The Challenge of Financial Reforms for Stability in Vietnam: Current and Past Experience

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Introduction

Financial reforms have played an important role in Vietnam's overall effort to transform a centrally planned economy into a market-based economy since the late 1980s. Although the financial system has undergone remarkable changes over the period, it is generally recognized that Vietnam still has a long way to go to reach a modern financial system which is essential for Vietnam creating a sound investment environment and sustainable growth.

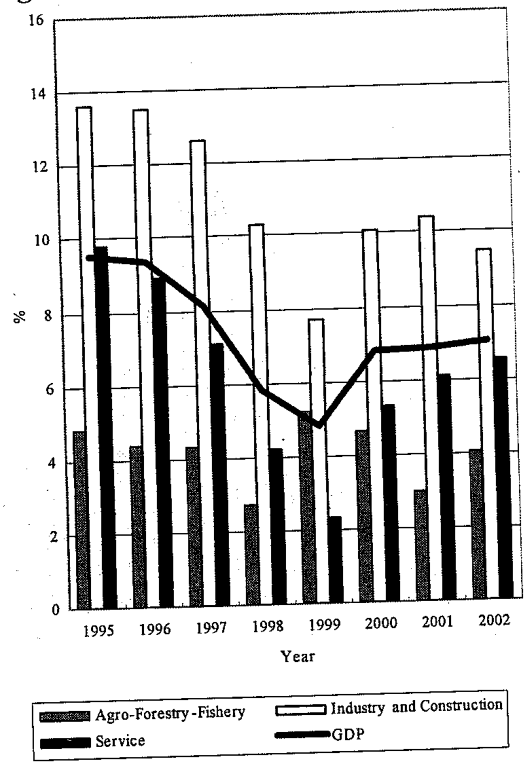
The purpose of this paper is to review the adequacy of recent measures and continued challenges to financial reform. The first section of this paper describes major economic reforms and outlines recent macroeconomic performance. Section 2 focuses upon the progress of banking restructuring in a developing market economy in Vietnam and figures out some characteristics of the financial sector in Vietnam after recent economic reforms. Section 3 discusses institutional reforms of the State Bank of Vietnam and its monetary policies in the transition. Finally, it argues the necessity of financial stability in the economic development of Vietnam and makes suggestions as to how to design financial regulation in the transition of Vietnam.

1. Economic Reforms and Macroeconomic Performance

Vietnam undertook its first steps towards economic reforms in the middle and the late 1980s when hyperinflation and food shortages put the economy under tremendous strain. From the spring of 1989, the series of economic reforms, called Doi Moi, was a watershed. These comprehensive reforms aimed at stabilizing and opening the economy, and promoting competition so as to transform Vietnam towards a market-oriented economy. Especially, some important steps have been taken on the road to a more market-oriented financial system. Prices were largely deregulated, and the exchange rate was allowed to reflect the supply and demand for dollars. Other steps taken were: Raising nominal interest rates and thereby pushing real rates to positive levels, reducing subsidies to State-Owned Enterprises (SOEs), curbing public sector expenditures, restraining increases in wages and state-run sector and state budget expenditures, and halting the financing of state budget deficits by printing money.

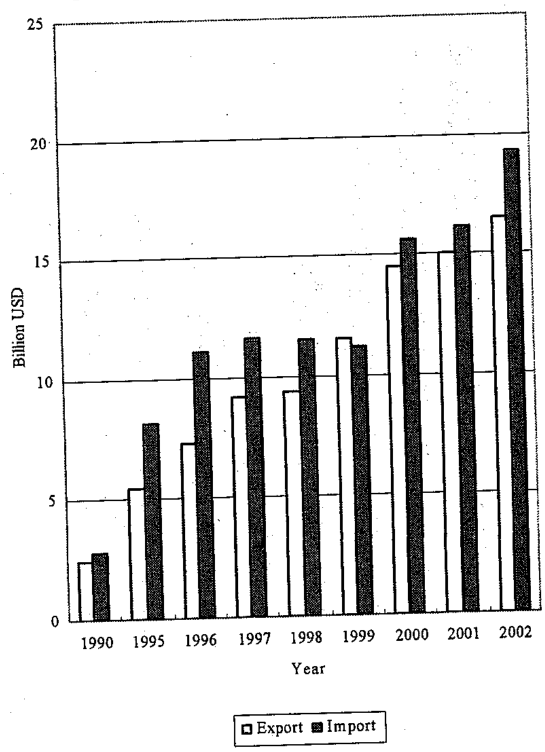
As a result, Vietnam recorded remarkable achievements in terms of economic growth, inflation control, export expansion, and attraction of foreign direct investment (FDI). The average economic growth in the period from 1992 to 1997 was nearly 9% a year. Agriculture continued to leap ahead by 4–5% a year, and Vietnam became a major rice and coffee exporter (Figure 1). FDI inflows — as much as \$2 billion a year — created a high level of investment and industrial growth. This inflow alone was 5–10% of GDP each year. Oil output and exports also grew to \$1.4 billion by 1997, nearly double the \$750 million of 1992. Exports in dollars rose from \$2 billion in 1990 to over \$16 billion in 2002 (Figure 2). During this period, several social indicators also improved: Mortality dropped, while educational enrolments rose, improving upon the best levels of the 1980s, which were already good for a poor country. Poverty probably fell in

Figure 1: GDP & Growth Rate by Sector



Source: IMF Country Report No. 5/02
World Bank Vietnam at a glance 9/4/03

Figure 2: Export & Import Level

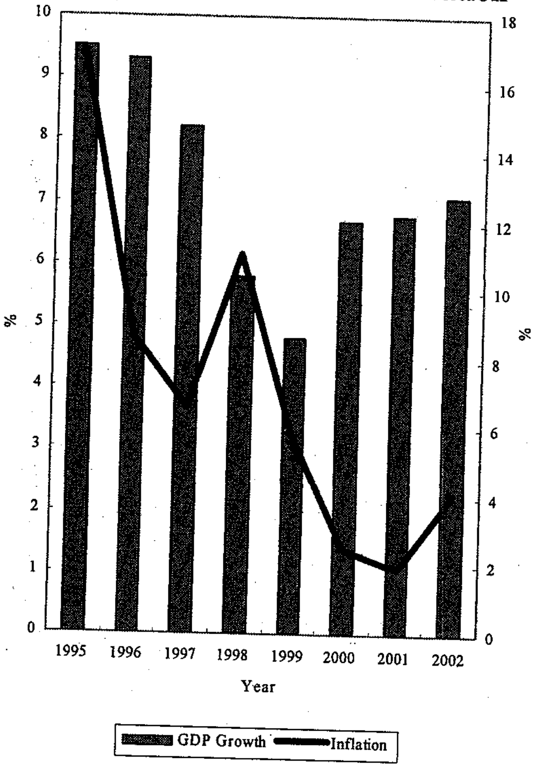


Source: General Statistics Office

half from 1987 to 1997. Taken together, this period was one of continuing rapid progress with GDP reached $350 per capita.

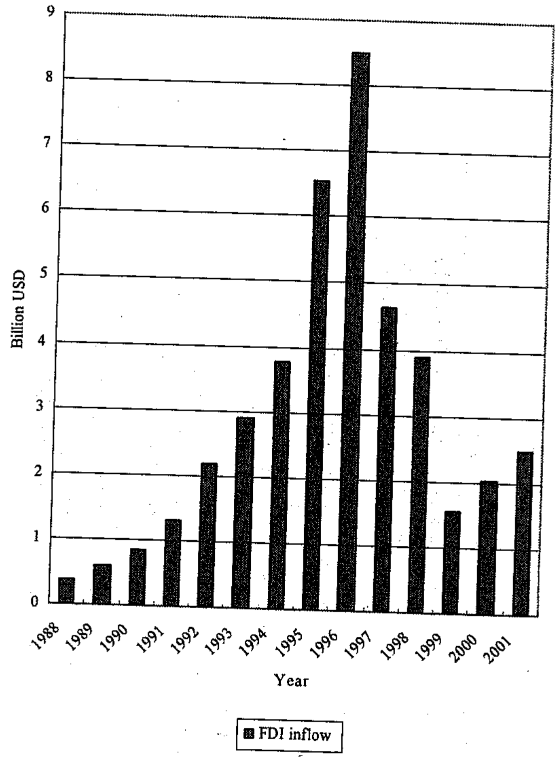
However, since 1998 the economy has experienced a slow-down, reflecting structural weaknesses compounded by the regional crisis. The GDP growth rate progressively slowed from 8.1% in 1997 to 5.8% in 1998 and 4.8% in 1999 (Figure 3). FDI, which has played a significant role in supporting economic growth, declined dramatically in terms of both commitments and disbursements. Vietnam saw licensed investment fall from $8.6 in billion to $1.6 in billion, a decline of over 80% in 1999 (Figure 4). However, it has now rebounded from 2000. Enterprises, mainly SOEs, have suffered from growing inventories. Having faced periods of limited hard currency availability, the government had limited the convertibility of dong into dollars. The unemployment rate has also increased, especially in urban areas, leading to growing social problems.

Figure 3: GDP Growth & Inflation



Sources: IMF Country report No. 02/5

Figure 4: FDI Inflow



Source: www.vneconomy.com.vn.quoted from Vietnam Economic Review of 09/05/2003

After a slowdown period during the East Asian crisis, Vietnam is again growing quite strongly. Good fundamentals in terms of macroeconomic stability, and the adoption of structural reforms, have led to increasing confidence in the economy. This improvement is partly due to a series of policy measures that put the economy on an enhanced medium-term growth path. This growth performance is sustained by a strong expansion of domestic consumption. Investment has also been an important source of growth in 2002, suggesting that the recovery is sustainable. Confidence in the private sector was boosted by the adoption of a detailed reform program in 2001. New private businesses are currently being established at a rate of 1,600 per month, and in early-2002 a special meeting of the Party Central Committee gave the strongest endorsement of the private sector ever. Investors are reacting positively to the reform announcements and commitments made by Vietnam. By July 2002, investment from new small and medium enterprises in the formal economy alone was about 40 trillion dong (approximately 2.7 billion US dollars). This is the equivalent of around 9 percent of GDP[1]. Also the formal private sector employs one million people, which represents almost two thirds of employment in SOEs. The non-state domestic sector continues to lead the growth process. Manufacturing thrives, with the private domestic and the foreign invested sectors recording annual output growth rates of 19 and 15 percent respectively.

This favorable outlook, combined with Vietnam's potential for sustained long-term growth, suggests that the effects of the East Asian crisis are over and a new phase of prosperity is about to begin.

2. The Progress of Banking Restructuring in a Developing Market Economy in Vietnam

The developments in the Vietnamese banking sector that began in the late 1980s and gathered momentum during the 1990s have also brought about some significant changes of direction in the goals of central banks, banking structure, regulation, and the operations of banks. These changes are the focus of a strategy which seeks to create a banking system to promote better mobilization and improved allocation of domestic savings as well as expanded banking services to support growth and employment creation.

From a Monobank System to a Two-tier Banking System

The first round of banking reform in Vietnam started in the late 1980s and achieved important changes in the form and structure of the system. Before 1988 the Vietnam banking system was a monobank system. The State Bank was the sole financial organization, and it performed both as the central bank and the commercial bank. The function of the banking system was mainly providing

1 World Bank (2002)

money to the SOEs, and other lenders according to central plan. In this situation it had to print money in order to satisfy the credit plan. Excessive money credits made monetary policy and credit policy of macroeconomic stabilization had little positive effectiveness and perhaps even negative effectiveness. As the result, a huge stock of money created hangover in the in economy.

In March 1988, the Council of Ministers promulgated Decree 53- HDBT concerning the reorganization and strengthening of the banking system. According to this decree, the monobank system was replaced by a two-tier system with the first tier consisting of the four state-owned commercial banks (SOCBs) and the second tier the State Bank of Vietnam (SBV), as the central bank. Other parts of the banking system such as joint stock banks (JSBs), joint venture banks, credit cooperatives, financial companies, representative offices and branches of foreign banks came into existence after 1990, when the relevant laws permitting them were approved (Chart 1).

The transition from a monobank system to a two-tier banking system was a comprehensive process which was considered as a breakthrough in the economic reforms in 1990s. The functions of the Central Bank were to maintain the stability of domestic currency, and to regulate and supervise the performance of the commercial banks and non-banking financial institutions.

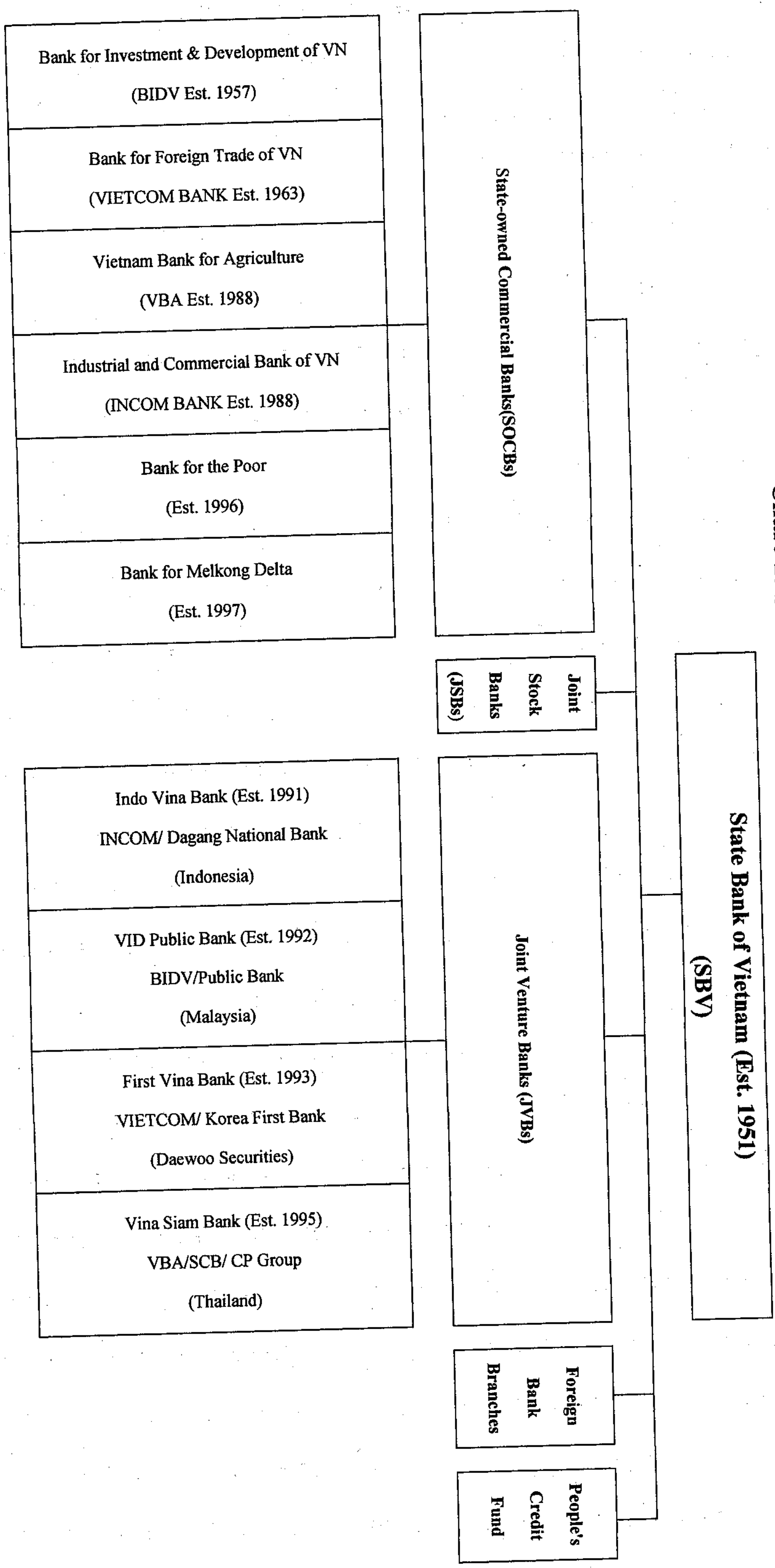
Structure of Vietnamese Banking System

There are now four main types of credit institutions in Vietnam: commercial banks, investment and development banks, credit cooperatives, and financial companies. Commercial banks include the four SOCBs, as well as 44 joint stock banks, 65 foreign branches and 4 joint ventures set up with foreign capital (Table 1).

The four SOCBs making up 70% of the total assets of the banking sector[2] have

2 World Bank (2002)

Chart 1: Structure of Vietnamese Banking System



Sources: SBV and others

Table 1: Banks in Vietnam (2001)

Forms of the bank	1990	1994	1999	2001
State-owned commercial banks (SOCBs)	4	4	6	6
Joint stock banks (JSBs)	0	36	48	44
Joint venture banks	0	3	4	4
Branches of foreign banks	0	41	103	65

Sources: The SBV & WB

been strengthened and have become independent of the SBV. They are granted State capital and may resolve their outstanding debts in order to perform their operating functions independently.

The permission for establishing JSBs and the presence of foreign banks have contributed to the diversification of forms of credit organizations and created a proper competitive environment conducive to enhancing service quality and banking efficiency. However, most of the JSBs are retail banks with a small capital base; this is reflected in the contradiction between their number of participation and their small share in the total assets of the whole banking system. They were newly set up at the end of the 1980s and in the early years of the 1990s. Up to now, it has not been long enough for them to establish reputation and public confidence. Therefore, they are facing many difficulties in raising funds. In the preceding period, the JSBs have not been significant competitors of the SOCBs, because they have many disadvantages compared with SOCBs as stated above. At this point, these banks are considered as supplementary institutions for the large banks in providing loans to small borrowers, particularly to private sector.

Besides JSBs, the number of foreign banks entering into Vietnam has increased rapidly in 1990s. Their participation is highly appreciated for bringing foreign capital into Vietnam, transferring modern technology and commercial banking skills, and generating significant competition which forces domestic banks to perform more efficiently. Looking at Table 1, during the five years 1994–2001 the number of foreign banks establishing branches in Vietnam has grown from 41 to 65 banks. In comparison to the domestic banks, particularly SOCBs, the foreign banks have advantages in terms of modern technology, commercial banking and risk assessment skills, and especially a strong foreign capital base, as well as a reputation in international market. At present, foreign banks are important competitors of the SOCBs in providing commerce credits despite some disadvantage compared to the latter. Firstly, it takes time for them to do marketing. Secondly, in the first half of 1990 the operation of foreign banks was restricted from mobilizing in domestic currency. However, with their advantages, these banks have adapted quickly to the market and economic environment in Vietnam so their position in both deposit and lending markets has improved rapidly.

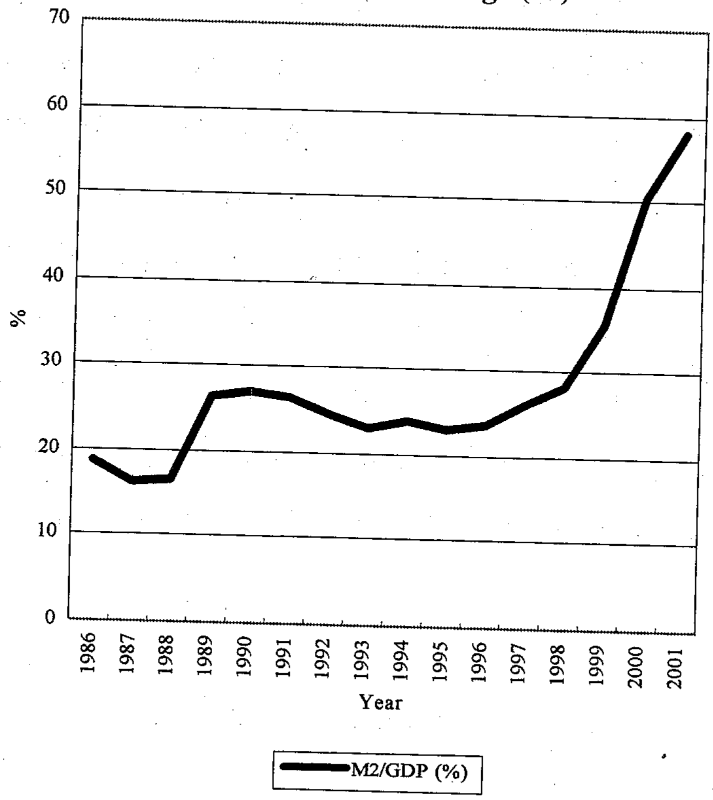
Characteristics of Vietnamese Banking System

Underdevelopment and Inefficiency

Even though structural changes have been undertaken in the Vietnamese banking sector for more than a decade, Vietnam is still far from being a financially deepened country. One of the indicators reflecting market development is financial deepening. Financial deepening in the Vietnam economy is very low compared to that of the market economies in neighboring countries (Figure 5). The ratio of M2 to GDP in 2001 standing at only 58 percent was far below the 160 percent in the People's Republic of China (PRC) and the 102 percent in Thailand[3]. Similarly, the ratio of total deposits to GDP also was only 39 percent at the end of 2001, which is much lower than other Asia countries, especially compared to the PRC. On the other hand, the currency-to-deposit ratio exceeded 35 percent at the end of 2001 (Table 2). The underdevelopment of the banking sector is also reflected in the low level of resource mobilization. The gross domestic saving rate

3 ADB (2003) Key Indicators of Developing Asian and Pacific Countries

Figure 5: M2/GDP Change (%)



Sources: ADB Key Indicators, World Bank, Vietnam Development Report 2002

Figure 6: Gross Dosmestic Saving (% of GDP)

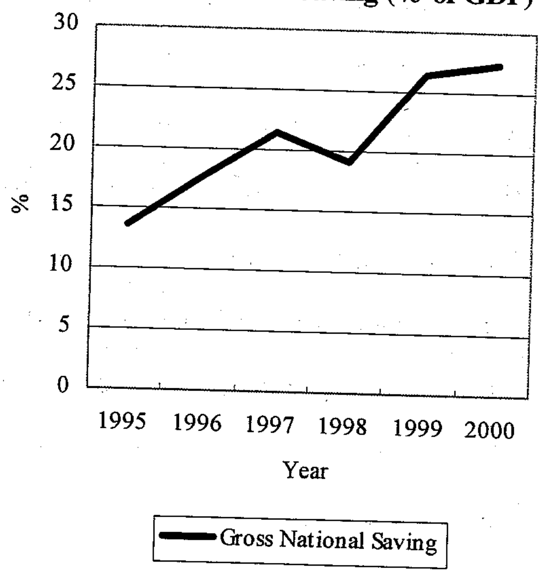


Table 2: Financial Deepening

	1999	2000	2001
M2/GDP	35.7	50.5	58.1
Deposit/GDP	27	36	39
Currency /Deposit	38	33	35

Sources(table 2 & figure 6):
Key Indicators (ADB)

in 2000 was only 27.3 percent (Figure 6), which was much lower than that in the PRC, Malaysia, and Indonesia. Furthermore, despite its low level, it has not grown fast either. Compared with the PRC, whose economy is also in transition, Vietnam has room for more improvement.

All this reflects inefficiency in the banking system and the low level of market development in Vietnam.

In concrete terms, it reflects not only the low savings rate of the Vietnamese economy, but also the weakness of the banking system, which cannot mobilize the necessary resources for development.

The domestic savings rate was as low as 15 per cent of GDP 1995 and, although it has increased in recent year, one can not say it is high compared to neighboring countries. This also reflects low income levels; on the other, it is evidence of the inefficiency of the financial system, especially the banking system. Although there are spare financial resources that can be transformed into investments, the financial system cannot mobilize the spare resources from households and individuals.

The increased share of the non-state sector in the total credits reflected significant progress in the Vietnamese banking system, but they are not enough to meet present requirements for the transition into a market economy. In addition, only private enterprises that are large or have a close relationship with government agencies or the banks can access the SOCBs' credit. Most farmers and private enterprises have no means of accessing it.

Domination of State-owned Commercial Banks

The four SOCBs still dominate the banking system and at the end of 2001, they accounted for 72% of all banks liabilities, 91% of outstanding SOEs bank credit, and 75% of nonperforming loans (NPLs) (Table 3). All of these things were caused by an inadequate regulatory, supervisory framework and a weak human

Table 3: Selected Banking Indicators (2001)

	Share(%) in total of		
	Bank credit Outstanding	SOE credit outstanding	Nonperforming loans
Four SOCBs	71.9	91.4	74.7
Other banks	28.1	8.6	25.3

Sources: State Bank of Vietnam & IMF

resource base in the commercial banks. In more detail, they are affected by at least three factors: (i) the government-directed lending in favor of SOEs, (ii) the information problem of the banks regarding private enterprises, and (iii) the cumbersome lending procedure and collateral requirement[4].

Concerning the government-directed lending, the government has been decisive in the allocation of credit from the SOCBs. The banks are required to allocate a substantial share of their credit to SOEs at concessionary interest rates and without collateral[5] as a matter of policy rather than because the loans are profitable. This lending policy has, among other things, brought into the banks' loan portfolios a high share of NPLs[6] because SOEs have usually failed to honor their loan repayment obligations[7]. As a result of the government-directed lending, SOCBs are refinanced by the government in many ways such as by using general revenues, by selling government bonds to the public, or by printing money[8]. This is likely to lead to moral hazard problem because this bailing-out irrespective of whether or not the banks adjust their behavior would mean that they continue to make bad loans to the SOEs. The credit from the SOCBs then becomes an instrument to help inefficient SOEs to survive. Any financial deterioration of

4 Webster (1999)
5 Gates (2000); IMF (2002a)
6. IMF (2002b)
7 O'Connor (2000)
8 Perkins (2001)

SOEs will thus create difficulties for the banks, but it may also induce the banks to give more credit to SOEs because they cannot get back the previous loans if those SOEs fail.

Concerning the information problem of the SOCBs with respect to private enterprises, since Vietnamese private enterprises, particularly small ones, often do not have bookkeeping, it is difficult for them and the banks to make a contract because the necessary information is lacking. In addition, the SOCBs' officials may be misinformed about private enterprises because the media often report the latter's frauds, bankruptcies, and misconducts[9].

This information problem may be mitigated if the banks are willing to obtain information about private enterprises. However, as discussed earlier, due to soft budget constraints the SOCBs do not seem to have incentives to do so. In addition, since the lending policy and soft budget constraints lead to a dearth of crucial banking skills, e.g., risk identification and management, that are essential in lending to private enterprises, the banks appear to be unable to properly analyze the information about private enterprises, even if available. This adds to the information problem of the banks with respect to private enterprises.

The lending procedure of the SOCBs to private enterprises is extremely cumbersome because they just want to select creditworthy borrowers from hundreds of private enterprises, enterprises which the media often report on regarding frauds, bankruptcies, and misconducts[10]. Unfortunately, this cumbersome procedure, coupled with the presence of unskilled and unmotivated bank officials, turns out to be an obstacle for private borrowers.

Lack of Confidence

The confidence of the people and enterprises in the financial system is limited.

9 Webster (1999)

10 Webster (1999)

At present there are several factors related to the weaknesses of the financial system.

First of all, the financial system does not mobilize resources for economic development. Its network is not convenient for people who want to deposit their savings. Many people still do not know about banks' deposit services and they keep their money at home rather than deposit it in bank accounts.

Another reason for the lack of confidence is the weak payment system. Payments through banks often take a lot of time. Payments within big cities are usually effected within one to two days while those between cities and provinces take about two weeks or more. That is why the people and enterprises usually use cash to purchase goods and services, causing a large flow of cash to circulate outside the banking system. It also explains why foreign currencies, especially US dollars, sometimes replace the domestic currency in payment transactions.

The banks' limited ability to assess investment projects prevents them from using the available resources efficiently. This fact explains why sometimes banks cannot lend out their financial resources, but enterprises still complain of the lack of credits, especially credits for medium and long-term investments. As a result, mobilized resources can not be used to invest. This means low efficiency of the banking system. All these factors affect the confidence of the people and entrepreneurs in the financial system. As a result, the financial system can not play an effective role in developing the economy.

3. Institutional Reforms of the State Bank of Vietnam and Monetary Policies

Reform measures should be aimed at strengthening the financial system so that it can play a better role in Vietnam's economic development. This requires improving the legal and institutional infrastructure, and improving public confidence in the banking system. The main measures should promote competition between state-owned, non-state banks and other non-bank financial institutions, and ensuring a healthy financial system.

Along with the need to improve the legal framework and efficiency of the banking system, (by promulgation of a bank law to clarify functions and operations of each financial institution, implementing training programs and introducing international accounting and auditing standards,) reform efforts should be aimed at establishing a market-oriented financial system. If the financial system functions in accordance with market principles under government supervision, public confidence would improve and it could then play an active role in the economic development of the country.

Current Status of the State Bank of Vietnam and its Reforms

On the banking reform front, the SBV is facing an enormous challenge. That is to transform a banking system that has traditionally been used as an instrument for implementing and financing Government policies into a modern banking system based on international banking principles.

The current role and structure were appropriate for the rudimentary stages of the transformation from a one-tier to a two-tier banking system. Accountability for the management and supervision of the banking system is presently confused due to the lack of operational independence of the SBV vis-à-vis other state bodies. Currently, the SBV which operates more like a government department than a central bank is tasked with acting on behalf of the government and as the state body managing the banking system. For example, its level of lending to government entities, and its role in the implementation of policies intended to give effect to government's developmental goals than banking system development.

To consolidate the roles and functions of the SBV and lay the ground rules for financial institutions, respectively, the National Assembly approved the laws on the SBV and on credit institutions in December 1997. The new legislation became effective on October 1, 1998. The law on the SBV defines the role of the central bank so as to provide it more autonomy in the conduct of monetary policy. It also improved the banking regulation and supervision system. On the other hand, the law on credit institutions has provisions to ensure the safety of the activities of deposit and nondeposit-taking institutions and special controls and special loans.

Though the SBV carries out its role adequately under the current law and regime, there are shortcomings. According to conventional practice, the authorities are more respected than the market mechanism that requires fair and transparent regulations and standards. Compared with the old decree, the new law on the SBV was supposed to guarantee more autonomy for the SBV in achieving the monetary target. However, contrary to its initial intention, this law does not grant independence and autonomy to the SBV in the conduct of monetary policy, in the banking regulation and supervision system, both of which remain subservient to Government intervention. Because of lax coordination with other government agencies such as the Ministry of Finance (MOF) and the Ministry of Planning Investment (MPI) in carrying out economic policies, the autonomy of the SBV is limited. In particular, the new law requires the SBV to seek National Assembly approval for monetary policy and the Government will continue to interfere with the credit allocation mechanism to serve the multiple socioeconomic objectives of the economy.

The quality of its regulatory and supervisory actions should be improved. With the ongoing transformation of the Vietnamese economy to a market based system, there is a need for supervision to become more proactive, better coordinated and, above all, to move from purely compliance-based supervision system to one that is more risk-based.

The most significant issues that have been identified in relation to bank supervision relate to the lack of clear accountability in the management of the sector, organizational weaknesses within the supervisory structure, inconsistency in application of laws and regulations, and a lack of real corporate governance and transparency in the banking system and the bank supervisory process. All of these fundamental areas impact the supervision and the potential health of the banking system.

The supervision of banks, therefore, need be significantly enhanced. The supervisory process is an important element of the banking system and is one of the key components used to ensure its health. The examination function is one of the tools used in the supervisory process that permits the supervisor to review the operations of institutions to ensure they are acting consistently with the rules and regulations for the industry.

The SBV has been working hard to develop both the general outlines of a banking reform process and specific plans for both the SOCBs and the JSBs. Under the SBV's reform plan, so-called "lending policy" aimed at supporting Government policies and priorities would be moved out of the banking system and into specialized financial institutions. Other difficult challenge of the SBV is facing to change the culture of the SOCBs and to convince SOCBs managers that they must in the future operate on commercial basis. Moreover, the SBV's task is made more difficult by the need for Vietnam to reform and modernize its state enterprise system at the same time with the banking system is being reformed. Effective and lasting banking system reform depends as much or more on effective SOEs reforms as it does on reforms within the banking system itself.

Interest Rate Policy

The main focus of monetary policy of the SBV has been restraining inflation and maintaining the stability of the purchasing power of Vietnam Dong (VND). In the rudimentary stage of transition, the SBV had to employ the direct instruments such as interest rate ceilings, reserve requirements, and credit volume. It is planned to replace such instruments by the indirect ones like refinancing auction and open market operations.

Until 1993 the SBV maintained a lending interest rates differentiation regarding borrowers and sectors. However, it abolished this differentiation in 1993.

In the early years of Doi Moi, deposit interest rates were higher than lending interest rates. For instance, in March 1989 the spread between the interest rates on industrial loans and the three-month household deposit rates was minus 1.5 percent, and it reached minus 3.3 percent by the end of the year. This spread has become positive since December 1992 when deposit rates fell below lending rates[11].

In 1995–1996, the yield of treasury bills was high. Believing that it would contribute to bank profits, the MOF reduced the interest rate margin to induce more efficient banking practices. However, these heavy financial repression taxes, from the bank's point of view, hampered banks rather than encouraged them to operate more safely and efficiently. On the other hand, the lower-bounded deposit rates retarded financial deepening and raised the potential for curbing markets.

In effect, the banking system was not provided a sufficient incentive to pursue profits. This interest rate policy squeezed banks' profits and transferred a part of banks' profits to the SOEs, the banks' major customers. This encouraged the SOEs to get excess liquidity beyond proper investment opportunities. At the same time, this led banks to lose motivation for profit-taking businesses, leaving them to manage conservatively and stay complacent.

Considering the changes and influence of the practical situation on credit interest rate in each period, the SBV has in recent years adjusted the ceiling interest rate up to four of five times.

11 IMF (1994, 1995a) and Dodsworth et al., (1996)

Since August 5, 2000, the SBV changed the way it handles interest rate in accordance with the requirement of the new economic stage. The SBV sets a base lending rate and margins above this rate to serve as limits for the lending interest rates charged by banks. This new mechanism provides adequate flexibility to credit institutions and should help to enhance enterprises access to credit[12]. This is because credit institutions may be more inclined to grant loans if they are able to price loans according to credit risks. At the same time, the government also adopted a market interest rate mechanism for foreign currency-based lending activities; the interest on dollar deposits is now based on the Singaporean Inter-bank Offered Rate (SIBOR).

The handling of interest rate under the new mechanism since August 5, 2000 is providing effective in creating favorable conditions for commercial banks and credit institutions in doing business and enhancing their competitiveness. However, credit constitutions' responsibility is also larger, requiring them to closely observe the market, update information, and make accurate decisions.

The new mechanism to handle the interest rates is seen as a move toward liberation of the market, conforming to the current trend of "globalization". However, its effect does not only depend on the mechanism but also on the business environment and those who handle it. For this reason, it is very important to raise social awareness of the issue and strengthen the role of managers in organizations, implementation and supervision of the new mechanism on interest rate.

Reserve Requirements

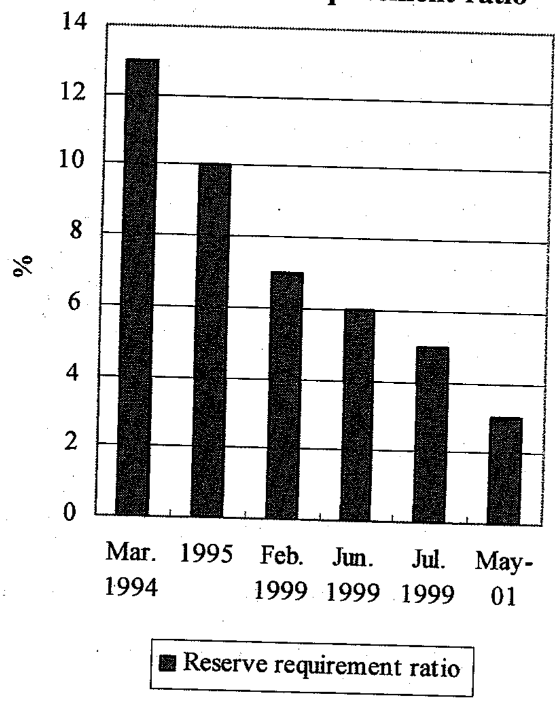
Reserve requirements are an instrument used by central banks to stabilize money market rates and to create a structural liquidity shortage. The SBV can change required reserve ratios and thereby change the ability of the banking system to

12 IMF (2002a)

extend credit or loans. This policy measure, however, is seldom adopted as a small change in required reserve ratios can have a great impact on the monetary aggregates and market interest rates. In reality, several SOCBs had reserve deposits far below the required minimum.

Until February 1994, the SBV maintained a formal reserve requirement ratio of 10 percent of all deposits. On March 1, 1994, the SBV introduced new reserve ratios for both domestic and foreign currency deposits: 7 percent for time and savings deposits and 13 percent for demand deposits. In 1995 the reserve ratio of 10 percent was applied to all types of deposit, except for domestic currency deposits with a maturity of over 1 year[13]. In February 1999 the SBV reduced the reserve requirement ratio of 10 percent to 7 percent for short-term deposits. Since May 2001 the reserve requirement ratio was further reduced to 3 percent (Figure 7). The reductions in reserve requirement ratio imply the government's intention to relax credit supply in order to encourage firm investment.

Figure 7: Reserve requirement ratio



13 IMF (1998)

Exchange Rate Policy

Exchange rate theoretically is not an instrument of monetary policy. However, in the case of Vietnam because of particular characteristics in the rudimentary stage of the transition, the SBV, to some extent, had considered exchange rate policy as an instrument of monetary policy[14]. This could be explained as follows: the Vietnam economy in the early years of the transition was in the situation of being "highly dollarization" with price being very sensitive to the fluctuation of the exchange rate of VND against USD. The stability of the exchange rate was an important mean for restraining inflation and expansion of the banks' business in foreign exchange.

Prior to the transition, Vietnam followed the transferable Rubble mechanism in transactions with members of the Committee for Mutual Economic Assistance (CMEA), and a fixed exchange rate against US dollar in transactions with in the currency convertible region. In 1991, the former mechanism was terminated after the collapse of CMEA. Since then, the exchange rate has been mainly determined against USD. The process of exchange rate reforms started in 1989 and the fixed exchange rate regime against the USD has been gradually replaced by a floating and managed one. This has closed the gap between the exchange rates in the parallel market and the official rates in banking system. In addition, after two years without regulations, since 1991, the SBV consolidated management over foreign exchange transactions of businesses and brought them into banking system. This helps the SBV to regulate the supply and demand in the foreign exchange market and hence to put exchange rate under the control of the SBV. As a result, the exchange rate of VND against USD during the period 1992-96 was rather stable; this had an important contribution to restraining inflation in the period.

However, some economists have studied the real exchange rate of Vietnam

14 IMF (1998)

during the concerned period, and they have found that the real exchange rate of VND again USD tended to appreciate. And this was a significant "bottleneck" for exports from Vietnam. The Asian financial crisis has caused currencies of neighboring economies devalue. The relative appreciation of VND against other currencies in Asia is reducing exports and induce imports to Vietnam in the comings years. This will put a hard burden on the trade balance and current account, and bring strong pressure on the exchange rates to devalue. In order to overcome these challenges, it requires the SBV to be conducive and flexible in finding a suitable exchange rate policy while enforcing an objective of monetary policy. Besides that, it requires the banking system to be active in moderating supply and demand of foreign exchanges in the market in order to support the exchange rate policy of the SBV.

4. Financial Reform for Stability in Vietnam

The idea that the functioning of the financial system affects economic development has a long history in the economic literature. Financial system serves several functions including mobilizing savings, allocating resources, and exerting corporate control. In performing these functions, the financial system can contribute to capital accumulation and technological innovation, thus impacting upon the rate of economic growth.

Given that the financial system provides such basic services necessary for sustainable economic growth, many economists have argued that financial reform has a particularly important role to play in economies undergoing the transition to a market economy[15]. Mobilizing savings for investment, exerting effective corporate governance over reforming SOEs, and selecting non-state enterprises to finance are all important elements of a successful transition. Financial reform in

15 Griffith-Jones (1995); World Bank (1996); Hermes and Lensink (2000)

transitional economies must also be more comprehensive than in most developing countries because it involves not only liberalization, but also shaping the structure and functions of the financial system[16].

Institutions and Polices for Maintaining Financial Stability

The term financial stability encompasses the stability of institutions, markets, and payment systems. Financial stability requires close, smooth interaction of all three, with each functioning correctly.

It is absolutely necessary for the institutions comprising the financial markets to deserve the highest degree of confidence. If the financial institutions are stable and sound, the system of which they are part will also be stable and sound. Besides being closely linked to the quality of institutions, markets, and payment systems, financial stability depends on the effectiveness of the central bank in preventing what it is called "systemic risk" which is another name for the contagion effects of institutional defaults.

What steps should be taken to promote financial stability? There are three kinds of measures: First, drawing up rules to defining permissible and disruptive behavior, embody them in a legal framework, and require compliance. Second, having established a system of rules, supervision is established to ensure the correct behavior of participants and gather information concerning the financial system. And third, setting up insurance systems and give guarantees in order to protect the financial system and its arrangements against mishaps and defaults.

The basic principles that should guide central banks in their exertions in support of financial stability are to assign the responsibility for maintaining financial stability to the markets as a whole, rather than to individual institutions; to ensure smooth operations of the payments system; and to provide liquidity to the

16 Long and Sagari (1991)

system when needed.

But the level of central bank involvement in banking system supervision which is necessary to ensure financial stability is still being debated. The most important requirement for financial stability is that the balance of payments, the financial institutions, and the markets should function in a sound and efficient manner. All of these are part of the system to prevent the emergence of a systemic risk. It is essential that data should be collected, that supervision should fulfill its preventive role, and that any damages that might arise should be limited in advance.

The Design of Financial Regulation in the Transformation

The key question is how to adapt the regulatory framework to the increasingly competitive environment of banking.

This question is quite complex. The dynamic environment of today puts the notions of regulatory arbitrage and level playing field high on the agenda. Competitiveness needs to be preserved, and the possibility of bypassing regulation needs to be recognized. The picture is even more complicated because stability and competitiveness are likely to be conflicting rather than complementary objectives, thus presenting regulators with a difficult trade-off. In particular, one could argue that restrictions on competition would improve banks' profitability, reduce failure rates and hence safeguard stability[17]. While others have the opposite idea that due to the lack of competition the vitality of an institution could be negatively affected in the long run, and one needs to recognize that eroding margins and fierce competition can undermine stability.

Against this backdrop and taking into account the features of Vietnam, the following polices need to be considered. (i) The restructuring of the banking system

17 Keeley (1990), and Demsetz, Saidenberg and Strahan (1996)

has to be designed and implemented comprehensively and promptly. In particular, reforms on SOEs, SOCBs, and JSBs must be implemented simultaneously. (ii) To promote competition among banks, the authorities need to put appropriate procedures in place to ensure that the SOCBs are run on a commercial basis, and to facilitate careful internal assessment and monitoring of the credit risk. (iii) In addition, the role of the banking system in distributing financial resources also has to be widely disseminated. The development of screening and monitoring techniques is fundamental for the role. Advancement of the payment system connecting the central bank, headquarters, and their branches is also necessary. (iv) To recover confidence in financial institutions, the Government must commit itself to the protection of deposits. Encouraging people to pay taxes and utilities and make other regular payments through banking institutions, and direct salary payments to employees' deposit accounts will contribute to bringing banks into the daily life. (v) Finally, the monetary policy has to be designed and implemented in harmony with other economic policies such as setting a monetary aggregate target, interest rate liberalization, and industrial policy. The monetary target must be determined considering not only inflation but also banking system development.

Conclusion

Vietnam faces a substantial challenge in reforming its financial system. In concluding, a few issues are summed up as the following: First, Vietnam still has a long way to go to reach a modern financial system. The Vietnamese financial structure at this time has many problems which need to be solved in the near future. The creation of a capital market and a regulated, supervised and cleaned-up banking system goes in the rational direction. Second, the SBV needs to be strengthened so that it can exercise effective supervision and prudential regulation of banks.

If Vietnam fails to transform its banking and financial system, the consequences are predictable. The intermediation of funds between savers and investors by banks and other financial institutions would probably continue to be marked by the inefficiencies already apparent. The continued fragility of the financial system would also limit the ability of the SBV to use monetary policy to dampen the marked fluctuations in economic activity that have characterized the reform era. Ultimately, the failure to transform the banking system on a timely basis increases the possibility of a domestic banking crisis. And as a result, it makes the domestic banking system continuing vulnerability.

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