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The Asian Financial Crisis and its Implication for Vietnam's Financial System*

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THE ASIAN FINANCIAL CRISIS AND ITS IMPLICATION FOR VIETNAM'S FINANCIAL SYSTEM*

Abstract

Economic globalization is an unavoidable trend. Financial liberalization to integrate into the international financial community is an aspect of globalization. Many East Asian countries had begun this process with a view to attract capital for economic development. The unexpected onset of the recent Asian financial crisis made these countries reassess the state of their financial systems as well as the pace and the sequence of financial liberalization. Due to its geographical location and increasing economic interdependence, Vietnam could not avoid the impact of the regional crisis. This paper looks at what Vietnam can learn from the crisis itself and from the recovery of the crisis-hit countries, given their experiences and the current situation of Vietnam's financial system.

Introduction

The financial system plays a vital role in any economic system. The financial system in Vietnam consists essentially of the banking sector which is a legacy of the planned economy. In 1951, the State Bank of Vietnam was formed as a governmental agency with the function of issuing cash and extending credit to facilitate development in the newly-established economy. During the years 1951-1988, banking was regarded as a planning and administrative instrument. From 1988 to 1990, the banking sector underwent a renovation process, in which a two-tier banking system was set up by separating commercial banking from central banking. State-owned commercial banks were created and the State Bank of Vietnam functioned as the central bank. Since then, the government has gradually carried out reforms in the banking sector, including rationalization of the structure of interest rates, cessation of concessionary refinancing for state-owned commercial banks, establishment of a unified refinancing rate, establishment of money markets, etc. Reforms have had positive effects. Total

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*The views expressed in this paper do necessarily reflect neither those of the Ministry of Foreign Affairs nor the Government of the Socialist Republic of Vietnam.

financial system assets have expanded rapidly to 38% of GDP at end-1998, more than triple the 1990 level. During the same period, the ratio of credit to GDP increased from 13.1% (1991) to 22% (1998). Furthermore, the balance between lending to the private sector and lending to the state enterprise sector improved. Despite this progress, Vietnam's financial sector remains relatively shallow compared to countries with similar levels of per capita income in the region (World Bank, 1997). In addition, the sector appears to be financially fragile. It also suffers from a low level of competition, which hampers efficient resource allocation.

The outbreak in 1997 of the Asian financial crisis raised concerns for Vietnam's financial system. In the first part of this paper, I will focus on financially related causes that created the Asian financial crisis and the impact on Vietnam's financial and monetary development. In the second part, the current situation of Vietnam financial system will be analyzed, along with implications of the regional crisis on Vietnam's future financial development. As the crisis-hit countries have embarked on further reforms aimed at preventing future turbulence and promoting further financial liberalization, Vietnam can learn from their experience. The last part emphasizes the building of a healthy banking system, improving mobilizations of savings, and developing capital markets.

I. The Asian financial crisis

1. The crisis

A brief overview

Two and half years have passed since Thailand announced it would float the baht on 2 July 1997, triggering the so-called "Asian financial crisis" in the region. The fortunes of the once booming economies of Southeast Asian suddenly went into reverse, and the crisis-hit countries[1] fell deeply into recession.

In 1997, the average economic growth of these economies was 5.5%, in comparison to 7.4% in 1996. In 1998, they registered negative growth rates (see Table 1).

Table 1: Growth in real GDP (%) in crisis-affected countries

	1996	1997	1998
Thailand	5.5	- 0.4	- 8.0
Indonesia	7.8	4.9	-13.7
Malaysia	8.6	7.7	-6.2
South Korea	7.1	5.5	-5.5
Philippines	5.8	5.2	-0.4

Source: Asian Development Bank

The country most affected was Indonesia, but Malaysia, South Korea and Thailand were also affected. From July 1997 to July 1998, the Indonesian rupiah lost over 90% of its value relative to the US dollar, while the Malaysian ringgit, Thai baht and South Korean won lost about 40% of their values. At the same time, the stock market in all Southeast Asian countries declined sharply as investors began to realize the risks of default on large foreign debts by many local firms. During 12 months (from July 1997 to July 1998), the Indonesian stock market lost 90% of its value, while the stock markets of Malaysia, South Korea and Thailand lost between 70% to 75%. It has been estimated that the Asian currency crisis has exacted one of the largest destruction of wealth in the world, wiping out some US $1.5 trillion worth of assets value in the affected countries. Capital movements across Asia decimated banks and firms saddled with large amount of debt, leading to a series of bankruptcies. By the middle of 1998, widespread unemployment and poverty were sweeping through Thailand and Indonesia. The rate of unemployment in Malaysia for 1998 increased 2.5 times as compared to 1997. The crisis caused not only economic but also political and social instabilities in some countries. It surprised the world with its occurrence, speed, depth and breadth.

The causes of crisis.

There are two major schools of thought on the causes of the crisis. One blames the weaknesses of domestic structural factors, while the other argues that unregulated short-term capital flows were a more important influence on events. Seiichi Masuyama of Nomura Research Institute asserts that “fundamentals alone did not justify the speed and magnitude of the currency and the economic adjustments. The volatility of international capital flow, particularly short-term capital and portfolio investment, due to the herd behavior of international lenders and investors is believed to have played a major role in causing the crisis". At the same time, the alternative view emphasizes the role of a weak financial system, rather than financial panic, as an essential element of the Asian crisis. In this section, a brief overview of the financially related causes, that have been discussed widely by many economists as well as in international financial institutions, will be given.

Unguarded capital account liberalization invited the crisis, and the weaknesses of the financial system in East Asian countries aggravated the problem (Masuyama, 1999). The surge of capital flows into the region over the last decade and the swift reversal of short-term flows since the middle of 1997 lies at the heart of the East Asian financial crisis. The capital inflows into the region ballooned between 1991 and 1996. Net external financing in the five countries almost doubled from US$45.2 billion in 1994 to US$84.6 billion in 1995. In 1996, it increased by more than 12 % to US$95.2 billion. The massive capital inflow into the region was primarily the consequence of acceleration of financial sector and capital account liberalization in the middle of 1980s. This trend was also encouraged by the lenders' over-optimistic view of the booming economies, underpinned by many healthy macroeconomic indicators such as low inflation or impressive fiscal performance.[2] Furthermore, higher interest rates in these countries relative to the rates in the US and Japan also attracted capital inflows. Although the capital stock in these countries piled up, most traditional indicators of debt problems gave little warning. Ratios of debt service to exports were generally low, giving no indication that the level of foreign borrowing was unsustainable. However, the amount of short-term debts surpassed the foreign exchange reserves, making these countries vulnerable to large capital outflows (see Table 2).

Table 2: Debt indicators (%)

	1990	1991	1992	1993	1994	1995	1996	1997
Indonesia								
Total debt/GNP	64.0	64.9	66.2	58.7	63.3	64.6	59.7	
Short-term debt/total	15.9	18.0	20.5	20.2	17.7	20.7	36.8	32.7
Short-term debt/reserve	129	138	157	144	146	174	166	170
Malaysia								
Total debt/GNP	40.1	40.7	36.8	43.8	43.6	42.5	42.1	
Short-term debt/total	11.6	11.4	18.2	26.6	21.1	21.2	27.8	39.3
Short-term debt/reserve	18	18	20	25	24	29	40	61
Philippines								
Total debt/GNP	68.7	70.5	60.7	64.9	60.8	51.8	47.3	
Short-term debt/total	11.5	13.3	13.3	14.0	14.3	13.4	19.3	29.7
Short-term debt/reserve	217	111	99	85	80	68	68	85
South Korea*								
Total debt/GNP	13.8	13.5	14.3	14.2	14.3			
Short-term debt/total	30.9	28.2	27.0	25.9	25.5			41.4
Short-term debt/reserve	—	—	—	—	—			325
Thailand								
Total debt/GNP	33.2	39.0	38.3	43.1	46.8	50.4	50.3	
Short-term debt/total	29.6	33.1	35.2	43.0	44.5	49.4	41.4	39.5
Short-term debt/reserve	58	95	70	89	97	111	97	145

Source: The World Bank, Bank for International Settlement.
* Figure for South Korea is taken from Corsetti et al. (1998).

By 1997, these countries had accumulated high external debts. The bulk of this debt was short-term and foreign currency denominated debt. A large part of short-term debt was direct borrowing by banks and corporations. Various incentives to borrow created by the government contributed to the problem. Some economies in the region provided explicit or implicit subsidies to foreign borrowing, by reducing the costs of borrowing abroad in relation to borrowing at home, or ceasing restrictions on foreign bank debt earlier than limits on foreign equity (Eleck and Wilson, 1997).[3] At the same time, the pegged exchange rate regimes created incentives, acting as an implicit subsidy to borrowing in foreign exchange, without the need of hedging, as the borrowers under-estimated the exposure risk. The high economic growth rate in Asian countries also played a role in this trend. There was an implicit expectation that with such healthy development, the borrowers would be able to service their debt. Therefore, these credits could often be rolled over to satisfy the borrower's long-term development. But in the end, such short-term debts created a mismatch between currency and maturity of liabilities and assets. This mismatch in turn increased the exposure of borrowers to debt payment risk in the event of foreign exchange fluctuation and sudden reversal of international capital flows (Masuyama, 1999).

How did the weaknesses of the financial system make the situation worse? Most financial systems in East Asia are still dominated by banks. For the past decade, the increase in bank lending surpassed that in real growth. The private credits-to-GDP ratio of these countries was far higher than that of developed countries: 65% in the U.S., 89% in Western countries, compared to Malaysia's 95% and Thailand's 105%.[4] Between 1990 and 1996, the ratio of bank lending to GDP grew by more than 50% in Thailand and the Philippines, 27% in Malaysia and 15% in Hongkong, China, South Korea and Singapore (Corsetti et al.1998). Most of the capital inflows were channeled through the banking system. The credit boom in East Asian was the consequence of two factors. First, as the economies developed, the demand for credit soared. Enterprises went to banks, as the bond markets were under-developed[5] in East Asia. Second, banks in these economies did not adequately analyze credit quality due to ineffective and insufficient banking disciplines. A credit boom itself is not a problem, provided that investment decision are sound and lenders retain confidence in that soundness.

However, in these economies the inflow of capital were allocated to unproductive uses, such as property development, durable consumer goods, and mega-projects leading to a financial bubble, e.g. in Malaysia, Thailand and Indonesia. When the bubble burst, the deteriorating asset quality increased the bad debt levels in the banking sector. Non-performing loans in the banking system reached a very high level (see Table 3).

Table 3: Non performing loans/total loans ratios (1997)

	Indonesia	**Malaysia**	**Philippines**	**South Korea**	**Thailand**
NPL ratios (%)	30-35	15-25	8-10	25-30	25-30

Source: Asian Development Bank

There are several features contributing to the fragility of the banking sector in these economies.

Financial fragility in Asia: contributing factors.

	Singapore	Hongkong	Indonesia	S.Korea	Philippines	Malaysia	Thailand
Related party lending			3	3	3	3	3
Weak capital & loans reserves			3	3		3	3
Weak supervision, compliance			3	3		3	3
Weak regulations-accounting disclosure	3	3	3	3	3	3	3
Weak under-regulated non-banks			3	3		3	3

First, a certain level of moral hazard should not have been tolerated. The tradition of public guarantees to private projects directly subsidized or supported by policies of direct credit to favored firms and industries was established, as governments made efforts to foster economic growth. Banks, both domestic and international should not have been so complacent in their credit appraisal. Their complacency resulted from sustained economic growth and the assumption that the government's or international financial institution's would bail them out in case of financial disaster.

The lending practice of commercial banks that relies on market value of real estate assets as collateral for loans, rather than credit assessment of cash flow analysis, contributed to rising bad debt. Over-investment and subsequently over-capacity in the property market also helped cause the bubble. Unavoidably, this bubble would ultimately burst. Subsequently enterprises in this sector went bankrupt, and asset quality of banks consequently deteriorated.

Next, inadequate legal framework also made it difficult and time-consuming for banks to seize or transfer collateral behind delinquent loans. For example, in Indonesia, it is nearly impossible for creditors to take control of collateral assets for debt recovery. So there is no pressure for borrowers to make repayments.

In the absence of strong supervision and enforcement of prudential regulation, commercial banking and non-banking financial companies had been allowed to operate with heavily insufficient capital adequacy ratios, weak credit appraisal and portfolio management capacities, inadequate asset classification systems, and poor provisioning for possible losses. In addition, prudential regulations and supervision had serious deficiencies, e.g. on connected lending, loan concentration, cross guarantees and foreign currency mismatch. Poor accounting and disclosure practices also contributed to the fragility of the financial sector as they allowed excessive risk taking. Consequently, the market participants were unable to identify the weaknesses and to predict the crisis.

The ADB suggested that the ponzi-game,[6] on which both banks and corporates were driven, made the banks more vulnerable to bad debt. More money was poured into highly indebted firms to prevent cyclical downsizing. However, this ultimately turned out to be a waste.

As the entry of foreign investors was often closely controlled, there was lack of competition in the financial system. The domestic financial institutions found no incentive to improve their performance.

In general, as the capital account was liberalized, the domestic financial reform did not keep pace with it. The resulting weakness of the domestic financial system made the situation worse when the economy was exposed to external shocks.

2. The impact of the crisis on Vietnam's financial and monetary development

It is often difficult to separate the negative effect of a regional financial crisis on a domestic financial system from that due to the internal weaknesses of that same financial system. Therefore, this section looks at the negative effect of Vietnam's financial system through its pressures on its domestic currency (Vietnam dong – VND), balance of payments and the banking sector.

Pressure of devaluation on Vietnam dong. The effects of the regional crisis have made Vietnam less competitive. During the crisis, the regional currencies decreased 30-70% in value. As the VND's exchange rate was fixed, VND was adjusted to devalue just about 15%. This devaluation was insufficient to offset the foreign exchange gains in competitors' position. In addition, the confidence on VND deteriorated sharply as the regional crisis spread. Consequently in Vietnam, people tended to speculate and hold foreign currencies, resulting in greater demand for foreign currencies than usual. In fact, the exchange rate of VND against US dollar deteriorated at a greater speed than that of prices of goods and services (see Table 4).

Table 4: Changes in US dollar value and goods/services prices 1997-1998

	US dollar (%)	***Goods and services (%)***
August 1997	0.1	0.1
September 1997	0.5	0.6
October 1997	0.4	0.3
November 1997	5.0	0.3
December 1997	3.7	1.0
January 1998	1.0	1.6
February 1998	1.2	2.2
March 1998	- 0.1	- 0.8
March 1998- August 1997	13.1	5.3

Source: General Statistic Office, Vietnam.

It is evident that the increase in value of the US dollar was nearly triple that of the price in goods and services during 1997-1998.

Impact on the banking sector. The impact of the financial crisis resulted in changes in deposits' structures, and a slowdown in foreign currency transaction, which then caused a shortage of foreign currencies. VND and foreign deposits increased by 1.6% and 49.4% respectively between June 1997 and December 1997. During the first nine months of 1998, VND deposit increased by 15.5% and foreign currency deposit by 29.3%. Many enterprises kept their foreign currencies in their accounts instead of selling them to the banks for VND. This resulted in an imbalance between demand and supply of foreign currencies, putting more pressure on the VND. The foreign currency transaction in the inter-bank market also deteriorated. In the second half of 1997, there was excessive demand for foreign currencies. Total value of the transaction in the whole banking system decreased sharply, from a monthly average of US$900-1,000 million to US$600-700 million in the first few months of 1998. In fact, the State Bank of Vietnam (SBV) bore the burden of supplying foreign currencies, because transactions in the inter-bank market nearly stagnated after the end of 1997, as commercial banks bought foreign currencies instead of selling. Some commercial banks even did not have sufficient foreign currencies to satisfy their traditional customers' routine demand.

In comparison, the indirect impact of the regional crisis seemed to have caused more problems. Many economists argued that because Vietnam had not liberalized capital controls and Vietnam's currency was not convertible, the financial system was spared the impact of highly volatile international capital flows, as witnessed in other ASEAN countries. However, the quality of bank assets in Vietnam had been deteriorating because of the weakening financial condition of its customers. The State-own enterprises (SOEs) — given that households accounted for a small proportion of banking business — were the banks' main customers, and they were performing poorly, partly because of the regional crisis. Exporters of major commodities and manufactures were generating less revenue, because of the decline in the prices and the deterioration of export markets. 70% of Vietnam's exports are to Asia-Pacific countries, including 27% to neighbouring ASEAN countries and 24% to South Korea and Japan. The weakening of these economies negatively affected Vietnam's exports. Furthermore, the devaluation of these countries' currencies had made Vietnamese exports less competitive. Falling domestic demand and smuggled cheap imports from neighbouring countries squeezed import-competing enterprises. As the VND was under pressure to devalue, the imported inputs for manufacturing enterprises became costly. As a result, the number of unprofitable enterprises increased. Moreover, the devaluation of the VND increased the debt burden of Vietnamese enterprises, which followed the practice of other East Asian enterprises by borrowing heavily in foreign currencies (around 12% of total SOEs debt, mostly US dollar), to take advantage of lower interest rates in a steady exchange rate environment. These foreign currency loans of SOEs were rather loosely controlled. In fact, the prevalence of deferred Letters of Credit caused tensions in the foreign currency supply in 1998. Unofficial sources also estimated that the 24.5% devaluation of VND against the US dollar, from the beginning of 1997 to the end of

1998, increased enterprises' debt to the banks by VND 4,000 billion (nearly US$3 million). In addition, as foreign direct investment (FDI) accounted for 32% of total social and economic development investment, falling FDI inflows from crisis-hit countries — including the five top FDI investors (Singapore, South Korea etc.) — reduced Vietnam's supply of capital for development in the next few years.

The deterioration of the fiscal budget and the financial conditions of enterprises, particularly SOEs, aggravated the already weak condition of the banking system.

Pressure on the Balance of Payments. Although Vietnam's debt burden had not been of great concern, the regional crisis made it heavier. Experts estimated that as the VND depreciated relative to the US dollar, enterprises' and governmental debt increased by 10% (computed at the exchange rate in May 1998). Meanwhile, state revenue from import-export tax — accounting for a significant part of the state budget — decreased sharply. As of 15th September 1998, import-export tax attained only 52.9% of the annual target. The crisis also caused a decrease in investment capital derived from FDI, ODA, or state budget, which would in turn affect future revenue. Moreover, the VND devaluation encouraged exports on one hand, but led to the increase in manufacturing expenses on the other. The Institute of Financial Studies (Ministry of Finance) estimated that at least 70% of Vietnam's imports (US$13 billion) were manufactured materials (US$9 billion). It meant that if VND's value against the US dollar is reduced by VND1,000 (e.g. from 12,000 VND/USD to 13,000VND/USD) manufacturing expenses will increase by VND9,000 billion; profits will go down correspondingly, and the state budget will consequently decline.

Policies responses to the crisis

The above difficulties arising from the crisis faced by the economy in general and financial and monetary areas in particular reminded the Vietnam government of the necessity to renew reform efforts. Several measures have been taken.

To cope with the problem of an over-valued VND, the exchange rate of VND against the US dollar was adjusted four times by the SBV. On 27 February 1997, the SBV widened the foreign exchange trading band between commercial banks from ± 1% to ± 5%, and on 13 October 1997, widened it further to ± 10%. On 16 February

1997, the official exchange rate was devalued by 5.6 % from 11,1175 to 11,800 VND to the US dollar. On 7 August 1998, the SBV decided to devalue the official exchange rate from 11,800 to 12,998 VND to the US dollar, and at the same time narrowed the foreign exchange trading band to ± 7%. These measures helped to put VND closer to its market value. It also ceased the pressure on dong devaluation and encouraged exports. A further encouraging step toward more competitive exchange rate was the announcement by the SBV on 26 February 1999 that abolished the official rate. The government would influence the exchange rate through the inter-bank markets. This arrangement made the management of the exchange rate more flexible.

With a view to dealing with the shortage of foreign currencies for payments and further reducing the dollarisation in the economy, enterprises were required to sell 80% (recently reduce to 50%) of their foreign exchange to the banks. If the enterprises fail to do so, they would have this amount automatically purchased from their foreign currency accounts by the banks.

In addressing the deteriorating performance of SOEs, the government took *ad hoc* measures to favorably treat SOEs borrowing from State-owned commercial banks (SOCBs). These included abolishing the requirement for collateral on borrowing from SOCBs and permitting lending to loss-making SOEs that submitted business plans, rolling over loans to enterprises in difficulty of repayment, and writing off bad loans. Moreover, credit institutions have been allowed to reschedule loans to troubled SOEs from 1-3 year terms to 1-5 year terms. Lower interest rates are now applied to SOEs. The preferential treatment of SOEs seems to have been enhanced rather than reduced, notwithstanding the recent deteriorating economic conditions. The apparent improvement in the non-performing loans (NPLs) ratio may reflect these *ad hoc* measures to help troubled SOEs.

To offset the increasingly heavy financial burden of SOCBs, the government has introduced a series of compensating measures. From the beginning of 1999, the income tax rate for the banking system was reduced from 45% to 32%. More government funds were allocated to SOCBs with a government decision in September 1999. In response to the worsening economic conditions, the government lowered reserve requirement ratios to 5% in March 1999, from the previous 8%.

II. The implication for Vietnam's financial system

1. The current position of Vietnam's financial system.

A functioning financial system is an important component in a modern economy. It consists of certain financial markets (e.g. capital and money markets), a variety of institutions (bank, insurance companies, pension funds, pawnshops etc.) with diversified financial instruments (e.g. bank notes, coins, cheques, shares, bonds etc.). The fundamental functions of a financial system are: a medium of exchange, an intermediary, a transformer and distributor of risks, and a provider of stability (Dau, 1992, p.18-19). The financial system in Vietnam is under-developed. It is dominated by the banking sector, which has many of the same weaknesses as the crisis-stricken countries in Asia, if not more. The banking sector accounts for 80% of total loans and deposits. As a result of the planned economy and the slow pace of equitization, the money and capital markets are at a primitive stage. There exist domestic and foreign inter-bank markets, primary treasury bonds and bills markets and primary equity markets. The range of financial instruments available is still limited.

So far, how does Vietnam's financial system function in its role as an intermediary — to mobilize savings and allocate funds to productive activities? A lack of capital is a problem in Vietnam. Shortage of capital exists for the state enterprises as well as in the private sector. In a survey of small-scale private enterprises, this problem was identified as one of the major obstacles to growth by around 55% of urban and 65% of rural enterprises. Meanwhile, capital accumulation is very low. The national saving rate was around 28% of GDP over the last three years (see Table 5), but it was still low when compared to that in other East Asian nations.

Table 5: Saving trends 1990-1998

	1990	1994	1995	1996	1997	1998
Savings/GDP (%)	14.4	25.5	27.1	28.1	28.3	28.7
Structure of savings						
- Capital assets (%)	91.2	95.3	93.6	93.6	94.3	91.1
- Capital (%)	8.8	4.7	6.4	6.4	5.7	8.9

Source: General Statistical Office, Vietnam

The ratio of total bank deposits to GDP is around 20%, as compared with 50.2% in China and 43.4% in the Philippines. The ratio of domestic currency in circulation to bank deposit is 53.9% — much higher than in China and the Philippines, which stayed at 16.1% and 13.2% respectively, indicating the preference of holding cash.

For the last decade, capital volume mobilized through financial markets had increased gradually. However, the total issued value of government's bonds between 1991-1997 accounted for only 2.5% of the GDP, falling far short of the capital demanded for development. Economists estimated that the Treasury had been able to mobilize only 15% of the idle capital from the public, whose idle capital could be worth VND 20-30 trillion (US$ 2.5 billion). It can be argued that Vietnam is a financially shallow economy and the financial system has not played the role of intermediary well. What are the problems preventing the financial system from performing better in this regard?

In effect, the formal financial system is dominated by the five state-owned commercial banks — SOCBs (accounting for 82% of total bank assets), complemented by 51 joint-stock commercial banks — JSBs (accounting for 10% of total bank assets), 5 foreign joint-venture banks and 23 foreign bank branches (together accounting for 8% of total assets) and 52 foreign bank representative offices. Total bank assets was equivalent to 38% of GDP at end-1998, total loans was 22% of GDP, and total deposits was 20% of GDP. The low level of domestic capital mobilization is due to three reasons. First, interest rates are not attractive. The interest rate structure was unified in 1995, and the real interest rate has been positive since around 1990. Under the Banking Law, which came into effect in 1998, the national congress has ceased to determine interest rates; the SBV decides a basic rate, and commercial banks can decide rates freely. A restriction on interest rate margin was lifted in 1998. However, interest rate ceilings are still imposed on lending, and this has been distorting effects on the interest rate mechanism and competition among commercial banks. The years 1998, 1999 witnessed the pressed decline in the interest rate. In 1999, the central bank adjusted the ceiling interest rate 4 times (May, August, September, and October), decreasing from 1.2% to 0.85% per month for urban lending. A low regulated interest rate clearly constrained the ability of the banking system to mobilize domestic capital. It is also a disincentive for banks to lend. Second, the banking system weaknesses have undermined the confidence of the public. People prefer cash, foreign currencies (mainly US dollar), and gold to deposits in the banks. Third, the extremely strong expectation of dong devaluation has discouraged domestic savings at financial institutions. Vietnamese witnessed a few harsh dong devaluation in the recent past. The exchange rate regime is inflexible and the exchange rate is substantially overvalued. The expectation of VND devaluation has been so strong as to make foreign exchange markets barely functioning. Moreover, the economy is highly dollarized. This situation developed along with the transition from the planned economy to the market one. Institutional changes permitted the maintaining of foreign currency deposits at commercial banks and the receiving of interest on such deposits. Although the share of foreign currency deposits in the total deposits of the banking system was declining, from over 50% in the beginning of 1990s to 30% in 1996, it is still high (Masuyama, 1999). Recently, the ratio is estimated to be around one-third. Moreover, banks are highly leveraged in foreign currency lending. The fragility of banking system can be a factor of economic instability in the future.

Total non-performing loans (NPLs). NPLs reached 12½% of total loans at the end of 1998. Among the individual SOCBs, the share of NPLs to total loans varied in 1998 from 2½-5% for the two stronger banks, to 19-23% for the two weaker banks. According to the IMF, using international auditing standards, NPLs at the SOCBs were at 30-35% of their total loans at end-1997. NPLs of the non state-owned banks soared during 1997, as a result of deferred letters of credit. It was estimated that the size of NPLs at the JSBs was around 30-40%.

Not only do the NPLs affect the banking sector's liquidity, but pose problems maturity mismatch. All bank deposits are of less than one-year maturity, while about 20% of all loans have a maturity of more than one year. Moreover, half the arrears are 6 months overdue. Therefore, the banks face the risk of runs on deposits.

Most banks are significantly under-capitalised. After the State Bank recapitalization in 1998, capital adequacy of the four SOCBs improved and presently exceeds minimum legal capital requirements (VND 5,500 billion VND). However, the capital base of Vietnamese banks is very weak (see Table 6). The capital/asset ratio of 3.8% is much lower than the minimum requirements[7] as well as desirable ratios of 5.6% and 10.3% respectively. The situation in joint-stock banks is even worse (Tam 1999).

Table 6: Capital Adequacy of State-Owned Commercial Banks, 1998

	Oct. 1998		**Minimum legal capital**	**Desirable capital**
	Actual	***Adjusted***		
Capital	*(In trillion of dong)*		5.5	9.8
	6.9	3.6		
Capital/Assets	*(In % of total assets at end-October 1998)*		5.6	10.3
	7.2	3.8		

Source: International Monetary Fund

*Banks are operating inefficiently***.** The profitability of the whole banking sector is very low. Two of the four SOCBs have been reporting zero profits in the past four years. Many JSBs faced losses. The reasons can be summarized as follows:

— First, as SOCBs are dominant in the banking system, there are no competitive pressures for them to improve weaknesses, e.g., redundant employees with low professional knowledge and credit analysis capabilities. There are no incentives for bank managers and employees to improve their own performance.

— Second, the SOCBs do not seem to have sufficient independence in making credit decisions. They exercise the dual functions of commercial lending and policy lending (i.e. government directed lending), but the two functions are not clearly separated. Preferential credit policies exist for several priority areas and projects. Around 70% of total bank loans are extended to SOEs. However, many of the loans directed by government are not implemented effectively, leading to mounting NPLs in SOCBs. In addition, the SBV executes its "governance over the banking sector by administrative order, rather than market instrument or forces" (Tam, 1999). The SBV controls each bank's total credit and provides detailed guidelines for commercial bank lending. In other words, over-regulation due to over-intervention by the SBV, the non-arm's length relationship between SOCBs and SOEs, and the government interference undermined independent commercial decisions of SOCBs. The SOCBs lack managerial independence necessary for developing its capabilities. Many JSBs face the same problem. Private JSBs are influenced by group lending and related-party lending practice. This problem originated from the establishment of joint-stock banks in Vietnam, whereby banks are established to satisfy a group of shareholders (usually the founders). Therefore, the portfolio of the JSBs is not sufficiently diversified.

— Third, weaknesses in banking supervision and prudential regulations and its weak enforcement contributed more to problems. The lack of appropriate accounting standards for businesses as well as transparency make it more difficult for banks to evaluate the feasibility of projects and the value of collateral offered.

Foreign exchange exposure. This is one of the dangerous features of the banking sector. The share of foreign currency lending in total loans was around 10% in 1991 and reached slightly less than 40% in 1996, and 30% in 1998 (over 50% in the case of non state-banks), of which over 70% was loaned to SOEs (see Table 7). Moreover, banks, particularly JSBs, are highly leveraged in foreign currency lending with the ratio of foreign currency loans to foreign currency deposits as high as 125%.

Table 7: Open foreign Currency Positions of commercial Banks, 1994-1998

	1994	1995	1996	1997	1998
Net aggregate long (>0) or short (<) foreign currency position in millions of U.S. dollars	134	144	115	217	753
State-owned banks	157	182	211	270	717
Non state-owned banks	-22	-39	-96	-53	37
As % of aggregate foreign assets and liabilities	11.3	9.7	6.1	12.2	38.8
State-owned banks	13.2	12.3	11.2	15.2	36.9
Non state-owned banks	-1.9	-2.6	-5.1	-3.0	1.9
Net short-term long (>0) or short (<0) foreign currency position in millions of U.S. dollars	148	280	332	385	785
State-owned banks	252	390	451	452	751
Non state-owned banks	-104	-110	-119	-67	35
As % of aggregate foreign assets and liabilities	12.5	18.9	17.5	21.6	40.5
State-owned banks	21.3	26.3	23.8	25.4	38.7
Non state-owned banks	-8.8	-7.4	-6.3	-3.8	1.8

Source: International Monetary Fund

The banks' indirect exposures are also very high, as the SOEs often use foreign currency loans for domestic operation. Overdue foreign currency loans are another concern. This trend can result in widespread bankruptcies, leading to more difficulties in the banking sector.

The financial markets. Some economists have argued that Vietnam's capital and money markets are non-existent. However, primitive markets do exist despite under-developed features. They include government and corporate primary bond markets, primary equity markets, and inter-bank domestic and foreign currencies markets. Since 1990, the government has issued to the public bonds including treasury bills, treasury bonds and project bonds. The issued volume soared up from VND 220.5 trillion in 1991 to VND 6,186 trillion in 1997, i.e., nearly 37.9 times (see Table 8). The maturity of the bond and bill has increased from 3-6 months to 2-3 years.

Table 8: The issuing treasury bonds and bills volume

	1991	1992	1993	1994	1995	1996	1997
Volume (trillion VND)	220.5	1,387	4,566	7,649	8,347	6,186	6,186

Source: State Treasury, Vietnam.

The inter-bank domestic and foreign currencies markets came into existence in 1993 and 1994 respectively. However, these markets exhibit several shortcomings. First, the bonds and the equity markets remain as immature primary markets where only the activity of bond and bill bidding takes place. Besides, the absence of secondary markets is an obstacle for the bond and bill transactions. The Citibank branch in Hanoi, which once bought VND 20 billion worth of treasury bonds from VietcomBank (an SOCB), was the only bank which conducted such transactions. Investors in bond and bill markets find it difficult to change their portfolio or to recall their money at exigencies. Second, nearly 90% of the bonds are under one year maturity. This short-term maturity, along with the low par value of bonds, has on the one hand discouraged investors to carry out bond transactions, and on the other, have not satisfied long-term capital demands. Third, issuing organizations are not forced to meet transparency, accounting and auditing standards. These organizations often follow direct issuing methods, which do not meet the international legal and technical standards. These primitive markets therefore pose high risks.

2. *The common symptoms*

"Most of the structural weaknesses that have contributed to the crisis in other Asian countries can be found in Vietnam as well" (Kokko, 1998). Indeed, in terms of weaknesses there is very little to distinguish the financial sector in Vietnam from those of crisis-hit countries.

A first glance at Vietnam's financial system reveal the dominance of the banking sector, which share the same fragile conditions with its counterparts in Asian countries. The ratio of NPLs to total bank loans and the exposure risk are very high, and they result from bad lending practices, and inflexible exchange rate management, as well as weak prudential regulation and supervision. Banks in Vietnam make loans decision based on the evaluation of the collateral pledged, not on debtor ability to repay loans. Vietnam's banking sector has the same tendency of short-term lending like other Asian countries. There are two reasons. First, because of their weakness in credit appraisal, long-term loans will bear more risk. Second, Vietnam still lacks a long-term financial market with fixed incomes (e.g. government bonds).

Although Vietnam has implemented financial reforms in line with economic reforms, the financial sector has been experiencing slow institution-building. Slow development of prudential regulations and supervision explains the insufficient capital adequacy, the deterioration of bank assets, and the failure of JSBs, which had been allowed to set up too easily. The legal, accounting and auditing systems in Vietnam are still under-developed. Because of the lack of a legal framework for collateral banking, banks carry high risk on credits based on properties. Banks also find it difficult to dispose of collateral properties freely. SOEs — the main customers of the banks — frequently do not keep satisfactory legal documents to support their ownership rights over collateral properties. This is a heritage of the socialist system. Information infrastructure is also extremely lacking. The information disclosure with regard to balance sheet and business conditions of SOCBs, private banks and SOEs is highly limited.

Vietnam's financial system suffers from a very severe governance problem. But, the causes of this problem are different from those of crisis-hit countries. They are unique to a transitional system like Vietnam, which is moving from a planned economy to a market one. We can trace these causes by examining the role of the SBV — the central bank — and the range of commercial banks activities. Created in 1990, the central bank does not fulfill the role of an independent agency that is responsible for commercial banks supervision, and monetary stability of the economy. While the Bank Law of 1998 strengthened its independence, the decision-making authority on monetary policy still stays with the National Assembly. Moreover, the structure of the SBV is cumbersome. It has many overlapping departments and too many local branches. The latter are later considered as agents of local authorities. There is suspicion that the local authority may influence the SBV through these agents (Masuyama, 1999) although the Banking Law does not permit this.

SOCBs do not have independent commercial decision-making power. Their decisions are influenced both by the government and the SBV. The SBV controls each bank's total credit. There are detailed guidelines for commercial bank lending. Meanwhile, SOCBs also function as a policy bank for several credits policies. Under the government direction, SOCBs also became trapped in the ponzi-game, like other countries in the region. To prevent social costs of hundreds of job losses, many unprofitable SOEs, amounting to 65-70% of total SOEs, are still subsidised either from state budget or banks loans under a government guarantee. SOEs enjoy the preferential access conditions to bank loans such as the absence of collateral requirement.

3. The implications

Vietnam's financial system is still in transition. It has been experiencing a slow space of liberalization. So far, capital inflows to Vietnam are mainly in the form of FDI. In the future, moving towards integration into the world economy, requires liberalizing the financial system. The lessons that Vietnam can learn from the regional financial crisis concern the sequence and the pace of liberalization of its financial system.

Vietnam weathered the crisis rather well, because it had not liberalized the capital account and its currency is not convertible. Vietnam is correct to retain tight capital controls, as the financial weaknesses in crisis-hit economies can be observed in Vietnam. In the future, Vietnam should be cautious about capital account liberalization.

A conventional sequence of financial liberalization suggests that domestic financial reform be followed by capital account liberalization. Countries in the region implemented domestic financial reforms in 1980s. In the early 1990s, laws restricting capital flows were abolished. However, the financial crisis proved that their domestic financial systems were not strong enough to be exposed to the volatility of international capital movement. There were institutional deficiencies as well. Therefore, the first step taken by Vietnam should be to strengthen the domestic financial system, in line with aggressive institution-building. It means that Vietnam should first correct the fragility of the financial system. As the financial system is dominated by the banking sector, the utmost priority is to have a healthy banking system with effective prudential regulation and supervision. The aim is to create a competent management, an effective risk-control system and an adequate capital requirement criteria. Supervisory authorities will also need sufficient autonomy to be effective.

To consolidate the reform achievement, Vietnam needs to accelerate its institution-building process as well as establish a legal framework that covers important elements such as transparency, disclosure, bankruptcy and collateral lending. In order to build and operate the necessary institutional infrastructure, reform of the governance structure is a foremost task. Reforms should strengthen the SBV's independence and increase the freedom of commercial banks to make their own economic decisions pertaining to interest rates and credit provision. Financial markets are embryonic in Vietnam at this time. The bond market should be developed initially to complement the banking system in providing long-term loans, since the credit crunch in the crisis was the consequence of an under-developed bond market.

As the Asian crisis can be related to the volatility of international short-term capital (and portfolio investment to some extent), mobilizing investment capital from national savings and foreign savings, mainly FDI, is a better choice. Thus, mobilization of domestic savings should be further encouraged.

Finally, the capital account liberalization should be introduced when the domestic financial system is strong enough, and when there are strong institutions as well as sufficient human resources.

III. Future agenda

1. Healthy banking system

In a bank-dominated financial system, the banking sector is the main vehicle to bring capital from savers to borrowers. The high growth rate in Asian countries is the result of high national savings, most of which are channeled through banks to private investments or public infrastructure development. This process can be smoothly carried out if the banking sector performs well and retains savers' confidence. The willingness of savers to entrust their money to a bank presupposes that their savings are secured and profitable.

In the Asian financial crisis, runs on banks partly resulted from the weakening of public confidence. When the crisis broke out, long queues of depositors in front of banks made the situation worse. In Vietnam, the lack of public confidence lies at the heart of the low mobilization of savings.

Therefore, the key approach to build a healthy banking system in Vietnam can be summarized as follows:

— Restore public confidence in banking system;
— Restructure the banking system to help the healthy core of the banking system perform soundly;
— Reform the governance structure and put in place effective supervision to ensure safe and sound performance and to prevent recurring of weaknesses.

The SBV should accelerate the implementation of the deposit insurance scheme. In practice, guaranteed returns may tempt depositors to put their money in high-risk, high-return banks, i.e. a moral hazard. Such behaviour has led to arguments that guarantees should be limited, such as under the form of explicit deposit insurance schemes or priority payment for small depositors during bank liquidation. However, the financial crisis has accelerated moves to introduce and strengthen such schemes all over the world. General guarantees covering all bank deposits were announced in three South East Asian countries — in August 1997 by Thailand, in late 1997 by Malaysia, and in January 1998 by Indonesia. Explicit deposit insurance schemes are now being developed.

The existence of guarantees for banks' deposits in Vietnam will help satisfy three goals. First, it helps promote savings as public confidence in the banking system increases. Second, depositor panic will be avoided during the banking sector restructuring process. The risk of contagion in Vietnam's banking system, however small, does exist. Vietnam's own experience in 1989-1990, when a number of credit cooperatives went under in Ho Chi Minh City, is still fresh in people's memory. A repeat experience of a similar kind would be a setback to emerging confidence in private financial institutions. Third, it contributes positively to leveling the playing field among different financial institutions. Where such a scheme does not exist, depositors may avoid smaller financial institutions in favor of state-owned banks (which enjoy implicit protection), large banks (which may be considered too-big-to-fail) or foreign banks (which may be able to rely on financial backing in their home countries).

Thus, to avoid moral hazard, the SBV should take into consideration deposit insurance schemes that include domestic depositors, foreign creditors, ceiling on the size of deposit covered, pricing (insurance premia) and the type of returns — long-term debt, equity, cash and others.

The second step will be to restructure the banking system. Although, a financial crisis has not occurred in Vietnam, it shares weaknesses with those in crisis-hit countries. It is not far-fetched to speculate that a banking crisis may occur in Vietnam in the near future. Reforming to develop a safe, sound, and competitive banking system that will help protect macroeconomic stability, instill financial discipline, and mediate effectively i.e. mobilize more savings and allocate them to more efficient uses — are very appropriate. Vietnam could include several measures taken recently by crisis-hit countries during banks restructuring as part of a detailed strategy to reform banks.

Thorough assessments of the nature and extent of banking problems is an important component of successful reform program. Independent diagnostic audits of the SOCBs and the SBV and assessment of the JSBs were completed in early 1999. On the basis of those assessments, the Government rightly decided to deal with the restructuring of JSBs, with Ho Chi Minh City as the first priority. This is because JSBs in Ho Chi Minh City were reported to be the most vulnerable segment of the banking sector and the fact that Ho Chi Minh City is the most important business center. Restructuring remaining JSBs and SOCBs, as well as leveling the playing field for all banks are the next steps to follow. However, more in-depth analyses of JSBs and SOCBs loan portfolios and operating practices should be carried out to supplement preliminary assessments, with a view to preparing detailed plan for individual banks.

Firm exit policies are an integral part of the reform program. The bail-out of ailing financial institutions in Asian countries proved to be counter-productive. This not only damaged the public confidence but also caused moral hazards. A firm exit policies could include transparent triggers for intervention by bank supervisors; instruction for detailed intervention (such as procedures on the timing and nature of actions to be taken), criteria for liquidity support and transfer of deposits to safe bank, criteria for acceptance of rehabilitation plans; and conditions for closure, merger, or rehabilitation. No more capital will be injected to troubled banks, especially SOCBs, before detailed plans for restructuring are accepted. Actions should be taken to prevent problematic institutions from extending credit to high-risk borrowers. Government measures that respond to the crisis by directing SOCBs to make new lending to highly indebted enterprise with sound business plan or permitting lending without collateral should not continue.

One more principle is loss distribution. Loss must be allocated first to shareholders, second to large depositors and last to creditors. In other word, the parties that have benefited from excessive lending should pay the price. This will encourage the bank shareholder and large depositors to be more prudent in the future. In order to prevent a collapse of confidence in the banking system, it is necessary to honor all the liabilities of banks through the infusion of public funds in the condition of bank restructuring and management changeovers.

Banking reform, particularly in the area of debt restructuring, needs to be carefully coordinated with SOEs reform. In the last few years, Vietnam has made some headway in the banking sector restructuring process. A Bank Restructuring Committee was established in early 1999. This agency is responsible for overseeing reforms in banking system. Based on the criteria of insolvency, illiquidity, and losses relative to capital, the SBV classified JSBs into four groups and developed different restructuring strategies for each group. Until now, several JSBs were put under "special control regime", four JSBs were closed and two JSBs were merged and several were put under "special supervision".[8] It is expected to reduce the number of JSBs to 44-45 in the year 2000 and to 40-42 in the next few years.

In the second round of reforms, the Bank Restructuring Committee should set up a transparent plan assuring that actions would not be delayed unduly. The plan needs to address both "stock" problem i.e. raising capital and removing NPLs, and "flow" problem involving operational restructuring. In other words, the plan will deal with NPLs problem, JSBs and SOCBs restructuring, governance reform, and prudential and supervision strengthening.

Asset management corporations (AMC) have been established to deal with non-recoverable debts in crisis-hit countries, although they appear to be under different models and adopting different strategies. Malaysia, Korea and recently

Indonesia chose centralized asset management companies, which typically need to be state-owned. Thailand employed a decentralized process, encouraging each commercial bank to establish its own separate asset management company. In addition, a public company was established to purchase NPLs from closing financial institutions. In practice, bad assets can also be bought by a special loan collection unit, usually established in a larger and well-performed bank.

In Vietnam, these three models have been considered (Hung 1999). Some people suggest that a state-owned AMC should be set up. This AMC can be an independent governmental agency or an incorporated section in the Bank for Investment and Development (BID). Others favored each commercial bank having their own AMCs. These AMCs will operate in a special framework created by government. However, each choice contains both advantages and disadvantages. So far, BID is one of the most profitable commercial banks with a low level of NPLs. If BID is responsible for an AMC for the whole banking system, it may not be able to concentrate effectively on its medium and long-term lending activities. To choose an appropriate approach, the government should be able incorporate each model to fit the Vietnam situation. A centralized AMC seems to be more suitable in Vietnam for 4 reasons:

— First, the most important difficulties faced by Vietnam in this restructuring process are: limited banking and restructuring expertise; the deficiencies in national legal and judicial frameworks on different areas such as collateral, land ownership, land usage right; and the challenge of coordination with necessary SOEs restructuring. A centralized approach should be the most effective method of overcoming these difficulties.
— Second, a centralized agency can be given legal powers to facilitate collateral disposition that is often slowed down by legal procedures. Furthermore, as most banks in Vietnam are in difficulty, the collateral acquired to some extent have a certain degree of homogeneity. A single entity may reap economies of scale and make the best use of scarce managerial talent.
— Third, the centralized AMC can serve as a vehicle for getting NPLs out of troubled banks, based on uniform valuation. The government's contribution to losses of different groups of NPLs can be made transparent more easily, based on uniform criteria. Even if each commercial banks establishes its owned AMCs, it is still necessary to

have an agency at higher level that is in charge of classification of NPLs, collateral, and supervising operation of these AMCs.

- Finally, it helps facilitate bank restructuring. The government can attach conditions to purchase NPLs in terms of bank restructuring.

This AMC would buy and sell bank loans secured by the collateral that the banks could not liquidate because of the nature of assets, lack of documents, or uncertain origin of loans. The AMC would be funded mostly by government budget or government-guaranteed bonds. However, to make the plan feasible, substantial further work is needed to improve the enabling legal environment for collateral liquidation and the functioning of the real estate markets and the court system.

As far as JSBs restructuring is concerned, in early 1999, the SBV submitted to the government the bank-by-bank restructuring plans emphasizing operational reforms, debt workouts and recapitalization (including through an increase in foreign ownership limit of bank capital). The SBV should accelerate this plan.

Efforts to restructure SOCBs are still at the early stage. The building of an overall restructuring plan is still in progress. The main challenge in this process is to reform SOCBs into commercially-oriented and viable banks, in particular, by preventing the recurrence of high levels of NPLs and creating a market-oriented credit culture in their management. For this purpose, actions that should be taken include:

- Reorganizing and consolidating SOCBs to strengthen management capacity and improve effective operations. It is necessary to streamline management operations to cut cost. Staff retrenchment is also necessary. The banks can use various methods such as technical assistance and incentive measures to improve management capacity. For example, by signing performance-related management contracts, the directors will have clearly-defined responsibilities, incentives and penalties they face. However, the prerequisite is that the banks are given autonomy in the formulation of business plans and the distribution of revenues. The banks should emphasize on improvement in management development and staff training, particularly on credit assessments, collateral valuation, and risk management. The banks' observation, research, analysis, and monitoring of clients have become increasingly significant; the more a bank knows about its clients, the smaller the risk. After the SOCBs restructuring is completed, it is possible to privatize some SOCBs.
- Governance structure reform is the core of financial sector reform as it helps to build and operate necessary institutional infrastructure.

The first thing to do is to preserve the independence and neutrality of the SBV. One of the contributing factors to the regional financial crisis is the lack of central bank independence. As a state institution, the activities of the SBV are under the guidance of the state. Financial policies implemented by the SBV are subject to decisions made in the National Assembly. It will affect the SBV's flexibility to respond to emergency situations, and this endangers the security of the financial system. In the short run, it is suggested that regional SBV branches should be established to replace the current administrative set-up of having SBV branches in each province or city. This measure can help not only strengthen SBV management and supervision over financial institutions, but also reduce intervention in SBV branches by provincial authorities. In the long run, the SBV should be given more authority in formulating financial and monetary policies. For this purpose, the SBV should gradually replace administrative management with market-oriented monetary instruments such as reserve requirements, discount rates, and open market operations.

Second, it is significant that SOCBs be free to make their own economic decisions based on market-oriented criteria. Thus, there is a need to separate "policy" or directed lending from purely commercial operation by establishing a separate policy bank. In the transitional stage, any such policy lending should be explicitly guaranteed by the government and clearly separated in the accounts of the banks. Moreover, the scope of policy banks needs to be clearly defined and their size should be limited so as not to crowd out commercial banks and to prevent their distorting effects on the financial system.

Third, it is crucial to level the playing field for SOCBs and non-state-owned financial institutions. This helps improve the efficiency and the competitiveness of Vietnam's financial institutions. The presence of foreign financial institutions also contributes to this task. So far, the lack of transparency and the restrictions on taking VND deposits are obstacles to their expansion. However, too rapid entry of foreign financial institutions may create too severe a competitive threat to domestic financial institutions and undermine financial stability. Thus Vietnam on the one hand should follow a controlled policy on entry of foreign institutions. On the other hand, it is necessary to permit a larger presence of the foreign financial institutions. For example, there is scope for them to take on a much greater role in training. They can bring in needed expertise and generate demonstration effects.

Since 1997, there has been some improvement in prudential regulation. The SBV issued several prudential regulations for banking operations, namely assets classification and loan-loss provisioning, financial ratios for safe operation of credit institutions, organization, and authority of banking inspector, etc. The new regulation includes 8.5% minimum capital adequacy requirement and a minimum deposit/capital ration of 20%, a single borrower limit of 15% of capital and a maximum 30% of total lending to the ten largest borrowers. Foreign currency exposure is limited to 10-15% of capital. However, Vietnam still needs to further strengthen legal, regulatory and supervisory framework and more attention should be paid to ensure strong enforcement.[9] After the outbreak of the Asian financial crisis, many bankers suggest that a modern supervisory framework[10] should include three essential elements: effective bank-level management (covering the notion of internal control), market discipline (meaningful public disclosure practice, harmonized accounting practice), and official supervision. Although Vietnam's financial system is still less complicated when compared with those of other regional countries, it should learn from their experiences during the financial crises and the development of their financial systems over the past several decades. Without effective and comprehensive supervision, it is difficult to preserve long-term financial stability so that the financial system can effectively perform its critical functions in a market economy.

2. Mobilization of savings

Households' disposable incomes are divided into consumption and savings. The latter can be used for future consumption or investments. If the benefits earned by savings can be higher than the current opportunity cost caused by not consuming, households will tend to save. Thus, in order to enhance mobilization of domestic savings, it is necessary to create positive benefits for savings.

It is estimated that the public idle capital is about 2.5 billion US dollars, with an annual rate of increase of 10%, 60% of which pertains to those sent back home by overseas Vietnamese working and studying abroad. This domestic capital resource can play a critical role in social and economic development, if it is utilized effectively. For the past few years, this capital has been used in the following ways:

- First, to finance private business. This can be seen by the increasing portions of GDP contributed by the private sector. To take advantage of this kind of investment, the government should facilitate the business registration process, launch programs to support these activities as well as to direct them into suitable development areas in coordination with the state strategy on economic structure transformation.
- Second, to develop real estate. This trend may dangerously lead to a bubble in real estate markets.
- Third, savings are put in the banking system to earn interest. Security followed by interest rate and convenience are the factors influencing householders' decision to deposit their savings. Besides, a considerable part of such savings is channeled through the informal financial system that offers very high interest rate but at a high risk.
- The last way is capital accumulation without any future plans. Forms of such savings include real estate, valuable assets, gold, and foreign currencies.

The above-mentioned savings structure changes considerably subject to two main factors: macro-economic stability and financial and monetary policies. When the inflation rate is increasing, or when the value of VND is unstable, households are reluctant to leave their savings in banks or to invest in business. Whereas if the interest rate goes up, gold and foreign currencies or real estate may be sold for VND savings in the banks. Thus, the prerequisite for further encouraging savings is to maintain macro-economic stability: to curb inflation and to maintain a stable value of the VND.

After having a look at the savings structure and its influential factors, it is evident that not only banks, but also capital markets (discussed in the next section) should be involved in mobilization of domestic savings.

As the banking system gradually raises the public confidence during the banking restructuring process, depositors would be mainly attracted by interest rate policies. A reasonable interest rate policy will become a leverage for mobilization of savings. In Vietnam's banking system, the phenomenon of " negative yield curve" in which long-term interest rate falls below that of the short-term, continues to exist to a certain extent. From the viewpoint of mobilizing of long-term funds, there is an urgent need to correct this situation and restore the normal yield curve. The banks should establish multi-level long-term interest rates based on the saving period. For example, banks can set the fixed interest rate for 5 years and higher interest rate for the next 5 years. Given that secondary financial markets have almost been non-existent, banks should consider savings regimes that impose lower interest rates to those who withdraw money before the due date. For example, if after 3 years, a 4-year-depositor wants to get his money back, then he can only receive the benefit at a 2-year-interest rate level.

As the banks are usually reluctant to mobilize medium and long-term deposits because of their high-risk nature, the SBV may impose a requirement for a minimum level of long-term deposits that commercial banks should satisfy. Although this measure is an administrative intervention, it can help to reduce the risk of time mismatch in commercial banks and to encourage banks to be more active in finding ways to attract long-term capital.

So far, the banking sector has introduced various mobilizing tools that include savings deposit in VND, savings deposit in foreign currencies, gold secured savings deposit, certificates of deposit in VND and foreign currencies, and housing saving deposit. Along with economic development and an increase in household income, banks should not stop with the tools available at present, but further introduce savings instruments which are more advanced and better suited to Vietnamese habits and customs. Savings accounts have been used widely in many Asian countries but an unofficial source estimated that only around 500,000 savings accounts exist in Vietnam. Therefore, this is still a potential for the banks to expand further. In addition, bonus programs for depositors on special occasions should be paid more attention. Contractual savings is another form to be considered. A fixed interest rate at the time of signing the contract assures the depositors of fixed benefits in the future. This form is particularly suitable in the current situation where both inflation and interest rate are decreasing.

The banks can also issue transferable bonds with different maturities. This is a way to attract medium and long-term capital for banks.

However, the banks cannot mobilize savings effectively unless their marketing infrastructure is developed. A wide range of modern banking outlets will facilitate the transaction between banks and their customers. The quality of services should also be increased. The banks need to offer their depositors convenient procedures for depositing and withdrawing money.

Generally speaking, security, attractive interest rates and convenient services will be the contributing factors to the banks' ability to mobilize savings.

In order to mobilize idle public capital, a postal savings system was started on August 2, 1999. This scheme is not aimed at making a profit, but rather to mobilise money that people kept at home. Under this scheme, capital will be mobilized in periodical, non-periodical savings, accumulated savings etc. with self-decided interests based on principles of self-settling expenses, having the capital preserved and developed in line with interest rates announced by the SBV. The postal mobilized savings sources will be partly transferred to the National Investment Assistance Fund (a governmental agency), and partly used to buy government bonds. The scheme also offers money-transferring service. There are several attractive aspects of the new savings scheme. First, the depositors face no risk. They are not threatened by the risk of bankruptcy. Second, customers can transfer or withdraw money at any post office in Vietnam. Third, this kind of service targets middle and low-income people looking for a convenient place to deposit their money. Many Vietnamese fall into this category. Thus, the factor that has most influence on the level of the postal savings is convenient service. It is necessary to raise the professional skills of staff and modernize the infrastructure. Moreover, the government should ensure the effective use of this capital source.

3. Development of capital markets.

Many economies in East Asia have well-developed equity (stock) markets, both relative to industrial countries and to other developing countries. Meanwhile, few economies have well-developed bond and other securities markets. Even a high-income country like South Korea is only beginning to develop such fixed-income markets. Such a slow development is considered as one of the reasons for the recent financial crisis in Asian economies.

Vietnam should develop its financial market to complement the banking system in the near future and to make it a competitor that would force improvement in the banking system. Banking system and financial markets are normally complementary sources of finance. Improved financial markets will lead to more balanced and more robust financial systems.

To develop capital markets, the first step is to create “goods” for the markets. Some economists argue that Vietnam’s capital market cannot come into existence if the government does not complete the SOEs equitization process. However, it is rightly recognized that bond markets should be developed initially by focusing on government bonds. It is learnt that the government is planning to issue annually VND10-15,000 billion (US$0.7-1 billion) worth of bonds for social and economic development. Such a policy will create a critical source of funds for bond markets in Vietnam. Besides the government bond, bond markets also include corporate bonds, bank bonds, municipal bonds and project bonds. In the past few years, the government had issued several government-guaranteed bonds for financing infrastructure projects. This has proven to be a suitable policy. In Asian countries, project securities are becoming means of mobilizing capital for infrastructure investment because many East Asian economies’ infrastructure requirements are too large to be financed externally, and the latter would create a major currency mismatch.

Bond markets can also supply enterprises and banks with long-term capital. These markets will help enterprises to be less dependent on bank credits, which account for 75% of the working capital. Thus, the government can be the biggest supplier to bond markets, followed by large utilities, banks and other corporations. The government should stop directed preferential loans to SOEs because such loans may restrict the development of corporate bond markets by lowering the incentive for these firms to issue bonds.

In order to have bonds traded in secondary markets, they should be transferable and have legal standardized form. The Ministry of Finance (MOF) needs to unify the bond forms, and set requirements for maturity date, issuing date, interest rate, etc. It is necessary to maintain a frequent-issue timetable and a minimum-issue amount to encourage bond transactions. Furthermore, MOF should set up a plan to transform old bonds into uniform bonds. It is estimated that the old bonds were worth VND13,000 billion (nearly US$1 billion). Together with VND10-15,000 billions worth of bonds that will be issued each year, these may serve as a warm-up for the running of the stock market.

In tandem with developing bond markets, Vietnam needs to develop equity markets (both primary and secondary) to absorb the stocks that will be issued for equitization of SOEs. The stock market in turn encourages capital management and efficient allocation in enterprises. However, it should be taken into consideration that during the equitization process, it is the equity value, not the total amount of equities, that plays a decisive role.

With a view to stimulating the development of securities markets, Vietnam should further study and carry out a plan on mortgage-backed securities. As with other East Asian countries, Vietnam is experiencing rapid urbanization. However, Vietnam has a poorly-developed housing finance system, with households often having to rely almost entirely on personal savings or informal borrowings, as there is no significant market for house financing. The mortgage-backed securities may be a way to settle this problem.

Who will participate in the capital markets? They are corporations, individuals, banks, securities companies, and the government. Successful experiences have showed that a solid institutional investors base help to enhance and stabilize the capital market development. Among institutional investors, Vietnam can initially encourage the developments of pension funds and insurance funds. Malaysia and Singapore can provide good models of a well-developed pension fund — provident fund — for Vietnam. Although in Vietnam the current population is still relatively young, it needs to reform pension funds policy to cope with an ageing population in the future. Vietnam's pension funds and social insurance system do not cover much of the population. Pension plan, health insurance, and other social insurance plans are mandatory for public sector employees. In the private sector, many enterprises try to avoid contributing to these funds for their employees. Thus, it is necessary to make the public understand and appreciate these schemes. Supervision should be strengthened to make sure that the labor law is strictly obeyed in this area. In parallel, government should launch voluntary pension and social insurance schemes and introduce them in rural areas. However, governance of these funds should be carried out effectively in order to allocate funds to high-return and low-risk investments. The insurance companies will be important actors in the future stock market. In order to improve the competitiveness of Vietnam's insurance market, the government can set up supporting programs to encourage insurance companies to diversify their services. The entry of foreign insurance companies can enhance competition that is necessary to further develop the insurance markets.

Because Vietnam is a transitional economy, the general public is not familiar with securities market and there is a huge need to educate them. Meanwhile, establishing securities companies and exercising securities transactions require time and expertise. Regarding the banking sector's role in stock exchange market, the question is which model should the banking sector adopt. In the first of the two models, the banking sector plays a critical role. In the alternative model, the banking system plays only a limited role as a normal investor. As the capital market in Vietnam needs to be established from scratch, there is no evidence to judge which is the better model. However, banks are familiar with the tasks of dealing and advising on securities. Thus, at the early stage, banks can play the significant role of a supporting actor for the development of stock markets.

Finally, in order to operate stock exchange market smoothly, Vietnam should put in place basic legal, regulatory and institutional frameworks.

In conclusion, Vietnam may, in the near future, organize the Securities Exchange first in Ho Chi Minh City, to be followed by Hanoi. In the initial stage, bond, bills and commercial papers would be the dominant commodities. Later, equity will play a larger role. Nevertheless, there is a need to establish an Over Counter Center for trading securities that are not listed in the Securities Exchange because companies having sufficient capital to fulfill listing requirements are few in numbers.

CONCLUSION

The regional financial crisis has not only created indirect effects on Vietnam's economy, but also brought positive lessons to Vietnam, regarding its financial sector and its economy as a whole. It has raised the awareness of the significance of a healthy domestic financial system, sufficient and strong enforcement of prudential regulations and supervision, and a proper sequence of financial liberalization.

For many observers, the Asian financial crisis appeared to have brought Vietnam's banking reform to a halt. In fact, the Government of Vietnam is still committed to accelerating the comprehensive banking reform process at a firm, consistent and appropriate pace. It is coupled with structural economic adjustment so that the banking system can effectively support social and economic development while gradually take active steps to integrate into regional and international financial community.

Since 1997, many banking reform measures have been taken. The government has approved several comprehensive plans to deal with banking problems, and to further develop financial markets. It is imperative that the government turn these plans into implementation. If and when Vietnam-American trade agreement is signed, along with the operationalization of Vietnam's commitments to AFTA, Vietnam's financial system will face increasing competitive pressures. Then, to survive Vietnam must rely on the strength of its financial system rather than government protection. Thus there is an urgent need to build a sound and safe market-oriented banking system, to improve the SBV's ability of management and supervision, and to establish and consolidate the financial markets.

The suggestions made in this paper stem from the viewpoint that Vietnam can learn important lessons from the causes and experiences of the Asian financial crisis. It is also necessary to study other countries' experiences in the financial liberalization process, and relate them to Vietnam's transitional economy.

NOTES

1. Crisis-hit countries: Thailand, Indonesia, Malaysia, Philippines, and South Korea.
2. See also IMF, 1999 p. 9.
3. In Indonesia, lending ceilings and most interest rate controls were abolished in 1983, and in 1988 required reserve ratios were dramatically reduced. In 1989, Indonesia liberalized portfolio capital inflows by elimination quantitative limits on banks borrowing abroad. In the same year, Korea loosened restrictions on foreign borrowing and from 1992, non-residents were allowed gradually increasing access to the local stock market. In Thailand, the establishment of the International Banking Facility in March 1993 greatly eased and encouraged access to foreign financing (Eleck and Wilson, 1997).
4. Jacques Nagels: Prerequisits et causes de la crise du Sud-est Asiatique, 1998.
5. For details, see Masuyama, 1999.
6. A ponzi-game is a situation in which a firm must borrow to meet an increase in payments of outstanding debt. The additional borrowing, however, serves to increase the firm's debt load, thereby worsening the financial position of the firm. The firm borrows to survive, but in doing so, makes its position more precarious.
7. As per Decree of the Government on the Legal Capital for Credit Institutions, October 3, 1998.
8.
    - "Special control regime": the SBV appointed teams to take over all aspects of bank operations and management.
    - "Special supervision regime": the SBV strengthens prudential oversight in order to correct shortcomings in operations. The existing management continues to run day-to-day operations of the JSBs but under closer supervision of the SBV.
9. For more details, see Tam, 1999.
10. William J. Mc Donough, President, Federal Reserve Bank of New York, 2000.

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ABBREVIATION

ADB	Asian Development Bank
FDI	Foreign Direct Investment
GDP	Gross Domestic Products
GNP	Gross National Products
IMF	International Monetary Fund
JSBs	Joint-stocks Banks
MOF	Ministry of Finance
NPLs	Non-performing loans
ODA	Official Development Assistance
SBV	State Bank of Vietnam
SOEs	State-owned Enterprises
SOCBs	State-owned Commercial Banks
VND	Vietnam dong
WB	World Bank

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