding. SBV instructed all existing JSBs to raise their capital levels by 2001. If a JSB will not be able to reach the minimum capital level, it will be expelled from the market. Thus, the number of JSBs is decreasing through closure or consolidation. We hope this movement will strengthen the financial base of the commercial banks and increase their competitiveness as a whole. However, since JSBs have played a pivotal role in fund mobilization for small- and medium-sized enterprises (SMEs), policymakers should take necessary action to avoid a decrease in SME loans during the JSB restructuring process. Private sector promotion is expected to create job opportunities and reduce poverty.

2-5 Establishment of the securities market

In July 2000, the HCMC Securities Trading Center started its operations. Since the numbers of listed stocks and tradable government bonds have been limited so far, the center has to manage the potentially volatile market by limiting the daily trading price fluctuation. The market seems to be still in the experimental stage for further development. However, its function of providing additional financing options to various enterprises is surely important. The Ministry of Finance (MOF), SBV and the State Securities Commission (SSC) are now preparing for the establishment of the Ha Noi Securities Trading Center in 2001. The legal framework for the listing procedure and trading activities has been cautiously created and has been provided to the market, and the disclosure rules for listed enterprises have also been introduced to make the market environment transparent. What this market needs to do now is to attract more potential candidates by providing better incentives and relaxing the market environment, and to supply more stocks and a variety of financial products that attract investors and meet their demands. It is expected that further development of the capital market will widen the domestic fund mobilization opportunities for both enterprises and the government. Also we expect that it will encourage SOE-reform activities by paving an optional road for more active equitization and privatization. The capital market will also be a new instrument for indirect money supply control by SBV—that is, open market operations.

As a variety of institutional frameworks have been established in line with the governmental reform plan, policymakers should pay much attention to the efficient implementation of each operation and achievement of its goal.

3. Review of the ad-hoc measures set by the Government and SBV since 1997 to bail out weakened enterprises and farmers

The Asian financial crisis and recurring natural disasters in rural areas had damaged the balance of cash flow among vulnerable SOEs and farmers. Responding to this situation, the government and SBV enacted several policy measures, aiming to facilitate the cash flow to loss-making SOEs and damaged farmers.

- Resolution No. 49/CP (May 1997): "SOEs are allowed to borrow from SOCBs without collateral, and without limitation based on their charter capital. For the farmers who borrowed from banks, if they face difficulties, they may receive debt relief and new loans to continue their production."

- Circular No. 03/1997/TTTL/NHNN-BTC on guidance to SOCBs for dealing with the remaining overdue debts of SOEs and cooperatives up to Dec. 31, 1996 (November 1997): "The overdue debts caused objectively by unavoidable reasons are considered canceled or to be carved out within three to five years."
- Memo No. 959/KTKH (March 1997): "...continue transforming the short-term funds of commercial banks into medium- and long-term loans for planned investment projects..."
- The SOCBs continue to reduce by 30 percent the lending interest rate for area III (hiland, Khmer ethnic group, and the area of natural disaster).
- Directive No. 08/1998/ct-NHNN (October 1998): "...[as for the] overdue debts before 30 June 1998 from SOEs which faced difficulties, the credit institutions are permitted to retrieve the principal value first, then retrieve the interest later. For the overdue debts caused by natural disasters, the borrower can enjoy debt relief. For overdue debts of loss-making enterprises, the credit institutions can consider the maturity of the loans but these loans in total cannot exceed a maximum of 15 percent of the redefining total credit outstanding."
- Decision No. 67/1999/QD-TTg (March 1999): "Farmers are not required to provide mortgage for loans less than VND 10 million. The cooperatives, plantation owners, agricultural cooperatives, and SOEs, which work as dealers of rice export and fertilizers import are allowed to use the assets formed by the loans for the loan guaranty."

Under these emergency measures, most loss-making SOEs and farmers were rescued from going into default. However, as long as these measures continue, the losses of borrowers will have to be borne by SOCBs, and the potential bad debts will be kept within the loan assets of SOCBs. Since these measures should be temporal ones, up to achieving their purposes, policymakers have to think how and when each measure should be phased out. Otherwise, the asset quality of SOCBs will continue to worsen and strict and healthy corporate management discipline of both lenders and borrowers will not be achieved.

4. Non-performing loan issues

4-1 Recent financial status of the commercial banks

The trend of business performance among commercial banks in Viet Nam is shown in appendix 4, which covers balance sheets and profit and loss statements. The table below shows the summary.

Table 3 Worsening of NPLs

(Unit: billion VND, %)

	1996	1999	99 / 96	Annual growth rate
Total assets	86,203	159,147	1.84	16%
Total loans	50,751	86,626	1.71	15%
NPLs	4,726	10,490	2.21	22%
NPLs / loans	9.3	12.1	...	
NPLs / assets	5.5	6.6	...	
Equity / assets	7.2	7.3	...	
Total income	8,969	11,973	1.33	7%
Operating income	2,840	3,427	1.21	5%

(Sources: SBV data and annual reports of four SOCBs)

The commercial banks in Viet Nam have expanded their assets at an average annual growth rate of 15 percent from 1996 to 1999. Meanwhile, the operating income (net interest income plus net non-interest income) has grown by only 1.2 times – that is, its annual growth rate for the same period was five percent—and the volume of NPLs has more than doubled—its annual growth rate was 22 percent—as shown in table 3.

Table 4 Four SOCBs' deposit structure and asset breakdown

(Unit: VND trillion)

	'95.12	%	'96.12	%	'97.12	%	'98.12	%	'99.12	%
Total Assets	**58.0**	**100**	**66.0**	**100**	**81.3**	**100**	**105.0**	**100**	**134.9**	**100**
Deposit (SBV)	5.7	**10**	6.5	**10**	7.0	**9**	7.4	**7**	11.2	**8**
Deposit (Other banks)	8.6	**15**	10.5	**16**	14.0	**17**	19.7	**19**	31.1	**23**
Loans to economy	33.6	**58**	38.3	**58**	48.0	**59**	59.1	**56**	72.4	**54**
Others	10.1	**17**	10.7	**16**	12.3	**15**	18.8	**18**	20.2	**15**
Liabilities & capital	**58.0**	**100**	**66.0**	**100**	**81.3**	**100**	**105.0**	**100**	**134.9**	**100**
Due of other banks	10.0	**17**	11.7	**18**	13.0	**16**	15.3	**15**	11.4	**8**
Residents' deposit	**24.6**	**42**	**30.5**	**46**	**44.2**	**54**	**61.7**	**59**	**87.3**	**65**
(in Dong)	17.6	**30**	22.9	**35**	31.6	**39**	41.8	**40**	55.6	**41**
-Enterprises	7.7	**13**	10.7	**16**	15.9	**20**	19.8	**19**	28.5	**21**
-Individuals	9.8	**17**	12.2	**18**	15.7	**19**	22.0	**21**	27.1	**20**
(in USD & others)	7.0	**12**	7.7	**12**	12.6	**15**	19.9	**19**	31.7	**23**
-Enterprises	6.0	**10**	5.3	**8**	6.8	**8**	6.0	**6**	12.4	**9**
-Individuals	1.1	**2**	2.3	**3**	5.8	**7**	13.9	**13**	19.3	**14**
Other liabilities	20.6	**36**	20.5	**31**	19.6	**24**	20.4	**19**	28.5	**21**
Capital & reserve	2.8	**5**	3.3	**5**	4.5	**6**	7.6	**7**	7.7	**6**

(Source: SBV data, for four SOCB's and 24 non state-owned banks)

Table 4 shows the trend of the deposit taking and the asset breakdown of the commercial banks in Viet Nam. As for the deposit side, its volume has remarkably increased both in domestic VND and in foreign currencies. VND deposit has tripled and the foreign currency deposit has expanded by 4.5 times in these four years. Expansion of foreign deposit by individuals was especially remarkable in 1998 and 1999. This deposit expansion is due to the stabilization of the macro economy. The decrease in inflation seems to be a major factor. Since households can now enjoy positive real interest rates, they tend to deposit their money in reliable commercial banks instead of keeping it at home. Meanwhile, looking at the asset side, the loan outstanding to the real economy is rather constant, even with the strong increase in deposits. This reflects the recent stagnant economy. It is also assumed that due to the weak domestic demand for foreign currency loans, commercial banks tend to mobilize their foreign currency deposits by investing in the international financial market through inter-bank operation. The volume of foreign currency deposit on the liability side almost equaled the deposit to other banks on the asset side in 1998 and 1999. SBV has eased the reserve requirement (to five percent from 10 percent) to increase the liquidity in the market. However, the commercial banks' deposit with SBV has not declined in terms of volume. This may show the lack of internal investment opportunities under the stagnant domestic demand. The above-mentioned asset allocation seems to be insufficient for producing enough commercial bank profit.

Table 5, showing the breakdown of the commercial banks' credit, reveals some characteristics such as,

- The share of credit for SOEs has gradually declined, while credit for the private sector and households has increased.
- By sector, the loans in construction expanded in 1997.
- By term, the share of long-term loans has increased.

We have to pay much attention to the increase in loan exposure to the construction sector and the maturity mismatch between funding and lending caused by the increase in long-term lending. Both may cause higher risk for the banks.

Table 5 Credit breakdown in commercial banks

(Unit: in VND billion, %)

	95.12	%	96.12	%	97.12	%	98.12	%	99.12	%
Credit total	**42,277**	**100**	**50,751**	**100**	**62,200**	**100**	**72,595**	**100**	**86,625**	**100**
(By ownership)										
1. SOEs	24,079	57	26,809	53	30,980	50	37,706	52	41,752	48
2. Others	18,198	43	23,942	47	31,220	50	34,889	48	44,873	52
(By sector)										
1. Agri/forestry	11,407	27	11,311	22	15,129	24	18,570	26	22,683	26
2. Industry	11,679	28	14,126	28	16,462	26	19,301	27	23,682	27
3. Construction	4,696	11	7,380	15	11,319	18	11,290	16	12,413	14
4. Trade, repair	11,942	28	13,608	27	13,618	22	15,480	21	18,771	22
5. Others	2,552	6	4,326	9	5,671	9	7,953	11	9,076	10
(By term)										
1. Short term	28,472	67	34,037	67	37,280	60	39,542	54	47,300	55
2. Long term	13,805	33	16,714	33	24,920	40	33,053	46	39,325	45

(Source: SBV Data for four SOEs and 24 non-state banks)

4-2 Negative effect of NPLs on commercial banks' profit

Appendix 5 shows the trends of interest rates and spread. Since the interest rate spreads of commercial banks (local currency, four to five percent per year: foreign currency, two to three percent per year) did not change over these three years, it is assumed that the increase in NPLs has damaged the quality of loan assets and the profitability of banks. The volume of NPLs in 1999 was more than VND 10 billion, and the NPL ratio was 12.1%. If we assume that NPLs did not produce any interest in 1999 and the interest spread was five percent annually, the commercial banks would have lost more than VND 500 billion in 1999. It is equal to 15 percent of total operating income of four SOCBs and almost meets their total net profit before tax, which was VND 735 billion.

The ratio of NPLs to total assets was 6.6% in 1999, which was nearly equal to the equity ratio (7.3%). If all NPLs are unrecoverable, the banks will lose their credit worthiness, which is usually measured by net assets (total assets minus total liabilities). The related authorities have to watch the change in asset quality carefully and respond to this problem as quickly as possible in order to avoid a liquidity crisis in a still fragile banking system, and to construct an efficient and robust financial system.

4-3 Scheme to resolve the NPL problem

In order to restructure weakened commercial banks, SBV and related authorities are now preparing a package of action programs, including re-capitalization to strengthen the equity base, and establishment of an asset management corporation (AMC) for the liquidation of the bad debts. The framework of the restructuring scheme and the concept of a planned AMC are shown in appendices 6 and 7. Regarding the operation of the AMC, I would like to point out several remaining problems, which should be resolved quickly.

- Identifying all of the functions of the AMC
- Determining which NPLs to cover (Does the AMC cover only NPLs with collateral?)
- Determining the purchasing price for bank assets (book value or market value)
- Activating the asset disposal and collection system (encouraging transfer of land use rights at the auction center)
- Determining how to settle the loss-sharing between the state and each bank
- Determining how to finance the estimated costs
- Providing a timeframe for the targeted asset disposal by the AMC

In China, the AMCs of four major SOCBs have already been established, starting their operation in 1999. The burden-sharing plans between the state and the banks were set based on each bank's responsibility for causing the bad debts. China's government planned to complete the disposal of the NPLs and the restructuring of the viable but loss-making enterprises through the AMC within ten years. The details are described in appendix 7.

As for the re-capitalization of commercial banks, it is essential to select the viable and creditworthy banks and to monitor their restructuring achievement periodically by a supervisory authority.

4-4 Cost estimation of the commercial bank reform

According to the SBV report for this phase 3 joint study, the required reform costs were estimated at about USD 1.5 billion (about VND 22 trillion), approximately six percent of GDP. Its breakdown is shown below.

- The costs of resolving the current NPLs and loans of SOE reform account for USD 700 million.
- The costs of raising the charter capital of SOCBs and JSBs are about USD 700 million.
- The amount for training banking staffs and investing in technology is USD 100 million.

If the implementation of these restructuring measures is delayed, further policy costs will be added and the Vietnamese financial system will continue to be vulnerable. Therefore, quick implementation of the restructuring measures is important above all.

4-5 Countermeasures for avoiding future NPL problems

Preventing future NPLs is more important than liquidating the existing NPLs through the above-mentioned bailout scheme. To achieve this, the following measures are necessary.

- Introducing prudential regulation by the SBV (see box 2)
- Building up the professional capacity, such as risk management and credit analysis skills, in the banking sector
- Separating the directed finance function from the commercial banks and allowing banks to be autonomous
- Strengthening the deposit insurance system as a financial safety net
- Accelerating the reform of SOEs to make them viable and healthy (good customers for the banks)
- Providing necessary incentives for establishing strict and sound corporate management discipline in both lenders and customers

5. Conclusion and policy recommendation

Viet Nam succeeded in stabilizing the macro economy in the early 1990s. However, the financial system in Viet Nam is still vulnerable and many issues remain unsolved.

- Improving the foundations of the domestic financial system
- Restructuring of the commercial banks (SOCBs and JSBs)
- NPL issues

- Separating the policy-based finance function from the commercial banks
- Introducing more market-based monetary policy instruments

A summary of the remaining problems and make some final comments on follows.

(1) The interest rate policy, while taking into consideration both commercial banking and SOE reform by the authorities, has been gradually liberalized and cautiously adjusted to meet the market demand. However, the current policy still seems to repress the commercial banks' lending activities to some extent. This policy, which is characterized by a base rate plus risk spread, should be liberalized to meet the market conditions in line with the achievement of the banking system reform and the restructuring of commercial banks.

(2) The ad hoc measures also seem to repress the commercial banks' profitability. Since these measures are temporal ones, policymakers have to consider the timing for phasing them out. Otherwise, the asset quality of SOCBs will continue to worsen and the corporate relationship between lenders and borrowers will be neither strict enough nor healthy enough.

(3) The separation of the policy-based finance function from the commercial banks progressed with the establishment of the Development Assistance Fund in the beginning of 1999. As long as it plays a banking function, it needs to be operated under sound banking principles. Autonomy in decision making and professional skills for credit appraisal will also be needed.

(4) The restructuring of the JSBs is proceeding as directed by SBV. Since JSBs play a pivotal role in channeling funds to SMEs, we are concerned about possible reduction in this area during the restructuring process. Policymakers should take necessary action to avoid a shortage of credit to SMEs.

(5) As for the asset and liability management of the commercial banks, there is danger of a maturity mismatch between funding and lending, due to the recent increase in long-term lending. This may increase the interest fluctuation risk for the commercial banks.

(6) As for the NPL issues, it is necessary for policymakers to implement a package of restructuring programs for commercial banks as quickly as possible, to provide a time schedule of the restructuring process and monitor its achievement periodically.

(7) Estimated costs for the restructuring of the commercial banks accounted for USD 1.5 billion, approximately six percent of GDP. If the implementation of those restructuring measures is delayed, we

have to note that further policy costs will accrue and the Vietnamese financial system will continue to be vulnerable.

(8) The securities market started its operation in July 2000. Though the market seems to still be in the experimental stage, its function of providing an additional financing option to various enterprises is surely important. The development of the capital market is expected to widen the domestic fund mobilization opportunities for both enterprises and the government, and to promote SOE equitization. It will also provide a new indirect money supply control instrument (open market operations) for SBV.

A reliable and robust banking system is essential for sustainable growth by any nation. Once the system collapses, it consumes time and administrative costs for recovery. Sound operation in each bank guarantees a reliable and smooth financial intermediary function in a nation's financial system. As a complement, SOE reform is very important for keeping competitiveness in the world market; however, it creates much unemployment and there are high social costs related to redundant employees. Though financing the costs of both the banking system and the SOE reform will be another heavy burden on the government budget, policymakers have to consider doing so, bearing the necessary costs in a future budget plan.

References

1. Viet Nam – Japan Joint Research Papers (Phase 3) provided by MPI, SBV, and MOF (consignment work) (2000)
2. Study on Economic Development Policy in the Transition Toward a Market-oriented Economy in Viet Nam (Phase 2) Final Paper (1998)
3. Watanabe and Ly, Joint Follow-up Research Project (JICA 1999)
4. The World Bank, Viet Nam Preparing for Take-off? (1999)
5. The World bank, The World Development Report (1989)
6. The World Bank, East Asia—Recovery and Beyond (2000)
7. International Monetary Fund, Statistical Appendix and Background Notes (2000)
8. OECF Research Paper No. 9, "Fiscal and Financial Reform in Viet Nam" (1996)
9. Kenichi Ohno, Globalization in the Transition Economies (Toyokeizai 2000)

Appendix 1

Macroeconomic performance in Viet Nam and China

	Viet Nam					China				
	'96	'97	'98	'99	'00/P	'96	'97	'98	'99	'00/P
Real GDP growth rate (%)	9.3	8.2	5.7	4.7		9.7	8.8	7.8	7.1	
GDP at current prices (in VND trillions)	272	314	361	399		6.8	7.4	7.9	8.3	(in CNY millions)
Consumption	225	251	283	302		4.0	4.3	4.6		
Investment	76	89	105	109		2.3	2.5	2.7		
Net exports	-30	-25	-26	-9		0.1	0.2	0.3		
Current account balance	-2,431	-1,664	-1,067	1,252		7,243	29,718	29,325		
Capital account balance	2,079	1,662	216	-334		39,966	22,957	-6,323	(in USD millions)	
Overall balance	-281	-4	-524	768		31,705	35,857	6,248		
Per capita GDP (in USD)	336	360	359	372		667	727	768	-	
CPI (%)	4.5	3.6	9.2	0.1	2.0	8.3	2.8	-0.8	-1.3	
Unemployment rate (%)	5.9	6.0	6.9	7.4		3.0	3.1	3.1	-	
Exchange rate (VND 1000/USD)	11.1	12.3	13.9	14.0	14.3	8.31	8.29	8.28	8.28	(CNY/USD)
Government revenue (in VND trillions)	62.4	65.4	73.0	69.5	74.5	0.74	0.87	0.99		(in CNY millions)
Government expenditure (in VND trillions)	64.3	77.6	80.2	84.4	94.7	0.79	0.92	1.08		
Budget deficit (in VND trillions)	1.9	12.2	7.2	14.9	20.2	0.05	0.06	0.09		
Budget deficit/GDP	-0.7	-3.8	-2.0	-3.7		-0.8	-0.8	-1.2		
Broad money: M2 (in VND trillions)	64.7	81.6	102.4	142.6	156.7	7.6	9.1	10.5	11.9	(in CNY millions)
Broad money growth rate (%)	22.7	26.1	25.6	39.3	45.6	25.3	19.6	14.8	14.7	
Deposit (in VND trillions)	42.0	56.5	75.5	101.1	113.8					
Deposit growth rate (%)	25.3	43.3	33.6	34.0	40.3					
Domestic credit (in VND trillions)	55.3	66.8	81.0	89.6	93.3					
M2/GDP	0.23	0.26	0.28	0.36		1.12	1.22	1.32	1.43	
Non-performing loans (NPLs: in VND billions)	4,726	7,656	8,693	10,490				→ CNY 2.0 trillion		
Npls/Loans (%)	9.3	12.3	12.0	12.1				→ 23%		
Npls/Total assets (%)	5.5	7.4	6.8	6.6				→ 18%		
Equity/Total assets (%)	7.2	7.9	9.1	7.3				→ 8%		
Npls/GDP (%)	1.7	2.5	2.4	2.6				→ 25%		

Sources: IMF's Statistical Appendix and Background Notes (2000) and SBV data

Appendix 2

Sequence of the financial system reform
- Strengthening the functions of the Central Bank -

- Stabilization of inflationary pressure
  - Monetary control
  - FOREX control

↓

- Improvement of the settlement system
  - Better networking
- Development of the inter-bank market
  - Refinancing instrument of SBV
  - Short-term call market

=

- Modernization of the Central Bank's function
  - Stronger financial survey ability
  - Improvement of monitoring and supervisory functions
  - Better fund management ability
- Standardizing the bank accounting system

↓

- Introduction of the safety net instrument
  - Deposit insurance system

↓

- Development of the securities market
  - Introducing a variety of financial products
  - Promoting a secondary market

↓

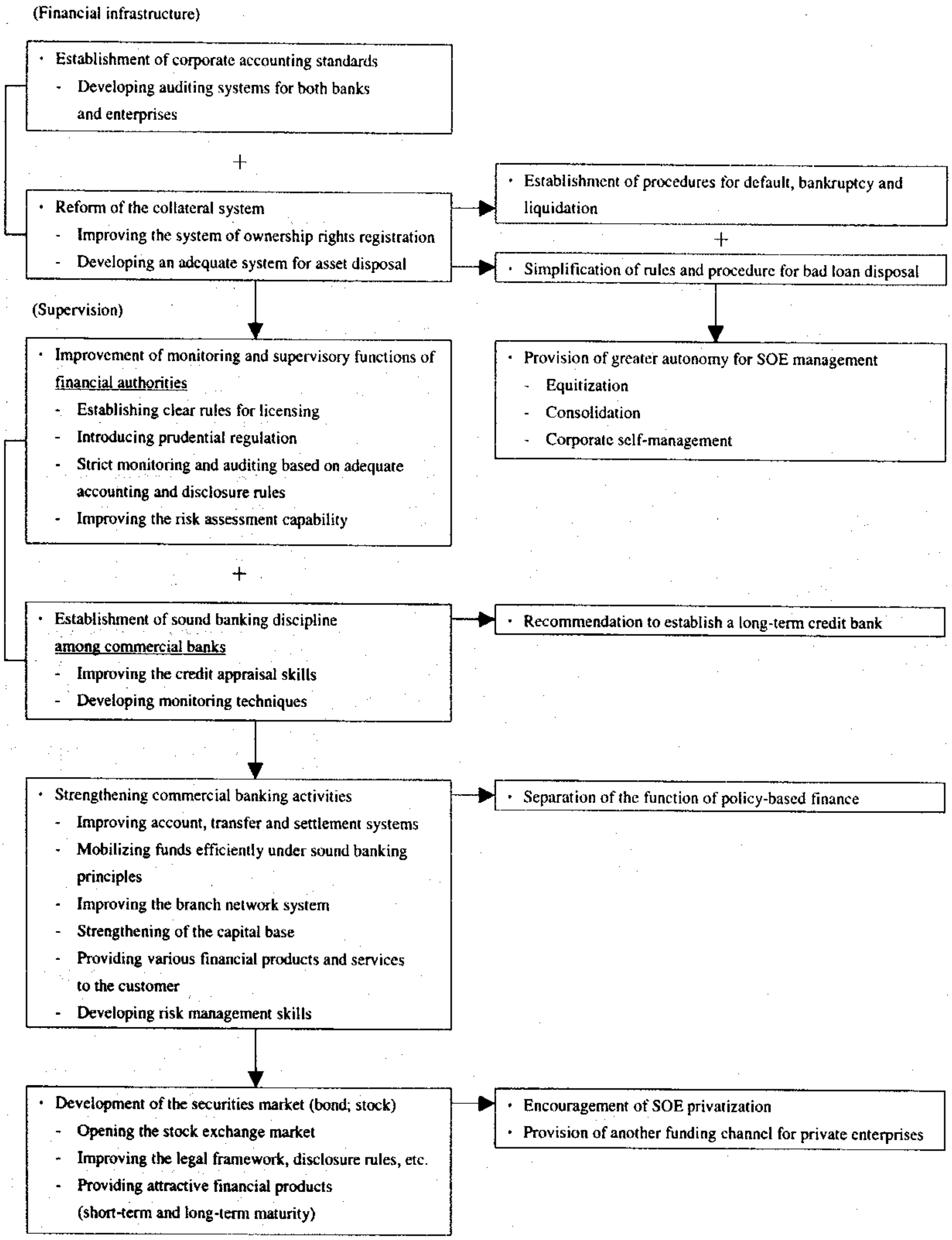
- Diversification of the monetary policy instruments
  - Liberalization of interest rates
  - Market-based money supply control
  - Market-based interest rate control

=

<Goal>
Maintaining a reliable and robust financial system

Appendix 3

Sequence of the financial system reform
- Strengthening the functions of commercial banks -
(SOE reform will be necessary in parallel with commercial bank reform)



Appendix 4

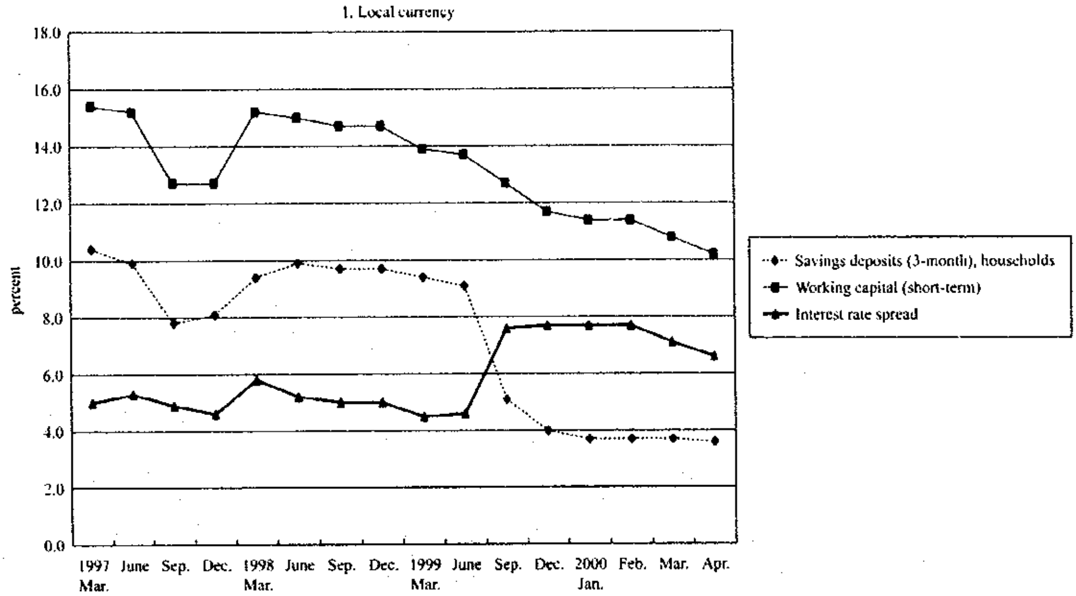
Financial status of the commercial banks in Viet Nam

(unit : VND billion)

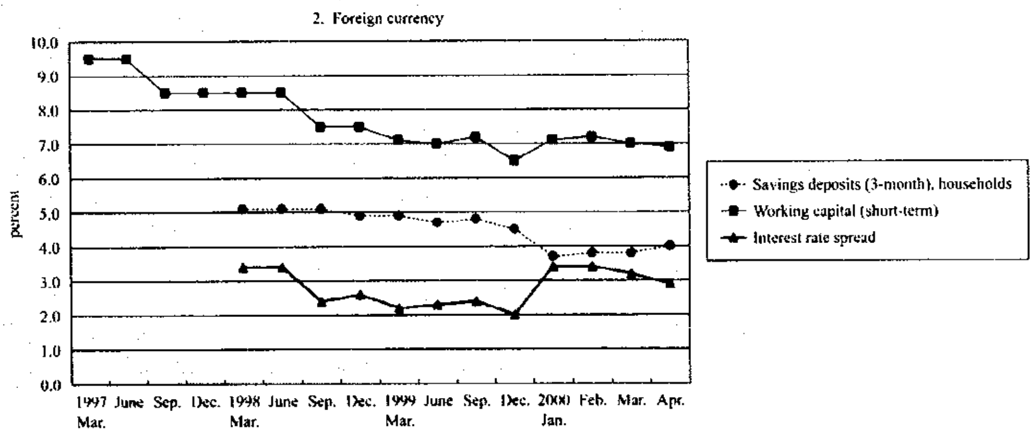
Balance Sheets	'95		'96		'97		'98		'99		'98/'97	'99/'98
<<Assets>>												
Cash	2,337	3.1	1,751	2.0	1,847	1.8	2,445	1.9	5,079	3.2	1.32	2.08
Deposits at SBV	6,762	9.0	8,159	9.5	8,289	8.0	8,614	6.7	12,123	7.6	1.04	1.41
Deposits at credit institutions	12,130	16.3	14,908	17.3	18,836	18.1	25,338	19.8	37,604	24.9	1.35	1.48
Loans to the economy	42,277	56.9	50,751	58.9	62,200	59.9	72,595	56.9	86,626	54.4	1.17	1.19
· short-term	27,832	37.4	33,021	38.3	34,566	33.3	39,542	30.9	48,300	30.3	1.14	1.22
· others	14,445	19.5	17,730	20.6	27,634	26.6	33,053	25.9	38,326	24.1	1.20	1.16
Fixed assets	1,312	1.8	1,697	1.9	2,100	2.0	2,434	1.9	2,869	1.8	1.16	1.18
Other assets	9,525	12.8	8,937	10.4	10,575	10.2	16,228	12.7	14,846	9.3	1.53	0.91
Total	74,343	100	86,203	100	103,847	100	127,654	100	159,147	100	1.23	1.25
<<Liabilities and Capital>>												
Due to credit institutions	12,690	17.0	14,614	17.0	16,338	15.7	17,988	14.1	15,368	9.7	1.10	0.85
Deposits	39,503	53.1	47,528	55.1	63,052	60.7	83,455	65.4	106,603	67.0	1.32	1.28
Credits from SBV	5,793	7.8	6,133	7.1	5,565	5.4	4,249	3.3	10,627	6.7	0.76	2.50
Other liabilities	11,065	14.9	11,691	13.6	10,710	10.3	10,400	8.1	14,927	9.4	0.97	1.44
Capital and reserve	5,292	7.1	6,237	7.2	8,182	7.9	11,562	9.1	11,622	7.3	1.41	1.01
Total	74,343	100	86,203	100	103,847	100	127,654	100	159,147	100	1.23	1.25
Non-prforming loans (NPLs)	3,337		4,726		7,656		8,693		10,490		1.14	1.21
NPLs/Loans (%)	7.9		9.3		12.3		12.0		12.1			
NPLs/Total assets (%)	4.5		5.5		7.4		6.8		6.6			
Equity/Total assets (%)	7.1		7.2		7.9		9.1		7.3			
Income Statements (4 SOCBs total)												
Total income			8,969	100	8,117	100	9,535	100	11,973	100	1.17	1.26
Interest income			8,355	93.2	7,360	90.6	8,827	92.6	11,388	95.1	1.20	1.29
Net interest income			2,225	24.8	1,922	23.7	2,209	23.2	2,845	23.8	1.15	1.29
Operating income			2,840	31.7	2,679	33.0	2,917	30.6	3,427	28.6	1.09	1.18
Profit before income tax			867	9.7	-65	–	79	0.8	735	6.1	–	–

(Sources: SBV and annual reports of 4 SOCBs)

Trends of interest rates and spread ('97-'00)



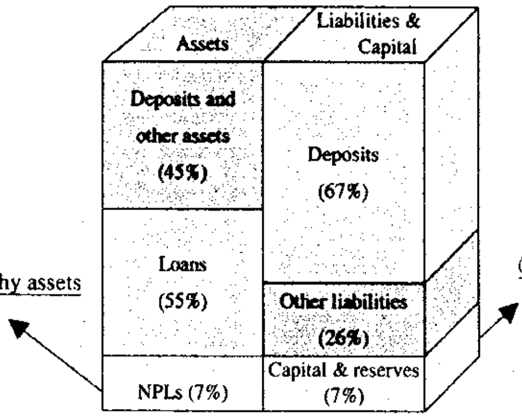
	1997 Mar.	June	Sep.	Dec.	1998 Mar.	June	Sep.	Dec.	1999 Mar.	June	Sep.	Dec.	2000 Jan.	Feb.	Mar.	Apr.
Savings deposits (3-month), households	10.4	9.9	7.8	8.1	9.4	9.9	9.7	9.7	9.4	9.1	5.1	4.0	3.7	3.7	3.7	3.6
Working capital (short-term)	15.4	15.2	12.7	12.7	15.2	15.0	14.7	14.7	13.9	13.7	12.7	11.7	11.4	11.4	10.8	10.2
Interest rate spread	5.0	5.3	4.9	4.6	5.8	5.2	5.0	5.0	4.5	4.6	7.6	7.7	7.7	7.7	7.1	6.6



	1997 Mar.	June	Sep.	Dec.	1998 Mar.	June	Sep.	Dec.	1999 Mar.	June	Sep.	Dec.	2000 Jan.	Feb.	Mar.	Apr.
Savings deposits (3-month), households	-	-	-	-	5.1	5.1	5.1	4.9	4.9	4.7	4.8	4.5	3.7	3.8	3.8	4.0
Working capital (short-term)	9.5	9.5	8.5	8.5	8.5	8.5	7.5	7.5	7.1	7.0	7.2	6.5	7.1	7.2	7.0	6.9
Interest rate spread	-	-	-	-	3.4	3.4	2.4	2.6	2.2	2.3	2.4	2.0	3.4	3.4	3.2	2.9

Appendix 6

Bank restructuring scheme (I)
Consolidated B/S of commercial banks (4 SOCBs and 24 non-state commercial banks)



① Swap NPLs for healthy assets
(TB etc.)

② Strengthen the net assets
- Recapitalize
- Accumulate sufficient provisional funds
- Maximize internal reserves

Total assets: VND 159 trillion
Total NPLs: VND 10 trillion (as of Dec. '99)

③ Restructure bank's management toward a sound commercial bank
- Split policy — or directed — lending function to the policy-based financial institutions
- Provide autonomous status
- Establish sound banking discipline
- Improve the risk management system
- Increase the human resource capability
- Introduce prudential regulation by SBV

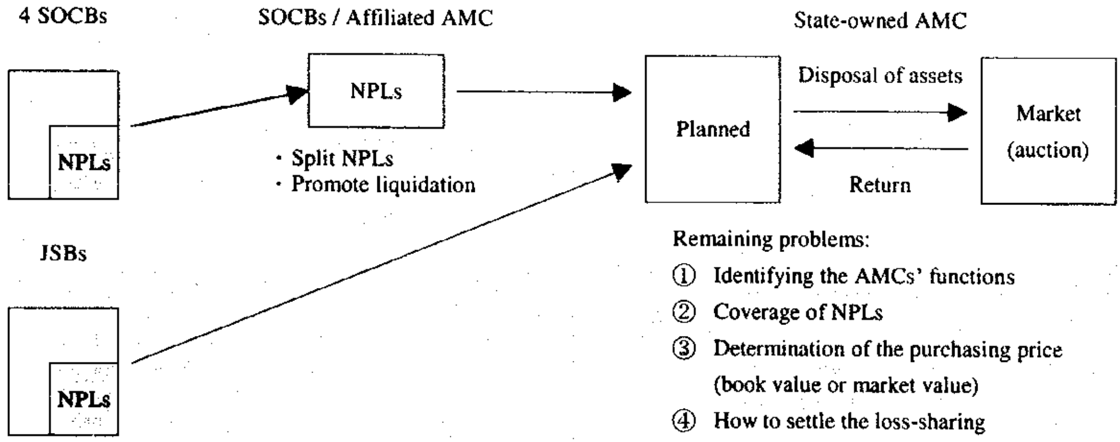
④ Speed up the SOEs restructuring (banks' main customers)
- Minimize the potential bad debts and social costs
- Write off promptly the bad debts for the banks

Appendix 7

Bank restructuring scheme (II)
- Liquidation of NPLs -

< In Viet Nam >

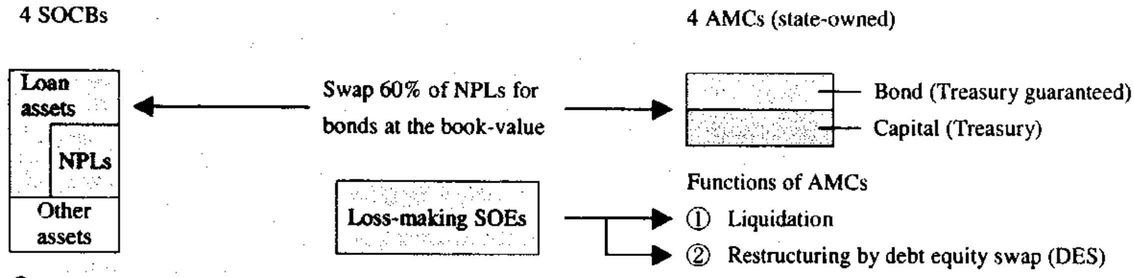
Existing NPLs:	VND 10,490 billion (as of Dec. '99)
Total loan assets:	VND 86,626 billion
NPLs/Loans:	12.1%
NPLs/GDP:	2.6%
NPLs/Budget:	12.4%



Remaining problems:
① Identifying the AMCs' functions
② Coverage of NPLs
③ Determination of the purchasing price (book value or market value)
④ How to settle the loss-sharing
⑤ How to finance the estimated costs

< In China >

Existing NPLs:	2.0 trillion yuan (as of Dec. '98)
Total loan assets:	8.7 trillion yuan
NPLs/Loans:	23%
NPLs/GDP:	25%
NPLs/Budget:	185%



① No loss for the SOCBs
② But remaining 40% of NPLs shall be borne

Functions of AMCs
① Liquidation
② Restructuring by debt equity swap (DES) for future privatization
③ AMCs and the government shall bear the final losses

Appendix 8

Financial restructuring in East Asia

Action	Indonesia	Korea	Malaysia	Thailand	China
Initial government response Liquidity support	USD 21.7 billion (18% of GDP)	USD 23.3 billion (5% of GDP)	USD 9.2 billion (13% of GDP)	USD 24.1 billion (20% of GDP)	None
NPLs / Total loans	31.4% (9/99)	17.9% (9/99)	24.0% (12/99)	41.1% (12/99)	25.0% (mid/99)
NPLs / Total loans after transfers to AMCs (asset management corporations)	12.4%	10.1%	17.5%	38.5%	12.9%
Bank closures	66 of 237	None	None	1 of 15	1 commercial bank
Closures of other financial institutions	None	More than 200	None	57 of 91	40 urban credit cooperatives and 5 trust and investment companies
Mergers	9 nationalizes of state banks are being merged	8 of 26 absorbed by other banks	58 to be merged into unspecified number by Dec. 2000	3 banks and 12 finance companies	Multiple urban credit cooperatives and 2 banks
Nationalization	12	4	1	4	
Public funds for recapitalization	Bonds equivalent to USD40 billion issued in 1999 USD 20 billion to be issued in 2000	Gov. injected USD 50 billion into 9 commercial banks; 5 of 6 major banks now 90% controlled by the state	Danamodal injected USD 1.7 billion into 10 institutions	Gov. injected USD 9 billion into private banks and USD 11 billion into public banks	Gov. injected 270 billion yuan (USD 32.6 billion) in mid-1998 into the 4 state banks. Banks now being recapitalized as loans are transferred to AMCs
Majority foreign ownership of banks	1 pending	1 announced, 1 pending	Not allowed; however, foreign banks share if significant.	4 completed, 2 pending	Allowed, but not for domestic currency operations
Weak financial institutions still in system	Many weak commercial banks	Many weak non-banks	Difficult to assess	Some	Many weak banks and non-banks

Source: Claessens, Djankov, and Klingebiel 1999a; from WB's "East Asia - Recovery and Beyond"

Asset resoulution strategies in East Asia

Strategy	Indonesia	Korea	Malaysia	Thailand	China
Set up AMCs to which NPLs are transferred	Yes, Indonesian Bank Restructuring Agency has accumulated more than USD60 billion in assets (NPLs).	Yes, Kamco has accumulated assets worth USD 49 billion (face value); USD 20 billion (purchase price).	Yes, Danaharta has accumulated USD 10.3 billion in assets.	No, workouts of NPLs are decentralized. Three banks have established private AMCs, and more are being considered.	Yes, four AMCs have been set up, one for each state bank.
Purchasing price by AMC	Subsidized price	Assets were initially purchased above market-clearing prices with recourse. Since Feb. 1998 purchases have been attempted at market prices.	Purchased assets are valued by independent outside auditors.	Not applicable	Book value (subsidized price)
Nature of AMCs: restructuring or disposition	IBRA: management and disposal of frozen bank assets	Nor clearly defined. Mostly engaged in disposing of assets	Restructuring	Not applicable	Planned for broad functions— from asset disposal to debt equity swaps
Type of assets transferred	Worst assets	No particular strategy	Loans larger than 5 million ringgit, and mostly loans secured by property or shares	Not applicable	Loans granted before the end of 1995 that are now rated doubtful or loss but not subject to write-off within the quotas allocated to each of the four banks
Assets transferred	44% of GDP (NPLs 23%)	49% of NPLs (11% of GDP)	50% of NPLs (14% of GDP)	Only failed finance companies (15% of GDP)	20% of loans from state banks (15% of '98 GDP, 12% of total loans)
Disposed assets share	0.1%	4.7%	0.1%	83%	Too early

Source: Claessens, Djankov, and Klingebiel 1999a ; WB report "East Asia - Recovery and Beyond"

B. Issues of Monetary and Foreign Exchange Rate Policy

B－1

Money Supply Control by the State Bank

Nguyen Thu Ha

State Bank of Viet Nam

Money supply control by the State Bank is the daily and the most important duty of any central banks. However, the process of money supply control is different from country to country.

A. Current mechanism of money supply control by the State Bank

Since 1992, the State Bank of Viet Nam has been pursuing a prudential monetary policy to achieve the long-term objectives of the monetary policy which are to stabilize currency, support the economic development strategy of the Government, and control inflation.

In order to achieve these objectives, the process of money supply control (M2) have been implemented according to the following summarized procedures:

Instruments	Operating objectives	Intermediate objectives	Ultimate objectives
- Reserve requirement			
- Interest rate control	Reserve money (MB)	Total liquidity (M2)	- Stabilize currency and foreign exchange market;
- Refinancing			
- Exchange rate			
- Issuance of State Bank's bills			- Economic growth;
- Credit ceiling			- Inflation

Direct instruments have been mainly used to control money supply (M2) in Viet Nam. However, the main objective of the State Bank is to gradually move toward using of indirect instruments such as open market operations, refinancing policy. The instruments of monetary policy that have been used are as follows:

1. Instruments of monetary policy

The renewal of the banking system in Viet Nam has started in the late 1980s and mainly from 1990 up to now. Therefore, the system of monetary policy instruments have been established and developed together with the renewal of the banking system. With the underdeveloped financial and monetary markets, Viet Nam has used direct instruments (interest rate control, credit ceiling) in combination with indirect instruments (reserve requirement, refinancing and open market operations). These instruments have expressed their usefulness, contributed to the achievements in the banking activities during the past years.

(1) Reserve requirement

Reserve requirement has firstly been applied since June 1992 under the Banking Decree (the Decision No.108/QD-NH5 dated September 6th, 1992). The requirement of 10% was imposed on all deposits with credit institutions and the required reserves were maintained on a separate account. Under such a management of reserve requirement, the role of reserve requirement was to implement the State Bank's function to withdraw money from or inject money into circulation and its initial role was to ensure the payment capacity and control over money supply. However, this limited the State Bank from forecasting the increase or reduction in bank's reserves and led to the inflexible use of the bank's capital. Until 1995, the reserve requirement had been changed as follows (Decision No.260/QDD-NH1 and 261/QD-NH1 dated September 19,1995):

- Deposit for payment and required reserve were integrated into one account;
- An uniform requirement of 10% on all deposits of less than one year with the structure of 70% to be deposited at the State Bank and 30% of cash and quasi money to be held at the credit institution's vaults.
- The calculation period of required reserve was 15 days (2 periods a month). Required reserve in each period was calculated basing on the reserve requirement ratios stipulated by the Governor on the total average deposit balance of the previous period of credit institutions.
- Credit institutions were required to regularly maintain enough required reserves deposited with the State Bank, i.e. the daily maintaining required reserve mechanism.

This regulation had partly allowed the State Bank to forecast the credit institution's demand for reserve by watching excess reserve. However, the daily control over reserve requirement, the underdeveloped money market and the State Bank has not acted as a real lender-of-last-resort in the inter-bank market made this instrument stiff and inflexible as no credit institutions, in any single day during the implementing period, were allowed to have deposits with the State Bank less than the regulated amount. As a result, credit institutions always had excess reserves. This limited the development of the domestic inter-bank market.

- Due to such limitations, in order to complete reserve requirement instrument, after the Law on the State Bank and the Law on Credit Institutions came into effective, it has been amended (Decision No.51/QD-NHNN1 dated February 10th, 1999) to comply with the above two Laws as follows:
- Reserve requirement has been expanded the coverage to co-operative banks, people's credit fund and credit co-operatives, the required reserve ratios are from 0% to 20%, required reserve deposit must be held at the State Bank, remuneration of deposits is stipulated by the Government;
- Required reserve is calculated on the average deposit balance with the State Bank during the implementing period;

As for foreign currencies, including DEM, JPY, GBP and FPF, if the deposit proportion in 1of those currencies occupy more than 50% of the total mobilized fund in foreign currencies, the required reserve must be held in that foreign currency at the Banking Transaction Centre of the State Bank.

According to the new method of calculating required reserve, credit institutions do not need to maintain deposits exceeding the necessary reserve level in every single day during the implementing period, so they can conduct their capital more actively. The State Bank can forecast the aggregage demand for reserve of commercial banks based on the fluctuations in the credit institutions' deposit balance at the State Bank to make decision on injecting or withdrawing money through its refinancing facility or open market operations, or in other words, to increase the State Bank's capability in controlling M1. However, this instrument still has the following limitations:

Required reserve is only applicable to deposits with maturity of less than 12 months (occupy about 65-70% of the total mobilized fund of credit institutions), so the relation between required reserve and the currency volume in the economy has only been implemented at M1 level while M2 is more flexible to inflation than M1, thus the control over M2 by the State Bank remains limited;

Remuneration of excess reserve does not stimulate commercial banks to use up their capital sources, thus leads to too much excess reserve and limits the overnight lending.

(2) *Refinancing facility*

Refinance lending is conducted under the Decision 285/QD-NH14 dated November 10th, 1994 of the Governor of the State Bank. According to this regulation, credit institutions including state-owned commercial banks, joint-stock commercial banks, joint-venture banks, foreign bank's branches, investment and development bank, and central people's credit fund are entitle to access refinancing loans. In order to receive refinancing loans, credit institutions have to meet certain conditions such as: they have to participate in the inter-bank market, make profit, comply with the State Bank's regulations, deposit enough required reserve. Refinancing loans only take place after credit institutions have tried their best to mobilize funds in the inter-bank market.

Refinance lending is carried out in two types: lending against collateral in the form of papers and directed lending.

- *Lending against collateral in the form of papers*: Collateral papers consist of undue Treasury bills and short-term loan contract of payable indebtedness and credit institution's foreign currency deposit (USD) with the State Bank. Residual time to maturity of collateral papers must be longer than the borrowing term. This type is conducted both in the central State Bank and the State Bank's branches in provinces and cities. Maximum lending maturity is 6 months. Lending interest rate is stipulated by the Governor of the State Bank depending on the objectives of monetary policy in each period.

- *Directed lending* is to finance several necesary areas depending on the demand of the economy in each period such as: purchasing food for export, temporary provisioning of food, recovering natural disasters or producing priority goods for export as regulated in the Law on Stimulating domestic investment. The State Bank only provides this kind of loan to credit institutions which are entrusted to do such businesses and have already used up capital sources as stipulated by current mechanism.

Apart from refinancing loans, the State Bank also provides loans for clearing purpose. Naturally, this is the short-term refinancing by the State Bank to commercial banks to off set the temporary shortage in payment. It is conducted as follows:

The central State Bank authorizes the State Bank's branches in provinces and cities (including the Banking Transaction Centre of the State Bank) to directly provide clearing loans to commercial banks which are member of clearing centre. Every quarter, the central State Bank announces the quarterly outstanding limit to each State Bank's branch based on the demand for capital to be on-lent for clearing purpose of the branch and the available capital source. In order to get clearing loans from the State Bank, commercial banks must be members participating in clearing transactions, have deposit accounts with the State Bank where the clearing transaction are taken place, have money available for payment in their account, and are authorized by their higher level commercial banks to take part in clearing transactions in local areas provided that the branch must operate normally and strictly comply with the payment principles with other counterparties and regulations on clearing transactions of the State Bank. Joint-stock commercial banks must have business licenses, be profit-making and fully comply with regulations of the Banking Decree. Maximum maturity of clearing loans does not exceed 10 days. In case the borrowing banks fail to pay the debts at the due date, the State Bank will transfer these debts to overdue debts. A bank will not be allowed to borrow clearing loans from the State Bank if it has overdue debts 3 continuous times.

Current interest rates on clearing loans are 0.06% per day for 1 to 5-day-maturity, 0.09% per day for 6 to 10-day-maturity and 0.12 % per day for the overdue debt (more than 10 days) (Decision no.84/QD-NH1 dated April 24th, 1993 of the Governor of the State Bank). They are rather high as compared to current refinancing interest rate so commercial banks have to quickly off set their shortage in capital for payment purpose.

(3) Credit ceiling

Credit ceiling instrument was adopted in 1994 to conduct monetary policy due to the demand of the actual situation, the inflation rate in 1994 intended to increase at a high level, the total liquidity went up quickly. The allocation of credit ceiling to credit institutions was calculated on the total increase in credit to the economy, operational characteristic of each bank, production and business seasonality in the year and its influence on each bank.

The adoption of credit ceiling instrument in 1994, 1995, 1996 and 1997 had contributed to constrain the increase in the total liquidity of the State Bank, limited the inflation rate at a low level and enhanced the credit quality. With the underdeveloped secondary market in that period of time, the State Bank was not able to use indirect monetary instrument, such as open market operations, to manage the increase in the total liquidity, this instrument helped to limit the monetary multiplier, upgrade the credit quality. However, it is a direct control instrument and should be used as a temporary instrument while not having enough conditions to use other indirect instruments, so credit ceiling implies some disadvantages:

- Credit ceiling was only allocated to some commercial banks so it limited the equality in competitiveness.
- In the condition that the demand for capital to invest in Viet Nam is very high, the inflation rate tends to reduce, the adoption of credit limit will partly affect the supply of fund to the economy and the business activities of commercial banks (increase costs of capital to commercial banks).

Due to the above limitations, until the second quarter of 1998, the State Bank has not used credit ceiling as a regular instrument in conducting monetary policy, but only used it in case of limiting the high increase in credit.

(4) Interest rate control

Interest rate is an important instrument of macroeconomic management. It directly affects the credit institutions' activities and the whole economy and is considered to be a sensitive monetary policy instrument of the State Bank.

Together with the renovation and development of the banking system in Viet Nam since the birth of the Banking Decree up to now, the management of interest rate by the State Bank has been continuously completed towards the liberalization of interest rate with prudential steps which are in line with the socio- economic situation of the country, the integration level of our economy with the regional and the international financial markets: in 1992, the State Bank had made a significant change from "negative" into "positive" interest rate mechanism, created an initial ground for the liberalization process of interest rate, and an important leverage for commercial banks to move from loss-making to profit-making. Based on the positive interest rate, the State Bank of Viet Nam has gradually loosen the interest rate control mechanism in line with the monetary and economic fluctuations, and the ability to manage monetary operations of the State Bank. It moved from a specified interest rates on mobilizing and lending to a separate lending interest rate framework to state-owned and non-state owned economic sectors, and at the same time, allowed the mobilizing and lending mechanism at a negotiated interest rate (October,1993-December,1995). Interest rate on deposit had been liberalized since January, 1996 and lending interest rate had been controlled by a "maximum lending interest rate" mechanism.

Ceiling on lending interest rate mechanism was to limit the maximum lending interest rate and commercial banks only earned a margin of 0.35% per month, including fees, taxes and interests. The ceiling on lending rate were stipulated in many different sub-ceilings which generated from the characteristic that many different types of credit institutions operating in different areas, having different supply of and demand for fund, different sizes and thus having different operating costs. There were initially 4 different sub-ceilings:

- Sub-ceiling on short-term lending interest rate;
- Sub-ceiling on medium- and long-term lending interest rate;
- Sub-ceiling on lending interest rate applicable for credit institutions operating in rural areas (higher than short-, medium- and long-term interest rates);
- Sub-ceiling on lending interest rate applicable for loans made by local people's credit funds to their members (higher than the above 3 sub-ceilings).

In reality, rural areas always have big demand for fund, however, mobilized fund in these areas is very thin and costs for banking activities in rural areas are high, so the sub-ceiling on lending interest rate in rural areas was stipulated at a higher level than in urban areas to absorb fund for rural areas. However, after a certain time of implementation, many people think that the lending interest rate in rural areas must be equal to or lower than the one in urban areas to give preferential conditions for agricultural development. Therefore, at the beginning of 1998, the State Bank abolished the difference between lending rates in rural and urban areas, reduced from 4 sub-ceilings to 3 sub-ceilings on lending interest rate, the different sub-ceilings were also narrowed and the margin of 0.35% per month was phased out.

The State Bank had controlled the ceiling on lending interest rate in foreign currencies and closely combined the interest rate control with the foreign exchange rate when there were fluctuations in foreign exchange rate, for instance limited the ceiling rate on deposits of businesses to strengthen the foreign currency management.

The interest rate control has been conducted flexibility since 1996 up to now, closely followed the economic growth target, inflation target, signals of supply of and demand for fund in the market, and the initiatives in determining interest rate of credit institutions have been expanded so as to increase the competitive ability while still controlling interest rate in the market to contribute to the deep development of the domestic financial market, encourage economic growth, stabilize the external and internal value of Vietnamese Dong. This has been implied in a high and continuous increase in mobilized fund and credit for investment to the economy of credit institutions.

However, the ceiling on lending interest rate regime has reflected some certain limitations to meet the demand for renovation of the economy and the demad for development of the money and capital markets. For instance, although the interest rate control in the money market has been conducted through the ceiling on interest rate regime which has loosen the credit institutions' rights in determining interest rate, however, there are still a lot of administrative interventions imposed by the State to control interest rate that make the interest rate not to reflect the supply and demand in the market, distort the allocation of credit to economic zones, areas, and as a result, limit the potential of the economy of the country. On the other hand, the administrative interventions also limit the credit institutions' capacity in implementing their intermediary role to transfer fund from one place to the others in time, and restrict the establishment and development of financial instruments in the market because this interest rate has not become a measure to price other financial assets in the market.

Due to this fact, the ceiling on interest rate mechanism expresses its inconsistencies to the economic development in Viet Nam nowadays and needs to be changed to be in line with the practice and the Law on the State Bank. Article 9, Item 12 of the Law on the State Bank stipulates that the basis interest rate announced by the State Bank will be the reference rate for credit institutions to determine their interest rates.

On August 2nd, 2000, the State Bank has decided to change the interest rate control regime: from the ceiling on interest rate to the basic interest rate management regime to Vietnamese Dong and the managed market interest rate regime to foreign currencies (Decision no.241/2000/QD-NHNN1 dated August 2nd, 2000).

According to the above Decision, the basic interest rate for lending in Vietnamese Dong has been announced on the basis of referrence to the commercial lending rate applicable to the best customer group of the best credit institution group which have been selected under the Decision of the Governor of the State Bank in each period. The selected credit institutions are those which operate in a stable and normal manner and represent many different types of credit institutions such as state-owned, joint-stock, joint-venture and foreign credit institutions. Standards for selection and the number of credit institutions to be selected can be changed from time to time provided that the lending interest rates of these banks must be the best reference to the State Bank to consider, adjust and announce the basic interest rate. The current selected credit institution group consists of 9 credit institutions (4 state-owned commercial banks, 2 joint-stock commercial banks, 2 foreign bank's branches and 1 joint-venture bank).

Credit institutions determine lending interest rates based on the basic rate announced by the State Bank with the condition that the lending rates do not exceed the basic rate and the margin stipulated by the Governor of the State Bank in each period. The basic rate and the spread are announced monthly and will be adjusted by the State Bank when necessary. Such adjustments will be announced in time. The current basic rate is 0.75% per month, the spread of 0.3% for short-term lending, 0.5% per month for medium- and long- term lending (Decision No.424/2000/QD-NHNN1 dated August 2nd, 2000).

The State Bank has removed the ceiling on lending interest rate in USD and moved to a flexible interest rate regime in accordance with the international market under the management of the State Bank. Credit institutions determine lending interest rates with the principle that these rates do not exceed the 3-month maturity interest rate applicable to the short-term lending and 6-month maturity interest rate applicable to medium-and long-term maturities in USD in Singapore Inter-bank market (SIBOR at the time of lending plus the spread stipulated by the Governor of the State Bank in each period of time (the current spread of 1% per annum for short-term lending and 2.5% per annum for medium- and long-term loans (Decision no.243/2000/QD-NHNN1 dated August 2nd, 2000). Lending interest rates in other foreign currencies are determined by credit institutions based on the international market rate and the supply of and demand for each foreign currency in Viet Nam as they only occupy a small proportion in deposit and credit operation.

The above basic interest rate control shows that the basic interest rate is determined on the market rate with low risk, ensuring the control of the State Bank over interest rate instrument in line with the law and reality in Viet Nam. This is the new and follow-up step towards the liberalization of interest rate.

(5) State Bank's bills

State Bank's bill is a short-term valuable paper issued by the State Bank to create instruments for the money market pursuant to monetary policy objectives in each period. Credit institutions are buyers of these bills

State Bank's bill is the bearer or registered bill with the maturity of less than one year. Credit institutions organizing and operating under the Law on Credit Institutions and having deposit accounts with the Banking Transaction Centre of the State Bank or the State Bank' branches, which are authorized by the Governor to conduct bidding operations, are eligible to buy the State Bank's bill. The purchase of the State Bank's bill depends on the voluntary basis. In necessary cases in order to achieve the currency stability target, the Governor of the State Bank will determine to issue State Bank's bill and request credit institutions to buy those State bank's bill. The State Bank's bill is freely traded, transferred and mortgaged among credit institutions. It is used as a or discounted at the State Bank, and as financial instrument for open market operations. The State Bank's bill is issued under the compulsory or bidding methods (volume bidding or interest rate bidding). The minimum face value of the State Bank's bill is VND 100 million and other face values are equal to the multiple of VND 100 million (Decision No. 211/ QD-NH1 dated September 22nd,1994 of the Governor of the State Bank promulgating Regulation on issuance of the State Bank's bill). Until October 1999, Regulation on issuance of the State Bank's bill was amended and substituted by the new regulation to comply with the Law on the State Bank of Viet Nam and the actual situation (Decision No.362/1999/QD-NHNN1 dated October 8th,1999).

The State Bank already issued 6 State Bank's bill sections with the volume of VND 3,415.5 billion since the first issuance of the bill to the end of 1999 (from 1995 to the end of 1999) based on the monetary, economic fluctuations and the inflation controlling target in each period to absorb commercial banks' liquidity, limit monetary expansion, contribute to restrain inflation in case it tends to increase.

Within the 6 sections, there were 4 compulsory issuance sections and 2 volume bidding sections with the maturity of 3 months.

(6) Open market operations

Open market operations (OMOs) are important monetary policy instruments. This is the initial decisive factor in changing short-term interest rate and money supply volume through the sale or purchase of short-term valuable papers. OMOs have been prepared by the State Bank since 1996, however, due to many different reasons (such as limited techniques issue, thin financial instruments, etc....), so up to the beginning of the year 2000, the regulatory basis governing OMOs has been completed to put it into operation in 2000 to add one more new instrument to the monetary policy instrument system in Viet Nam, and to comply with the development trend of an open and modern economy.

In the Regulation on OMOs, goods traded in the open market include Treasury bill, certificate of deposit, State Bank's bill and other short-term valuable papers which are stipulated by the Governor of the State Bank in each period. Besides, short-term valuable papers must be tradable papers, issued in Vietnamese currency, registered at the State Bank as stipulated in Regulation on registration of short-term papers. OMOs have been conducted in 2 trading methods: outright transaction and sales and repurchase agreements.

OMOs have officially come into operation in July, 2000. Based on liquidity forecast (commercial banks' deposits with the State Bank) and the monetary policy objectives, the Liquidity Management Section will make proposals to the OMOs Executive Board on the volume of valuable papers needed to buy or sell, interest rate and trading maturity, etc... in each auction. Up to now, there were 7 auctions with the purchasing volume of VND 470 billions and selling volume of VND 550 billions of T-bills and SB's bills, the timing for OMOs auction is every 10 days, the purchasing rates are from 4.5%-4.9% per annum and the selling rates are from 4.5%-4.6% per annum. There are about 2 to 3 banks participating in one OMOs auction. OMOs have helped to gradually adjust the excess liquidity of credit institutions and created more instruments for the money market.

However, OMOs have been in a preliminary period of development, there are still a lot of limitations such as: necessary information for liquidity forecast as well as for the conduct of OMOs do not exist due to the underdeveloped inter-bank market; number of credit institutions participating in OMOs remains limited and they are mainly state-owned commercial banks, participants are requested to invest equipment for OMOs, knowledge in OMOs have not been widely expanded so as not to encourage many credit institutions to participate in OMOs; financial instruments (goods) remain thin (only Treasury bills and SB's bills with limited volume). Credit institutions prefer using these goods as an investment instrument rather than a money market instrument to regulate their capital. Under the above circumstance, the recent OMOs auctions have been implemented to regulate credit institutions' liquidity and facilitate the conditions to increase financial instruments and abstract more participants.

(7) Exchange rate

In 1997, Vietnamese economy appeared adverse signals, which might affect the stability of the macroeconomic environment, implied in the following tendencies: current account balance was slowly improved, export growth speed stood still and went down; foreign investment sharply declined, it became more difficult to get oversea loans, and borrowing and lending conditions became less advantage as compared to previous years, payment obligations to foreign countries were increasing due to the businesses' debts run out of grace period and the principal of the loans started to be paid; inter-bank foreign exchange market operated less actively and the tendency of holding foreign currency was increasing. USD/VND exchange rate always closely reached the allowed ceiling, the difference between the market and the official exchange rate was large; the State's foreign currency reserve managed by the State Bank was in a danger of reduction because of the demand pressure in the inter-bank foreign exchange market.

The above tendencies have become more clearly since the monetary and financial crisis started in Asian area in July 1997, currencies of countries in this region were devalued at the same time, the Bath: 46%, the Philippine Peso:40%, Malaysian Ringit: 38%, Rupiath: more than 60%, Singapore dollar: 18%, Korean Won 5% and Japanese Yen 14%.

Such tendencies need to be strictly considered and necessary adjustments in policies should be taken, especially the exchange rate control therefor, Vietnamese economy can suit well with and avoid disadvantage influences of external shocks while still ensuring the State management capacity. Due to domestic and international changes, the target of foreign exchange rate control is not to incline to stabilize the value of Vietnamese Dong, but to move toward the long-term targets which are to stimulate production, push up economic growth, especially pay much attention on encouraging export, controlling import and increasing foreign currency reserve, and not to cause turbulences and big changes in the social economy. In order to achieve these targets, the State Bank had adjusted foreign exchange rate 4 times in 1997 and 1998. The first time was made on February 27th,1997, the State Bank expanded the trading band from +/- 1% to +/- 5% as compared to the official exchange rate announced by the State Bank. The second time was taken place on October13th, 1997, the State Bank continued to widen the trading band form +/- 5% to +/- 10% as compared to the official exchange rate announced by the State Bank. The third time was on February 16th, 1998, the official exchange rate was increased from 11,175 VND/USD to 11,800 VND/USD (up to 5.6%). The fourth time was on August 7th,1998, the trading band was narrowed from +/- 10% down to + 7%, and at the same time, the official exchange rate was increased from 11,815 VND/USD to 12,998 VND/USD. In this sense, the official exchange rate announced by the State Bank on August 7th,1998 was also the closing exchange rate in the foreign currency inter-bank at the end of

August 6th, 1998. This means that the official exchange rate between VND and USD has been determined by the State Bank based on the trading exchange rate in the inter-bank foreign exchange market, which has correctly reflected the supply of and demand for foreign currency in the market.

In the regional and world economic crisis situation, the above exchange rate adjustments have brought about active achievements, contributed to maintain macroeconomic stability with the economic growth rate of 6% in 1998, and controlled the inflation rate at 9.2%, reduced import by 3%, increased in export by 1% even if it did not reach the estimated growth level, at the same time, the exchange rate adjustment made the foreign exchange rate move closer to the real market exchange rate, suit with the supply-demand, thus increase the market accommodating ability of foreign exchange rate stipulated by the State, reduced the difference between the daily announced foreign exchange rate and the real trading exchange rate; partly resolved the stagnation in the inter-bank foreign exchange market, make the trading turnover of commercial banks tend to increase, stimulate supply of foreign currency due to the foreign exchange rate has been adjusted reasonably and beneficially, reduce the pressure on the State's foreign currency reserve, the State Bank has no longer sold foreign currency to maintain exchange rate as it did in the past, increase the competitive capacity of Vietnamese goods for export in international market, and control import, etc...

The State Bank has changed the exchange rate control regime since February, 1999. The State Bank only announces one exchange rate which is the average trading exchange rate in the inter-bank foreign exchange market between VND and USD instead of announcing 2 types of exchange rate as it used to do: the official exchange rate and the real average trading exchange rate in the inter-bank foreign exchange market. The average trading exchange rate in the inter-bank foreign exchange market is determined on the real average exchange rate in the inter-bank foreign exchange market of the latest trading day. This exchange rate has been applied as a basis for credit institutions which are allowed to buy and sell foreign currency to determine the trading exchange rate, and for the State Bank to announce the exchange rate between VND and other foreign currencies, and used to calculate the export-import taxes.

Also based on the average trading exchange rate in the inter-bank foreign exchange market of the latest trading day announced by the State Bank of Viet Nam, credit institutions which are allowed to buy and sell foreign currency will determine the spot exchange rate not to exceed 0.1% as compared to this exchange rate. Spot exchange rates applied to currencies other than USD are determined by General Director (Director) of credit institution.

2. Illustrations of the State Bank's money supply control in 1999

a. Economic developments in 1998, especially in the later months of the year showed that the possible tendency in 1999 might happen. They were: the economic growth rate would hardly achieve the growth rate as in 1998 (5.8%-6%), and the inflation rate might continue to increase (the inflation rate in October

1998 increased by 0.3% as compared to September 1998; 0.1% in November 1998 as compared to October 1998, 0.8% in December as compared to November), the inflation rate was 9.2% for the whole year. With such developments, the pursuance of a tightening and prudential monetary policy is needed. The control of M2 was set up at 20% with the target of increasing foreign currency reserve of USD 500 million as compared to the reserve level at the end of 1998, credit increased at 16% and no more overdue debts arised.

b. In January 1999, the inflation rate was 1.7%, higher than that in the same period of 1998 (1.6%). However, many implications showed that the credit expansion was difficult due to the ceiling on interest rate was higher than the profitability of businesses. At this point of time, the Governor of the State Bank had a policy to issue State Bank's bills to withdraw banks' excess reserve with the total value of VND 600 billions and 3 month maturity (Decision No.29/1999/QD-NHNN1 dated January 15th,1999). In order to push up economic growth, the Governor of the State Bank had the Directive No.01/1999/CT-NHNN1 dated January 17th, 1999 to reduce the ceiling on lending interest rate by state-owned banks to their customers in urban areas from 1.2% per month down to 1.1% per month for short-term lending and from 1.25% per month down to 1.15% per month for medium- and long-term lending.

c. In February 1999, the inflation rate was still at a high level (the inflation rate in February increased by 1.9% as compared to that in January 1999) and there were signs to show that credit would increase with a higher level than that inJanuary 1999. Commercial banks' reserves were rather high. Together with measures in interest rate and issuance of State Bank's bills, on February 25th,1999, the Governor of the State Bank decided to change the exchange rate regime to make it closer to the developments in supply of and demand for foreign currency in the market: transfer from announcement of the official exchange rate, a heavily administrative and subjective regime to the average trading exchange rate in the inter-bank foreign exchange market and permit commercial banks, which are allowed to buy and sell foreign currency, to determine the spot exchange rate between VND and USD, but not exceed 0.1% as compared to the real average trading exchange rate in the foreign currency exchange market (Decision No. 64 and 65/1999/QD-NHNN7 dated February 25th ,1999).

On April 21st, 1999, the Governor of the State Bank decided to issue the State Bank's bills (the second section) with the total value of VND 700 billions, 3-month maturity, and interest rate of 0.85% per month. Thus, the volume of currency to be withdrawn from circulation in the two consecutive issuance of State Bank's bills was VND 700 billions and took place more slowly than the need of monetary regulation in practice so as to reduce the money supply control capacity of the State Bank.

d. There appeared signs of deflation at the beginning of March 1999 (continuously deflated in March, April and May of -0.7%, -0.6% and -0.4% respectively). This was a signal to announce a danger of deflation in Viet Nam that would reduce the speed of the economic growth rate. In the condition that the world price was strongly declined, especially countries in crisis regions, together with other developments of the economy implied that in the coming months, price would continue to reduce, domestic products would be in inventory situation (coal, cement, iron, etc,....), world price of some goods items reduced (crude oil, rice, coffee, etc...) then, domestic price reduced, the farmer's income decreased, as a result, the domestic purchasing power would decline.

Due to such developments, the continuous pursuance of a tightening monetary policy may conflict with the objective of pushing up the economic growth and expanding domestic purchasing power by widening investment. In these practices and together with the Government's deflation protection measures, the State Bank of Viet Nam has adjusted from a "tightening" to a "prudential loosening" monetary policy target since the second quarter of 1999.

In pursuing of a prudential loosening policy, since the second quarter of 1999, monetary policy instruments have been conducted as follows:

- Ceiling on lending interest rate: had been continuously reduced to suit with the inflation index, credit supply and demand relationship in different periods and contribute to implement the Government's measures in pushing up demand for investment. This year, the ceiling on lending interest rate had ever been adjusted as many times as before by the State Bank. Until December, 1999 the State Bank had adjusted the ceiling on lending interest rate 4 times since the adjustment of ceiling on lending rate made by state-owned commercial banks to urban areas, the ceiling on lending interest rate was reduced by 0.35%-0.4% as compared to that at the beginning of the year. At the end of the year, ceilings on lending interest rates were as follows:
  + 0.85% per month to urban areas;
  + 1% per month to rural areas;
  + 1.15% per month applicable to loans made by rural joint-stock banks;
  + 1.5% per month applicable to loans made by local people's credit fund to its members.
- *Refinancing rate*: The State Bank had reduced refinancing rate 4 times in 1999, from 1.1% per month at the beginning of the year down to 0.5% per month at the end of 1999, and at the same time, the State Bank announced a discounting rate of 0.45% per month.
- *Reserve requirement*: The State Bank had reduced requirement ratio applicable to credit institutions 2 times from 7% down to 5% (1% for rural joint-stock banks, central people's credit fund, and local people's credit fund). Except for the Viet Nam Bank for Agriculture and Rural Development, requirement of 3% was applicable to this Bank as it had to implement some policies serving agriculture and rural development.
- The trade balance had shifted from over-importing to over-exporting, and the amount of foreign currency remitted to Viet Nam increased with a higher level than that in 1998. Thus, by the end of 1999, the State Bank bought a large amount of foreign currency that helped to raise foreign exchange reserves from an equivalent of 10 weeks of import to 13 weeks of import. In 1999,

exchange rate was rather stable and basically in line with foreign currency supply and demand in the market and the management objectives of the State Bank.

3. Increase in total liquidity (M2) and credit in quarters of 1999 (in percentage as compared to the end of last year)

	December 1998	March 1999	June 1999	September 1999	December 1999
Total liquidity (M2)	25.5%	5%	10.3%	18.1%	39.2
Credit	16.7%	4.4%	7.3%	8.9%	19.2%

B. Renovations to strengthen the extent and effeciency in monetary control of the State Bank

Strengthening the extent and effeciency in monetary control of the State Bank is the objective in the process of reform of the Vietnamese banking system. The renovations in monetary control of the State Bank in recent years have, to some extent, contributed to the process of reform of the banking system, an important part in stabilization of macro-economy, created capital for economic growth, facilitated conditions for the development of the money market. However, during the process of monetary control, the usage of monetary policy instruments has certain disadvantages such as: the role of refinancing facility has been limited, not really effective in conducting monetary policy, the allocation of refinancing loans have focussed on state-owned commercial banks under instruction, joint-stock banks rarely take part in refinancing transactions as they do not meet the conditions to get refinancing loans; refinancing interest rate has neither created an announcing affect to the market interest rate and nor stimulated an increase or a reduce in money demand; the underdeveloped money market, the poor and less liquid of financial instruments, etc... The above limitations have influenced the State Bank's role in controlling monetary policy. Hence, to strengthen the extent and effectiveness in monetary control, in the coming time, the State Bank will continue to push up the transition from direct to indirect instruments, develop the money market, reinforce and develop the information system to support transactions in the market.

1. Push up the transition from direct to indirect instruments in conducting monetary policy

In a market economy, the common instruments that are used by central banks in other countries in controlling monetary are reserve requirement, refinancing facility, open market operations. However, depending on the situation in each country and each period of development, the usage of these instruments is also different. Many countries are still using direct instruments in combination with indirect instruments.

In Viet Nam, monetary policy instruments have been established and developed together with the renewal process of the banking system. Based on the real situation in Viet Nam, the State Bank of Viet Nam has conducted the monetary control by using direct instruments, such as: credit ceilings, interest rate control, exchange rate, and at the same time established and initially adopted indirect instruments which are reserve requirement, refinancing facility, open market operations.

Nowadays, the tendency of integrating into the world economy is becoming deeply and widely and the influence of a globalization process is increasing, the task of the State Bank is to push up the transition from direct to indirect instruments to control money effectively. These indirect monetary control instruments are very important to the development of the country because as the domestic markets develop, the direct control instruments are becoming less effective and separated from the market, especially in a globalization world market. Thus, in the process of moving from direct to indirect instruments, the State Bank needs to continue completing instruments that have been used and strengthen and develop new instruments to create a rather complete instrument system. Details are as follows:

(1) Open market operations

Open market operations are the most effective indirect instruments in monetary control. These are the main instruments in monetary control of developed countries and becoming important to developing countries like Viet Nam. OMOs allow the State Bank an active initiative in the timing and the currency trading volume at its wishes, stimulate the objective relationship in the form of running business with the market members, and at the same time, eliminate the inefficiency of the direct control. OMOs affect money supply and banks' reserves and thus, influence interest rate in the money market.

In Viet Nam, after a process of attempts to prepare for legal framework, equipment, and technical issues, OMOs have been adopted in July 2000. Up to now, even though the influences of OMOs on the money market conditions have not been clearly significant but the recent trial auctions have shown that OMOs have partially adjusted credit institutions' liquidity, absorbed in case of excess liquidity and injected when there is a liquidity shortage. At the same time, the OMOs auctions created more than VND 500 billions of instruments for the money market.

However, at present OMOs have been in a rudimentary process, thus, need to be gradually adjusted and completed: financial instruments remain thin, the inter-bank money market has not developed so that the State Bank lacks of necessary information in the market for forecasting liquidity as well as for conducting OMOs.

In face of the above reality, and with the small number of tradable securities, the narrowed and less active market, the State Bank, apart from implementing the monetary policy objectives, needs to continue implementing the market development objectives. This process has been carried out into 2 phases:

- *The first phase*: The State Bank implements OMOs in the primary securities market to achieve the objectives of adjusting commercial bank's reserve and creating instruments for OMOs. In this period, members do not directly buy and sell among themselves so that the State Bank can take the role as an intermediary, then members will directly traded among themselves. On the other hand, the State Bank also needs to create instruments for the market. Securities that are currently allowed to be traded in the open market are Treasury bills and State Bank's bills. However, the volume of these securities is limited (as indicated above). In this situation, more treasury bills with multi-maturities should be issued and the size of the Treasury market should be expanded to provide basis for the operation of OMOs. At present, the volume of treasury bonds with the residual days to maturity of less than 1 year is rather big. These bonds will partly solve difficulties in creating instruments for the market if they are allowed to be traded as instruments for OMOs. Other instruments, such as certificate of deposit and other short-term valuable papers have not been used as financial instruments for OMOs. In the coming time, when the Government issue its Decision on guiding the implementation of the Decree on Commercial Bills, the State Bank will have stipulation on eligible valuable papers to be traded in the open market.

- *The second phase*: The State Bank will gradually move to intervene in the secondary securities market. In this period, number of members will be gradually expanded, consisting of not only credit institutions but also non bank credit institutions which have tradable securities and necessary equipment. The expansion of members will make the monetary control ability of the State Bank more actively.

In order to conduct OMOs effectively, the Government securities market must operate well as Government securities are tools which meet conditions for trading in the market. In Viet Nam, The Government has recently issued Governmental Decision No.01/2000/ND-CP dated January 13th, 2000 on Regulation governing the issuance of Government Securities to create goods for the Securities Exchange Centre. In this Regulation, methods of issuing Governments bonds have been improved such as: agent, auction, guarantee for issuance, so as to quote Government securities in the Securities Exchange Centre. Government bonds with maturity of more than 1 year have been auctioned through the Securities Exchange Centre. Treasury bills with maturity of less than 1 year have been issued through auction at the State Bank as before.

During the past time, Treasury bills auctioned through the State Bank have been mainly to offset the state budget deficit. The creation of instruments for the money market remains limited. The issuance has been carried out in the form of interest rate bidding with an instructed interest rate, which make the market operate less actively with a small number of members. In the coming time, to make this market operate more actively and the interest rate reflect the market rate, apart from the above interest rate bidding, the decision on the bidding should be improved. The successful volume of bills will be calculated on the accending order of the bid rate until reaching the expected volume.

In case that the volume of Treasury bills is not enough for trading, the State Bank will issue its bills.

The determination of interest rate is a crucial issue. Interest rate is to be decided on the volume needed to adjust bank's reserves back to a necessary level. Added to that, the State Bank has to ensure the stability of interest rate at a reasonable level to develop the money market. The good management the market interest rate will be considered as a reference rate for determining other types of interest rates. When the Treasury bill market has been fully developed, the State Bank will cease issuing the State Bank's bills as it will affect the State Bank's costs. The State Bank only issues its bills when necessary to reach the monetary policy objectives.

(2) *Combine with other monetary policy instruments*

The combination between different monetary policy instruments depends on the development of the money market, the liquidity level in the market and the healthiness of the banking system. In each period of development of the market, the combination of these instruments is different and needs to be adjusted to be in line with the practice. In the initial stage, OMOs have not developed yet, so reserve requirement and refinancing facility are still main instruments in regulating monetary in Viet Nam. In the next stage, when OMOs become the main instrument to control money, other instruments will be adjusted to be supporting instruments in implementing the intermediate targets of monetary policy.

As mentioned above, the adoption of monetary policy instruments in Viet Nam to control money during the past time had certain limitations that need to be improved:

a. <u>Reserve requirement</u>

Basically, current regulations on reserve requirement ensure the banks' flexibility in using their fund. However, there are still some limitations such as: requirements are only applied to all deposits of up to 12 month maturity, so the relation between reserve requirement and the volume of currency in the economy is only at the relation with M1. Hence, the State Bank's capacity in controlling M2 is still limited. Remuneration of excess reserve has discouraged banks to use up their fund so there are, at some point of time, a lot of banks' excess liquidity, which limits overnight lending. To overcome the above limitations, in the coming time, these instruments should be adjusted as follows:

- Excess reserves are to be unremunerated, but required reserves are to be remunerated;
- Apply reserve requirements not only to deposits of up to 12 months maturity, but also impose on deposits up to 24 months maturity to expand the State Bank's control ability.

b. <u>Discounting and refinancing facility</u>

In order to make refinancing facility become an instrument of the State Bank in providing short-term credit and payment instruments to banks, and a lender - of - last - resort, refinancing facility should be renovated by clearly regulating types of refinancing. Refinancing facility may be divided into the following types:

The first type: Refinancing granted to banks to meet demand for credit of the economy (it is called as normal refinancing). This type is again subdivided into 3 sub-types:

- *Sub-type 1*: Refinancing in the form of discounting, rediscounting commercial papers and other short-term valuable papers (Regulation on discounting and rediscounting promulgated in accordance with Decision No.356/1999/QD-NHNN14 dated October 6th,1999). Discounting rate is lower than lending interest rate in the inter-bank market to stimulate banks to borrow from the State Bank to offset the shortage in reserve, avoid the unexpected changes in the market interest rate, reduce the short-term pressure on the market reserves. Discounting rate will establish a floor rate in the money market.
- *Sub-type 2*: Refinancing against credit documents and collateral in the form of commercial bills and other short-term papers. This type is to meet the demand for short-term capital of banks after they have already used up their discounting limit or not met the conditions for discounting in the above case. Refinancing rate of this type is higher than discounting rate and depends on the monetary policy objectives in each period.
- *Sub-type 3*: Lending though a special discount window is to offset the temporary shortage in short-term capital for payment of banks. The lending through the special discount window must be collateralized by commercial bills or other short-term valuable papers. The interest rate is higher than the refinancing rate of the above 2 subtypes. Lending maturity is very short, may be overnight, or 3 days as maximum (In fact, it is the lending for clearing purpose at the moment).

The second type: The State Bank acts as lender-of -last-resort to ensure the security of the whole banking system. Maturity of this type is rather long, from 1 - 5 years. Commercial banks under special control situation are allowed to borrow this type of loan.

Renovation of refinancing facility as the above types will help to recover the outstanding problems and at the same time, increase the efficiency of this instrument. The above refinancing types will influence credit conditions in the market and ensure the State Bank's role as the lender-of-last- resort, the last saver to ensure the safety of the system.

(3) Develop the money market

The adoption of indirect instrument requires to develop the inter-bank market to link supply-demand among credit institutions and convey influencing signals of policy and of interest rate to the whole economy.

1) <u>Real situation of money market in Viet Nam</u>

The money market in Viet Nam has been established since 1990s, comprising domestic currency inter-bank market and foreign currency inter-bank market (mainly traded in USD) with the managed floating exchange rate mechanism. Members of this market consist of state-owned commercial banks, joint-stock bank, joint-venture banks and foreign bank's branches. The operations of the money market act a very small role in allocating credit. Especially, the money market lacks of various instruments which can be traded by commercial banks to manage their liquidity. At present, commercial banks are holding more than VND 3,000 billions of T-Bills and VND 500 billions of State Bank's bills. Credit institutions are not interested in buying T-bill, because T-bills maturity is rather long and there is only a maturity of 364 day. Apart from that, the MOF maintains the stability of interest rate and stipulates a ceiling rate so the sold volume of T-bills is lower than the offered volume which badly influence the demand for T-bills, T-bills interest rates do not reflect the market inter-bank rate.

2) <u>Measures should be taken by the State bank to develop the money market</u>

- Co-operate with the MOF to improve the T-bills auction through the SBV, interest rate of T-bills should be determined by the market.
- The inssuance of Government bonds through the securities market has limited the volume of T-bills issued through the SBV. It is necessary to issue short-term bills to save issuing costs, and the liquidity management costs as well as to develop the money market.
- When the T-bill auction market is fully developed, the State Bank of Viet Nam will restrict issuing SBV's bills so as not to influence the SBV's expenses and the SBV only issues its bills when necessary.
- In the coming time, the SBV will relax restrictions on mobilization in VND by foreign bank's branches to increase the competitiveness among banks in the market.
- Restructure commercial banks(including joint-stock banks, joint-venture banks), upgrade the operation quanlity of banks, bank's accounting system must be in line with the international accounting standards to make transactions transparent.
- To further develop the money market for commercial bills the SVB needs to ensure a more appropriate and completed legal framework.
- To develop the foreign currency inter-bank market, the forward market needs to be developed, payment agreement need to be improved to implement payment orders quickly and fluently within a day.
- Complete the clearing system to facilitate short-term transaction of banks, develop overnight operations to push up the development of the inter-bank market which is the basis for the development of OMOs.

3) <u>Adverse affects occur if regulations on interest rate and rate and credit are abolished.</u>

Interest rate control and credit control are methods of monetary policy management of central bank of each country. However, adoption of these instruments depends on monetary economic conditions of each country. The tendency of liberalization of interest rate, elimination of regulations on credit control together with price and trade liberalization, liberalization of foreign exchange market have become popular in many countries.

- In Viet Nam, as presented above, the application of interest rate and credit control in the renovation period has brought about active renewals, gradually moved to be in line with each period. The abolishment of credit ceiling and the application current base interest rate control, which have encouraged saving, accumulating and investing in economic development, gradually moved to an indirect monetary and interest rate control.
- Given the current economic conditions in Viet Nam, if all regulations on interest rate control have been fully phased out, the competitiveness among the banks will be enhanced and the economy will be change considerably in line with the development of the market. Given the low ratio of capital over total assets of the Vietnamese banks, the banking system in Viet Nam will not be weakened, provided that the abolishment of interest rate control is linked to enforcement of regulation on risk prevention and supervision.
- With a flexible interest rate regime, banks will concentrate on investing in highly profitable and risky projects and neglect the recovery of the fund. Regulation on risk prevention is not appropriate, the management capacities of the central bank as well as commercial banks remain limited. Information and payment system have been slowly improved. Those issues reduce the efficiency of monetary control and the role of interest rate in allocating capital sources. Besides, the underdeveloped financial market , the insufficiency of instruments will lead to an overconcentration of risks on the banking system and place in the borrowers in the face of interest risks or restrict them to access capital sources.

Experiences from other countries and current conditions in Viet Nam have shown that VN can not completely phase out regulations on interest rate control because:

- Macroeconomic environment is still unstable: Although the declining trend in economic growth has been ceased, the economic growth rate has still not reached those of the years from 1995 to 1997. Inflation has been controlled but the tendency of having negative CPI has emerged for a long time, foreign investment has been in a stagnation, balance of payment surplus is small, domestic accumulation is low.
- Banking system, especially joint stock-banks are having many weaknesses such as small size of capital, low level of management skill, the staff are not really qualified to meet the requirements of the works and the banks are on the way of restructing
- Monetarization level is still at low level (M2/GDP is about 33% as compared to the average level of 66% of many other countries). The instruments of the money market (commercial bills, short-term valuable papers) are limited. OMOs have newly come into operation and are still in a preliminary period so the can not be a key instrument in controlling money of the State Bank;

- Dollarization in the economy has not been reduced, public confidence in the banking system is not high, the fluctuation of interest rate and exchange rate in the market strongly affect the people's psychology.
- Management ability of the State Bank has been improved but still faced a lot of challenges;
- Economies in the region have been recovered after the crisis, liberalization of their financial markets are implemented at a high speed while the integration level of Viet Nam is limited, so the abolishment of interest rate control will weaken the finance- banking system in Viet Nam.

In summary, the elimination of regulations on interest rate control in Viet Nam needs to be carried out in line with economic environment, conditions and integration level of the financial and banking system in each period, especially, strengthening of the public's confidence in the finance- banking system. Conditions for the elimination of regulations on interest rate control are the stability of the macro-economic environment, a healthy and efficient banking system with adequately competitive power, a completed supervision and protection mechanism of the State Bank, development of monetary policy instruments which can be used to intervene the market when needed, enhancing financial capacity of businesses to minimize interest rate risks.

B－2

Foreign Exchange and Exchange Rate Management

Chu Hong Minh

State Bank of Viet Nam

During the past years, the renovation process of foreign exchange control and exchange rate management has made certain contribution to stabilizing value of the Vietnamese Dong, improving international balance of payment and increasing official foreign reserves of the country. To obtain these results, series of policies, regulations governing foreign exchange management and foreign exchange related activities were promulgated. These policies were continuously revised towards developing a dynamic foreign exchange management regime that corresponds to new requirements of the market economy, supports targets of the monetary policy and creates preconditions necessary to make Vietnamese Dong convertible and the only currency circulating in Viet Nam. Exchange rate management becomes more flexible, thus helping to increase export, control import, attract foreign capital and eliminate negative impacts of the region's economic crisis.

The purpose of this paper is to review policies on foreign exchange management, foreign exchange transactions, foreign exchange trading management and foreign exchange related activities (private transfers, foreign direct investment, external debts...), exchange rate management, relationship between interest rate and exchange rate since 1994. This paper will also give some predictions about policies that are likely to be implemented in the next 5 - 10 years. It will conduct analyses and assessments of the effects of the policies and regulations on the foreign exchange market, as well as on international trade of goods and services. Considering the current economic situation, achievements in the renovation of foreign exchange management and some other prerequisite conditions, the paper will discuss about the possibility of introducing the convertibility of Vietnamese Dong and measures needed to be carried out to reach this purpose. Besides that, the issue of exchange rate monitoring and necessary conditions required to sustain the current mechanism to control foreign exchange rates are mentioned in the last part of the paper.

In the context of the paper, gold control is not mentioned, although foreign exchange concept is defined in the Decree No.63/1998/ND-CP dated 17 August 1998 on foreign exchange management as consists of also gold of international standard.

1. Review of policies on foreign exchange management, foreign exchange related activities, exchange rate arrangement since 1994

1.1 Foreign exchange management

Before, foreign exchange management was carried out in accordance with the Regulation on foreign exchange management promulgated under Decree No. 161/HDBT dated 18th October 1988. However, in responding to the process of transforming to the market economy and international practices, the foreign exchange management policy had been gradually adjusted towards strengthening ability of the State Bank to manage and control foreign exchange, reducing scope of foreign currencies using in the economy.

In particular, after issuing the Government's Instruction on strengthening foreign exchange management and Decision No.396/TTg dated 4th August 1994 by the Prime Minister on amendments of the foreign exchange management in new circumstances, foreign exchange management policy has been basically changed to achieve the above mentioned targets. According to the Decision No.396/TTg, a part of enterprises' revenue in foreign currencies is permitted to retain to meet their expenditure needs, and the remaining amount should be sold out to banks. This Decision also had stipulations concerning management of the enterprise's foreign currencies accounts (included and accounts opened in a foreign country). According to this, all payment activities must be carried out through the authorized banks and finance companies; trading and servicing entities that have revenue in foreign currencies must receive payment for their sold products, services in Vietnamese Dong. The purpose of this regulation is to concentrate foreign currencies sources in banking system, eliminate use of foreign currencies and gradually reach the target of making Vietnamese Dong the unique currency in Viet Nam.

In order to cope with requirements of foreign exchange management in market economy, Governor of the State Bank of Viet Nam had issued Decision No. 203/QD-NH13 dated 20th September 1994 on the establishment of the foreign currency interbank market. Transactions in this interbank market are conducted through telecommunication (fax, telephone, computer net ...) which limits disadvantages of direct method in the 2 previous foreign currencies transaction centers. In particular, the exchange rate is determined by market participants within allowed band of +/-0.5% of official rate announced by the State Bank. The State Bank plays the role of the last resort buyer or seller in the market. It intervenes the market by buying and selling with other market participants. Recently, in order to meet new demands of diversifying market activities and instruments, Governor of the State Bank had replaced the above mentioned Decision No. 203/QD-NH13 with the Decision No. 101/1999/QD-NHNN13 dated 26th Mach 1999 concerning Regulation on organization of the foreign currency interbank market. The new decision stipulates detailed requirements that credit institutions must satisfy before taking part in the market (the minimum trading volume is equivalent to 50,000USD, trading principles, trading methods...)

Facing with complicated consequences of the regional financial - monetary crisis in 1998, the Government had applied administrative measures on strengthening foreign exchange management. These measures aimed at eliminating the adverse impacts of crisis on the Vietnamese economy, at improving control over foreign capital flows, reducing foreign currency tense in the interbank foreign exchange market that badly affected exchange rates. One of the above measures was Decision No. 37/1998/QD-TTg dated 14th February 1998 by the Prime Minister on foreign exchange management measures.

Under the Decision No. 37, enterprise that has revenue in foreign currencies must put all of this revenue in an account opened with a credit institution, after deducting an amount needed for its next month's estimated expenditure purposes. On the other hand, each enterprise is permitted to open only one foreign currency deposit account with one credit institution. It is required to register with the State Bank of Viet Nam if the enterprises wish to maintain more than one foreign currency deposit account. All local enterprises are required to sell excess foreign currencies to banks. At the end of each month, the amount retained in the foreign currency account is not to exceed projected requirements in foreign currencies for the following month. When excess foreign currencies are sold, the seller has a right to purchase back minimum amount equal to the sold amount within six months by entering into a forward contract with a the same bank, provided that these foreign currencies would be used for purposes in compliance with the foreign exchange management regulation.

However, the enforcement of the Decision No. 37 has faced some difficulties. For example, enterprises overestimate the amount of foreign currencies needed in the incoming period as they fear that they will probably have to accept a high buying rate offered by banks. Given this circumstance, following Decision No.37, the Government issued the Decision No.173/1998/QD-TTg dated 12th September 1998 on the obligation to sell and right to buy foreign currencies of institutional residents. This Decision specifies that enterprises have to sell 80% of their foreign currencies received from current account transactions to banks within a 15-day period from receipt. Besides that, the Decision also affirms the right to buy foreign currencies of institutional residents when they need foreign currencies to facilitate their current account transactions and other eligible transactions. At the same time, Circular No. 08/1998/TT-NHNN7 dated 30th September 1998 was promulgated by the State Bank of Viet Nam to give instructions on implementing Decision No.173/1998/QD-TTg. Then, on December 1st 1998, the Government issued Decision No.232/1998/QD-TTg to modify points 1 and 2 of Article 1 of Decision No.137. Decision No.232 stipulates that institutional residents have to surrender foreign currencies to licensed banks as soon as foreign currencies are transferred to or credited in their foreign currency account with banks. In 1999, thanks to a more favorable supply-demand condition in the foreign exchange market, it was able to reduce the surrender ratio of foreign currencies to 50% of enterprises' current income. This had given enterprises greater autonomy in using foreign currencies with the eventual aim of liberalizing foreign currency transactions (the Government's Decision No.180/1999/QD-TTg dated 30th August 1999).

The 17th August 1998 marked an important milestone in the foreign exchange management as the

Government replaced the Decree No. 161 by the Decree No. 63/1998/ND-CP on foreign exchange management. This new Decree has some basic amendments as follows:

- It introduces new concept of foreign exchange.
- It clarifies concepts of resident and non-resident to facilitate foreign exchange management.
- It classifies transactions under foreign exchange management into 3 major categories: current account, capital account transactions and foreign exchange related transactions of credit institutions.
- It officially specifies the right of individual to use foreign currencies.
- It recognizes only gold of international standard as foreign exchange.

The Decree also makes amendments to some stipulations relating to issuing valuable papers in foreign currencies, principles of determining exchange rate, foreign currency account, obligation to sell and right to buy foreign currencies of entities, buying and transferring foreign currencies by individuals, foreign exchange activities by credit institutions,etc. Then, the State Bank of Viet Nam has issued Circular No.01/ 1999/TT-NHNN17 dated 16th April 1999 which gives instructions on implementing Decree No 63 and detailed regulations on foreign exchange and foreign exchange management in new situation.

It could be said that foreign exchange management policies in Viet Nam have been developed more comprehensively and systematically, aiming at the goal of making Vietnamese Dong convertible in the foreign exchange transactions, increasing ability of integration with international markets, accelerating economic growth and improving balance of payment.

1.2 Regulations on foreign currency transactions and foreign exchange trading management

Along with such administrative measures, Governor of the State Bank has signed Decision No.17/1998/ QD-NHNN17 dated 10th January 1998 on foreign currency transactions in which credit institutions are permitted to carry out forward and swap transactions. The purpose of this Decision is to stabilize foreign currencies market, support the market development towards integrating with global markets by means of diversifying interbank market instruments and enhancing flexibility of credit institutions in the market. At the same time, the State Bank has had Decision No.16/1998/QD-NHNN17 dated 10th January 1998 regarding the principles to determine the foreign currencies forward and swap buying, selling rates of credit institutions allowed to conduct forward, swap transaction in foreign currencies. With these two decisions, the State Bank has created a legal framework for foreign currencies transactions, provided instruments for hedging against future interest risk and exchange rate risk. It has equipped import and export enterprises with greater autonomy in their operation.

Maintaining open foreign exchange position by local commercial banks and open position limit for Vietnamese Dong by foreign bank branch is one of the measures taken to strengthen management over foreign exchange trading of commercial banks, to prevent speculative activities that lead to untrue demand and exchange rate shocks. Credit institutions have to maintain foreign exchange position as stipulated in the Decision No. 204/QD-NH7 dated 20th September 1994 regarding temporary regulation on foreign exchange position of credit institutions permitted to trade in foreign currencies. This Decision has been replaced in 1998 by the Decision No. 18/1998/QD-NHNN7 dated 10th January 1998 on foreign exchange position of credit institution permitted to trade in foreign currencies. According to the later one, the aggregate long or short position limit of credit institution at the end of each day must not exceed 30% of its own funds, the long or short position in USD at the end of each day must not exceed 15% own funds. Open position limit for Dong is governed by the Decision No. 20/1998/QD-NHNN1 dated 10th January 1998 on position in Vietnamese Dong of foreign bank branch operating in Viet Nam. As specified in the Decision, these banks' branches are allowed to take position for Dong that is not exceed 15% of the capital assigned by their head offices plus reserves. This ratio was 10% pursuant to the Decision No. 380/1997/QD-NHNN1 dated 11th November 1997 by Governor of the State Bank. Besides that, State Bank continuously makes great efforts in supervisory activities so that it can catch with most recent changes in the market and apply measures as necessary.

1.3 Management of foreign exchange related activities, external debt management

In addition to the above mentioned policies, during the past few years, the Government of Viet Nam has implemented many measures to encourage Vietnamese overseas to transfer funds to Viet Nam. This is reflected in the Prime Minister's Decision No.170/1999/QD-TTg dated 19th August 1999 and the Circular No. 02/2000/TT-NHNN7 dated 24th February 2000 of the State Bank to guide the implementation of the Decision No. 170/1999/QD-TTg. According to these documents, the beneficiary does not have to pay income tax on the received amount. He or she has the right to draw their funds in Vietnamese Dong or in foreign currencies as required (before, only Dong is accepted), to open personal foreign currencies account at an authorized credit institution...The Decision No. 170 has marked a new progress in liberalizing step by step current transactions.

Foreign exchange and exchange rate management can not be separated from foreign currencies flows in different forms. That is why Government pays more and more emphasis on foreign debt management, including management external short-term borrowing through deferred L/C.

Before the year of 1997, foreign debt management was governed by the Government's Decree No. 58/CP dated 30th August 1993 to promulgate Regulation on foreign debt management. As stipulated in the Decree, foreign debt by the Government and enterprises is jointly controlled by such authorities as Ministry of Finance, State Bank of Viet Nam, Ministry of Planning and Investment. By 1996, external borrowing by enterprises is carried out in accordance with the public sector's foreign borrowing limit agreed between the Government and IMF within the framework of ESAF. However, foreign debt, in particular short-term one in form of deferred L/C, has become a big problem (trade balance deficit has reached enormous level, in which value of imports under deferred L/C counted for a remarkable portion of total import in 1995). In order to closely manage deferred L/C opened by commercial banks, the Regulation on deferred L/C was promulgated under Decision No. 207/QD-NH7 dated 1st July 1997. This Regulation determines conditions that banks and enterprises must to satisfy if they wish to open deferred L/C; the maximum deferred period of 1 year in case of importing materials and consumer goods; the minimum deposits required in case of importing consumer goods with deferred payment method. After that, the State Bank specified in the official letter No. 931/1997/CV-NHNN7 dated 17th November 1997 that limit on external short-term borrowing and guarantee by banks for short-term borrowings must not higher than 3 times of their own funds; the minimum deposit level required in case of opening a deferred L/C is equal to 80% value of imported goods. Moreover, the Circular No. 07/1997/TT-NHNN dated 4th February 1997 was issued by the State Bank to guide the implementation of the Prime Minister's Decision No. 802/TTg dated 24th September 1997 on dealing with remaining problems of L/C (in which the responsibilities of guarantor-bank and resolution of collaterals related to deffered L/C are specified).

In order to attract and manage effectively foreign capital sources for economic development purposes, 7th November 1998, the Government issued Decree No. 90/1998/ND-CP concerning Regulation on foreign debt management. This Decree has made amendments and replacements to some stipulations in the Decree No. 58 that were not suitable with new conditions, creating a legal framework for external debt management of banks and enterprises. To carry out responsibility of the State Bank in foreign debt management as stipulated in Articles 22 and 24 of the Decree No.90, Governor of the State Bank has issued Circular No. 03/TT-NHNN7 dated 12 August 1999, giving guide to borrowing and debt servicing by enterprises.

For the goal of attracting external sources of funds, Vietnam's Government has trying its best to establish a completed legal environment needed for foreign investment. Examples can be taken from foreign exchange management regulations applied to enterprises with foreign invested capital, to foreign parties in business-cooperation contracts (BCC), as follows:

- Tax on repatriation or remittance of profits has been reduced from 5%, 7%, 10% to 3%, 5% and 7%, respectively, as determined in the Law on foreign investment of year 2000.
- Besides that, the old Law on foreign investment required that foreign invested enterprises, foreign parties in BCC must satisfy foreign currencies needs themselves. The State would assist to balance foreign currencies needs for infrastructure constructions, import-substitutes production and other vital purposes. In such condition that Vietnamese Dong is not convertible and foreign reserves are still limited, this requirement is necessary to stabilize international balance of payment. But in the new amended law, foreign invested enterprises, foreign parties in BCC are permitted to buy foreign currencies from commercial banks to make current transactions and other eligible transactions as specified in the Decree No. 63 regarding foreign exchange management. The Government takes responsibility to ensure sufficient foreign currencies supply for a limited number of extremely important projects, to assist in balancing foreign currencies needs for infrastructure constructions

and other vital projects.

- Amended Law on foreign investment of year 2000 allows foreign-invested enterprises to open account at banks abroad in special cases after getting permission from the State Bank. According to the Law of year 1996, the enterprises are permitted to maintain only borrowing account.

Management and use of official development aid (ODA) are currently governed by Decree No. 87/CP dated 5 August 1997, which replaced Decree No. 20/CP dated 15 March 1994.

1.4 Exchange rate management

It is worth to notice that since 1994, with the establishment of the foreign currencies interbank market, the State Bank has made a fundamental change toward applying new exchange rate management regime instead of the previous multi-rate one. Since then, the State Bank makes announcement about official VND/USD rate; and market rates are allowed to range within a band of +/-0,5% of this official rate (Decision No. 245/QD-NH7 dated 3rd October 1994 regarding buying and selling rates offered by banks that are permitted to trade in foreign currencies). Next, with the aim of stimulating banks to take active participation in foreign currencies interbank market by giving them more flexibility in adjusting exchange rate, the band was widened to +/-1% from 21st November 1996 by Decision No. 311/QD-NH7. This measure also helped to eliminate overvaluing of Vietnamese Dong.

At the beginning of 1997, banks had experienced huge demand for foreign currencies to make payment under L/C and service external debts. The market was lack of foreign currencies, while current account deficit was at an alarming level. Currencies of some neighboring countries had been slightly devaluated. In order to balance supply-demand in the market and to mitigate foreign currencies constrains, the State Bank had widened trading band to +/-5% in the Decision No. 45/QD-NH7 dated 27th February 1997.

On 13th October 1997, the State Bank made another adjustment by increasing trading band to +/-10% (Decision No.342/QD-NH7) so that the adverse effects of regional monetary crisis could be partly prevented.

Given such international and domestic changes, the foreign exchange management policy would not be inclined to stabilize the value of domestic currency vis-µ-vis foreign currencies. It rather aims at the long-term objective of promoting production, encouraging economic growth, limiting wide fluctuation and socio-economic disruption, focusing on stimulating exports, controlling import and increasing foreign reserves. In achieving these policy objectives, the State Bank actively increased official exchange rate from 11,175 VND/USD to 11,800 VND/USD in February 16th 1998 (devaluation of 5.6%). Next, on 7th August 1998, the State Bank made another currency devaluation of 9.2% by downsizing trading band to +/-7% and increasing at the same time the official rate from 11,815 VND/USD to 12,998 VND/USD (Decision No. 267/1998/QD-NHNN7). It is important to note that the official reference rate stipulated by the State Bank on 7th August 1998 is the closing rate of the inter-bank foreign currencies market on 6th August 1998. This means that the official VND/USD reference rate is established by the State Bank on the basis of buying and selling rate in the interbank foreign exchange market. Thanks to this mechanism, the official rate will be more closely linked with the demand-supply relationship in market.

In 1999, State Bank changed from administrative management to the state-regulated market mechanism. In accordance with the Decision No.64/1999/QD-NHNN7 on announcement exchange rate between Vietnamese Dong and some other foreign currencies and the Decision No. 65/1999/QD-NHNN7 on principles of determining foreign currencies buying and selling rates by authorized credit institutions, from 26th February 1999, the State Bank started to announce an weighted average trading exchange rate in interbank foreign currencies market. This rate serves as basis for defining authorized banks' offered rates and for calculating import, export taxes. Based on the effective average trading exchange rate in the interbank foreign currencies market on the latest day, which is announced by the State Bank, credit institutions can determine their own rates that not exceed 0.1% of the former one. The new exchange rate management mechanism provides commercial banks with greater freedom in determining exchange rate between Vietnamese Dong and other currencies (except the US dollar).

With this new management mechanism, exchange rate is established on the basis of transactions in the market. It reflects objectively purchasing power of Vietnamese Dong in comparison with other currencies, thus creates conditions for enterprises to be more active in their operations while ensuring supervisory function of the State.

1.5 Dealing with relationship between exchange rate and interest rate

Changes in interest rates always have impact on flows of funds and consequently on exchange rate. This explained why during the past several years, foreign exchange and exchange rate management could not be separated from interest rate and credit mechanism management. The year of 1998 can be served as an example. In 1998, the devaluation of local currency by approximately 16% had lead to a tendency of shifting from Dong saving deposits to US dollar deposits. In order to eliminate this tendency, from the beginning of 1998, the State Bank had issued Decision No. 39/1998/QD-NHNN1 dated 17th January 1998 that increased ceiling rate of short-term credit in Vietnamese Dong from 1% to 1.2%/month, ceiling rate of medium and long-term credit in Vietnamese Dong from 1.1% to 1.25%/month. The maximum lending rate in foreign currency by credit institution was decreased also from 8.5% to 7.5%/month, ceiling rate of foreign currencies deposits by enterprises in credit institution was decreased to 1 - 1.5% (Decision No. 309/1998/QD-NHNN1 of the State Bank). Pursuant to these two decisions, credit institutions have ability to increase Vietnamese Dong deposit rates and decrease foreign currencies deposit rates in order to limit flows from Vietnamese Dong to foreign currencies.

1.6 Projected policies on exchange rate and foreign exchange management in the coming 5-10 years

In the next 5 to 10 years, foreign exchange management policy will be carried out towards gradual liberalization of foreign exchange operations with regulation that are in compliance with international practices and stipulations of international organizations, groups of countries that Viet Nam has membership status (IMF, ASEAN...). Foreign exchange management mechanism will be increasingly flexible and will fit for development of country as well as integration with global community. Intervention by the State Bank in foreign currencies market will be made mainly through policies. The management activities will be conducted by means of economic measures, while administrative instruments will be mitigated as much as possible.

Particularly, in order to achieve convertibility of Vietnamese Dong, the restrictions on foreign exchange are planned to be loosen step by step and removed entirely. At present, there are big concerns regarding surrender requirement and foreign exchange management regime applied to foreign invested companies. The prevailing surrender ratio is 50%, which is less than ratio of 80% in 1998. This ratio is expected to be removed in 2001 in accordance with the PRGF framework of the IMF. As stipulated in the Law on foreign investment of year 2000, withholding tax has been reduced from 5%, 7%, 10% to 3%, 5% and 7%, respectively, and requirement of foreign currencies self-balancing by foreign invested enterprises is starting to be relaxed.

In about next 2 to 3 years, some other restrictions on current payment and transfer will also be abolished under scheme of implementing Article VIII of the IMF Status. The establishing the convertibility of Vietnamese Dong will be taken step by step from current account convertibility to capital account convertibility. (This issue is discussed in detail in part 3 regarding possibility of introducing the convertibility of Vietnamese Dong). Moreover, it is expected to put an end to present dollarization, aiming at the goal of making Vietnamese Dong the unique currency circulating in Viet Nam.

Foreign currencies inter-bank market will operate more regularly. It is projected that the market will be developed in size, trading volume, number of participants and as well as in transaction instruments. Commercial banks plan to expand their direct transactions among each other in general, forward and swap transaction in particular. The state management role of the State Bank in this market will be fulfilled more flexible through acting as the last resort buyer and seller and other development measures. Besides that, the domestic foreign exchange market is developing either with different types of instrument and transactions, thus creates conditions for balancing supply and demand in the market.

Exchange rate regime will be adjusted to be more flexible and closely reflecting supply-demand relationship in market. Instead of US dollar pegged system or crawling peg system, the official rate will be pegged with a basket of currencies. It means that value of Vietnamese Dong is determined on the basis of supply-demand relationship in foreign currencies market and changing tendency of currencies of main trading partners (Japan, NIEs, EU...) in order to promote export, control import and improve balance of payment. With this objective, currencies selected in the basket could be some strong ones (US dollar, Japanese yen, Euro) and currencies of countries in the region (China, Indonesia, Thailand, Malaysia, the

Philippines). The portion of currencies in the basket will be determined according to their weights in trading and investment relationship with Viet Nam.

In order to increase foreign currencies supply and encourage economical use of foreign currencies, the Government and other ministries will promulgate synchronous policies and solutions for export promoting (policies on capital, privileges of interest rates and tax...), import controlling, attracting Vietnamese remittance, private transfers, foreign investment promoting (legal environment, financial market, securities market...), tightening external debt management (just foreign funds are to be allocated to the only efficient projects, etc.)

2. Impacts of foreign exchange and exchange rate management policies on foreign exchange market from 1994 until present

Generally, impacts of foreign exchange and exchange rate management policies on foreign exchange market could be observed in development of inter-bank foreign currencies market, limitation of State intervention, stabilization of exchange rate and increase in official reserves. Other policies governing activities related to foreign exchange, such as regulation on Vietnamese remittance, deferred L/C..., also have certain effects on ensuring supply of foreign currencies in the market, mitigating pressure of shortage of currency supply on exchange rate. However, this paper does concentrate on assessment about only some policies that have significant impact on foreign exchange market.

2.1 Decision No. 37/1998/QD-TTg

Before the issuing of Decree No. 37/1998/QD-TTg, organizations and enterprises were allowed to maintain several foreign currencies accounts at different credit institutions. This situation had lead to the fact that foreign currencies volume was not concentrated, which made difficult for banks to take control. On the other hand, enterprises that have balance in foreign currencies accounts were not willing to sell to banks as they were afraid of adverse exchange rate fluctuation and of frequent foreign currencies shortage of banks. The inter-bank foreign currencies market did not function as expected, with demand for foreign currencies was much greater than supply in the market.

According to the Decision No.37, each enterprise is allowed to maintain only one deposit account and if it needs to open more than one account, it has to register with the State Bank. The above requirement is enforced seriously in reality. In addition, commercial banks have to submit monthly report regarding foreign currencies credits and debits of accounts in different banks, in different localities. This practice enables banks to take initial efforts in detecting enterprises that have unused foreign currencies and requires them to sell this surplus amount to banks This aims at attracting foreign currencies into banking system, preventing speculative hoarding and inappropriate use of foreign currencies. This can be observed by the activities of