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FUNDING ECONOMIC DEVELOPMENT: A COMPARATIVE STUDY OF FINANCIAL SECTOR REFORM IN VIETNAM AND CHINA

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ACRONYMS AND ABREVIATIONS

ABC: Agriculture Bank of China
ACB: Asia Commercial Bank
ADB: Asian Development Bank
AMC: Asset Management Company
BIDV: Bank for Investment and Development of Vietnam
BOC: Bank of China
BTA: Bilateral Trade Agreement
CADB: China Agriculture Development Bank
CAMEL: Capital adequacy, Asset quality, Management, Earnings, and Liquidity
CAR: Capital Adequacy Ratio
CBRC: China Banking Regulatory Commission
CCB: China Construction Bank
CDB: China Development Bank
CEIB: China Export-Import Bank
CIRC: China Insurance Regulatory Commission
CSRC: China Securities Regulatory Commission
DAF: Development Assistance Fund
DATC: Debt Asset Trading Company
FDI: Foreign Direct Investment
FDIEs: Foreign Direct Investment Enterprises
FED: US Federal Reserve (central bank of the United States)
FETP: Fulbright Economics Teaching Program
FPI: Foreign Portfolio Investment
GDP: Gross Domestic Product
HASTC: Hanoi Securities Trading Center
HOSTC: Ho Chi Minh city Securities Trading Center
ICB: Industrial and Commercial Bank of Vietnam
ICBC: Industrial and Commercial Bank of China
ICOR: Incremental Capital Output Ratio
ILO: International Labor Organization
IMF: International Monetary Fund
IPO: Initial Public Offering
JS: Joint Stock
JSCB: Joint Stock Commercial Bank

LDIF: Local Development Investment Funds
MHB: Mekong Housing Bank
NGO: Non-Governmental Organization
NIM: Net Interest Margin
NPL: Non-Performing Loan
OECD: Organization for Economic Co-operation and Development
OTC: Over the Counter
PBOC: People's Bank of China
P/E Ratio: Price –Earning Ratio
RCC/UCC: Rural/Urban Credit Cooperative
RMB: Chinese currency (Remimbi or Yuan)
ROA: Return on Assets
ROE: Return on Equity
ROSCA: Rotating Savings and Credit Association
Sacombank: Saigon Thuong Tin Commercial Joint Stock Bank
SBV: State Bank of Vietnam
SCIC: State Capital Investment Corporation
SEZ: Special Economic Zone
SOCB: State Owned Commercial Bank
SOE: State Owned Enterprise
SSS: State Securities Commission
TVEs: Township and Village Enterprises
UNDP: United Nations Development Program
USD: United States dollar
VBARD: Vietnam Bank for Agriculture and Rural Development
VBSP: Vietnam Bank for Social Policy
VCB or Vietcombank: Bank for Foreign Trade of Vietnam
VDB: Vietnam Development Bank
VDI: Vietnam Deposit Insurance
VND: Vietnamese dong
VNPT: Vietnam Post and Telecommunications Corporation
VPSC: Vietnam Postal Savings Company
WB: World Bank
WDI: World Development Indicators
WTO: World Trade Organization

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EXECUTIVE SUMMARY

I. Study Objectives, Methodology, and Limitations

Given the importance of financial sector development for sustained economic growth, especially in the context of Vietnam's own performance since embarking the *Đổi Mới* economic reforms twenty years ago, the objective of this study is to analyze the financial sector development in Vietnam and China within the framework of financial sector reforms introduced in the two countries. The study will assess the progress to date and future challenges for each country; compare and contrast financial sector reform strategies and performance; and formulate policy recommendations for further financial sector reform in Vietnam.

The methodology of this study is to draw on the existing literature on financial sector development to design a conceptual framework for analysis of the sector reforms introduced in Vietnam and China. The study focuses on three key dimensions of reform: financial sector liberalization; financial sector deregulation; and financial sector stabilization. The conceptual framework is then applied to a comparative review of financial sector development in Vietnam and China, relying mostly on secondary sources for descriptive data and on interviews for supplementary data to assist in interpreting this information. The same conceptual framework is used to formulate suggestions for future financial sector reforms in Vietnam by linking policy analysis to the recommendations.

Due to the extreme sensitivity of the subject the limitations of the study pertain to access to information and data. Many financial institutions consider their data proprietary, and are thus reluctant to share information with external parties for fear of breaching client confidentiality, exposing internal weaknesses to customers and regulators, and giving away trade secrets to competitors. Financial sector policy makers and supervisors share this reluctance to share information for fear of exposing their institutional shortcomings and national vulnerabilities. Thus, there are significant data gaps, which when filled, could alter some of the findings and recommendations of the study; these gaps are duly noted as they appear in the text. Moreover, similarities and differences between Vietnam and China should not be viewed as "best and worse practices," but rather, as a source for discussion and reflection in the hope that experiences elsewhere might help to better understand the situation in Vietnam and provide ideas that could be adapted as per requirement and capabilities.

II. Conceptual Framework for Assessing Financial Sector Reform

Instead of analyzing financial sector reforms in Vietnam and China sequentially, with a chapter devoted to describing reform in each country followed by a chapter comparing and contrasting reform in the two countries, this paper is structured thematically. Vietnam and China are examined in parallel along the three key dimensions of financial sector reform: financial sector liberalization; financial sector deregulation; and financial sector stabilization.

Financial sector liberalization describes the movement from administration-based to market-based financial systems. When applied to banking systems, this means that instead of administratively-dictated interest rates and credit allocation, market prices are used to determine the value of funds and return on capital is used to allocate these funds. It also entails the use of reserve requirements to enhance the stability of depository institutions rather than as a fiscal tool to tax capital or finance budget deficits, or as a monetary tool to control money supply in lieu of open market operations. When applied broadly to financial systems, it refers to market-determined foreign exchange rates and open capital accounts.

<u>Financial sector deregulation</u> describes the movement from a closed to a competitive financial system. When applied to banking systems, this means transitioning from a banking monopoly or oligopoly, where legal or administrative barriers limit competition, market entry, expansion, and diversification, to an open and competitive banking system where market performance rather than preferential treatment determines market share and bank profitability. This entails creation of "a level playing field" not only for privately owned banks to compete with public sector banks, but also for foreign banks to compete with domestic banks. In the broader context of entire financial systems, it refers to application of the same principles to both non-bank financial institutions as well as to capital markets.

<u>Financial sector stabilization</u> relates to ensuring the long-term stability of a country's financial system. Most often, this means restoring liquidity and solvency to the banking system after a banking crisis by resolving bad debt overhang, and if necessary subsequent bank recapitalization together with improvement of bank regulation and supervision capacity to maintain the future safety and health of banks. When applied broadly to the financial systems it entails mitigation of market failures in the financial sector, like asymmetric information and incomplete markets, to address potentially destabilizing behavior such as adverse selection, moral hazard, and fraud.

III. Financial Sector Overview in Vietnam and China

a. Establishment and Structure of the Formal Financial Sector

Vietnam

SBV (State Bank of Vietnam) was established on 6 May 1951 and acted as a monobank, whereby it played the role of both a central bank (issuing money) and a commercial bank (raising and lending funds). The State also owned and controlled directly two specialized banks, commonly referred to as SOCBs (State Owned Commercial Banks): BIDV (Bank for Investment and Development of Vietnam) was founded in 1957 to provide long-term capital to infrastructure projects and public works; VCB (Vietcombank) was established in 1963 to finance foreign trade activities, manage foreign exchange, and support SOEs (State Owned Enterprises). Under the mono-banking model, Vietnam's banking system served as a vehicle for implementation of government policies by providing fiscal resources to the State and funding for SOEs. The key development financing instrument was directed credit at highly subsidized interest rates.

The shortcomings of this approach became evident during the 1980s, as SBV could control neither money supply nor credit quality. This resulted in high inflation, negative real interest rates so low that they were less than deposit rates, and substantial non-performing loans (NPLs); leaving Vietnam with acute vulnerability to both a banking crisis and macroeconomic instability. Thus, in 1988, Vietnam launched the first major reform of its financial sector by: transferring SBV's fiscal management function to the newly created State Treasury; transferring SBV's commercial banking function to the SOCBs (State Owned Commercial Banks); establishing two more SOCBs, VBARD (Vietnam Bank for Agriculture and Rural Development) and ICB (Industrial and Commercial Bank of Vietnam), to provide financing to their respective economic sectors, namely agriculture/rural development and industry/commerce. It also allowed all economic organizations, including private entities, to borrow and raise money from the public, precipitating a Credit Cooperatives and Credit Funds crisis in 1990, together with a more general loss of public confidence in the nation's banking system.

This effectively shifted Vietnam from a mono-banking system to a two-tier banking system, whereby the central bank's functions are restricted to monetary policy (issuing money and controlling inflation) and oversight of commercial banks (regulation and supervision of banking operations); while financial intermediation (funds mobilization and allocation) is shifted to commercial banks, together with transfer and payment services.

However, the SOCBs were not market-based commercial banks: both their lending and deposit rates were set by SBV; lending rate differentials were determined by relative investment priority (economic sector) and loan use (working capital or fixed asset investment) rather than relative loan risk. The loan eligibility criteria reflected government policy preferences rather than market potential; and savings rates were based on type of depositor (household or business) and currency (VND or foreign) instead of market prices and a bank's liquidity needs. The period from 1986 to 1988 was a very unstable period: as the government printed money to finance its budget deficit, hyperinflation surged up to triple-digit rates; the financial liberalization initiatives were conducted without reform of SOEs, manufacturing, or trade - only the agriculture sector had been liberalized, and prices of many goods were seriously distorted; and liberalization went so far that all economic organizations were allowed to trade currency, without any financial monitoring system.

However, the Vietnamese banking system did not begin to operate formally as a two-tier banking system until two years later, when the Vietnam State Council promulgated the banking ordinances of 1990. At this time, due to their collapse, credit cooperatives were renamed people's credit funds.

Other key developments in the evolution of Vietnam's banking system since 1990 are: JSCBs (Joint Stock Commercial Banks) have been permitted and foreign banks have been allowed to enter the market via the opening of branches or establishment of joint ventures with domestic banks; three policy banks and another SOCB were established (VBSP – Vietnam Bank for Social Policy, VDB – Vietnam Development Bank, VPSC – Vietnam Postal Savings Company, and MHB – Mekong Housing Bank); relations with international financial institutions were normalized; the Law on the State Bank of Vietnam 1997 confirmed the role of SBV as the central bank; VDI (Vietnam Deposit Insurance) was established; four AMCs (Asset Management Companies) were established as wholly-owned subsidiaries of the SOCBs; this same model was followed as other AMCs were established under JSCBs; DATC (Debt Asset Trading Company) was established as a commercial enterprise with the mandate to generate profits from the purchase and sale of bad SOE assets; SCIC (State Capital Investment Corporation) was established to manage State capital in all but the 19 largest SOEs; and Vietnam has continued to gradually open its financial sector to foreign institutions by signing a bilateral trade agreement with the United States in 2001 and joining the WTO (World Trade Organization) in 2007.

At present, Vietnam is planning to equitize its SOCBs in a manner similar to China's equitization program, but the process has been relatively slow to date. Only VCB has had an IPO (Initial Public Offering)-December 2007; the other four SOCBs (BIDV, ICB, VBARD, and MHB – Mekong Housing Bank) hope to go public by the end of 2009. In addition, unlike China, VCB had its IPO without first finding a strategic investor, so although the sale went reasonably well, public confidence in VCB has fallen sharply since the IPO, as indicated by a roughly 70 percent drop in its share price. To foster capital markets development, the SSC (State Securities Commission) was established in 1995, followed by creation of HOSTC (Ho Chi Minh City Securities Trading Center) in 2000 and the HASTC (Hanoi Securities Trading Center) in 2005.

China

PBOC (Peoples Bank of China) was established on 1 December 1948 under the Ministry of Finance, and like SBV in Vietnam, operated as a monobank. Shortly thereafter, three specialized banks were created to serve the function of financing the economy: BOC (Bank of China), ABC (Agriculture Bank of China), and CCB (China Construction Bank). China also issued a new currency in 1951, called the remimbi or yuan.

One of the reforms launched by Deng Xiaoping in 1978 as part of his plan to transform China from a centrally planned economy to a "socialist market economy" was the Chinese State Council's decision that PBOC should become the country's central bank in September 1983. BOC and ABC were also made SOCBs in 1979. These two key decisions formally converted China to a two-tier banking system. In addition, another bank - ICBC (Industrial and Commercial Bank of China), was founded in 1984 to join the other three specialized banks listed above. These four banks are now the largest commercial banks in China. At that time, these banks were responsible for financing their assigned economic sectors, working closely with PBOC. Regional banks and JSCBs were also established, and foreign banks were allowed to participate in the form of joint ventures, branches, or 100% foreign-invested banks.

In 1994, three policy banks were established to separate directed credit from trade credit, namely CDB (China Development Bank), CEIB (China Export-Import Bank), and CADB (China Agriculture Development Bank). The following year, China's National Assembly passed two key statutes as the next steps in financial sector development: the Law on the People's Bank of China that confirmed the role of PBOC as the central bank, and the Law on Commercial Banks that formally designated the "big four" SOCBs as commercial banks and separated banking, securities, and insurance activities.

As part of capital markets development, the Shanghai and Shenzhen Securities Exchanges were established in 1990 and 1991, respectively, and the CSRC (China Securities and Regulatory Commission) was established in 1992. CIRC (China Insurance Regulatory Commission) was established in 1998. Also in 1998, PBOC was restructured, consolidating its provincial branches into nine regional offices.

In 1999, under the joint management of the Ministry of Finance and PBOC, four AMCs were established with $20 billion funded by the Chinese government to resolve $169 billion in bad debts of the "big four" SOCBs,. Unlike the AMC model in Vietnam where the AMCs were part of the SOCBs, these were separate institutions from the SOCBs,.

In the first meeting of the Tenth National Assembly in 2003, China decided to establish CBRC (China Banking Regulatory Commission) to separate the regulation and supervision function from PBOC. The establishment of CBRC has helped PBOC focus more on the function of monetary policy execution.

During the course of restructuring of the banking system, especially the SOCBs, BOC and CCB were transformed into single-member limited liability companies under the State Capital Investment Corporation of Huijin in August 2004. In October 2005, CCB went public and conducted an IPO on the Hong Kong Securities Exchange, followed by BOC in June 2006, and finally ICBC in October 2006. These three banks have been listed on the Hong Kong and Shanghai Securities Exchanges up to now. As planned, the Chinese government is going to spend about $100 billion to strengthen the financial condition of ABC before it goes public in 2008 or 2009.

An important subject in the development of China's banking system is credit cooperatives. Numbering approximately 60,000 at their peak, both rural and urban cooperatives have become an integral part of China's banking system. They now play a critical role, as well as create significant vulnerabilities in the Chinese banking system. Reforming credit cooperatives, especially the rural ones (RCCs), is considered a high priority of the Chinese central government over the next five years, beginning with a reform of ownership and governance structures and an injection of $20 billion in recapitalization funds.

During economic reform and fiscal decentralization, the regional banks, most of which are owned by local governments, have been established. Their primary role has been to act as "sponsors" of local development schemes. This is one of the greatest concerns of China's banking officials, since many regional banks are unsound. Hence, they are also a focus of the plan to reform the banking system.

Regarding China's interactions with the international financial community, it: rejoined the IMF (International Monetary Fund) and the World Bank in 1980; and joined the WTO in 2001, agreed to incrementally open its financial sector to international institutions within five years.

b. Provision of Key Financial Sector Functions

Monetary Policy

In Vietnam, SBV is responsible for monetary policy as well as bank regulation and supervision. SBV is a ministerial agency under the government's executive branch, with its headquarters in Hanoi and offices in most cities and provinces. The SBV governor is appointed by and serves at the will of the government, like a cabinet minister. Given its legal status and organizational structure, SBV's policies and operations are significantly influenced by the central and local governments, as has been evident during the current macroeconomic crisis. SBV's provincial branches are considered departmental agencies similar to other sectoral offices of the government, and a standard branch template is applied regardless of location, leading to overstaffing and local political interference.

A plan to transform SBV into a modern central bank has been approved by the Prime Minister, and both the Law on the State Bank and the Law on Credit Institutions are expected to be amended in 2009 to reform SBV on the lines similar to the Chinese strategy. This entails moving the function of banking supervision to a new departmental agency, thereby leaving SBV to focus only on managing monetary policy.

In China, responsibility for bank supervision was shifted out of PBOC with establishment of CBRC in 2003, allowing PBOC to focus exclusively on managing monetary policy. The objective of this initiative was to improve the quality of both bank supervision and monetary policy execution by allowing CBRC and PBOC to specialize in their respective responsibilities. Unlike SBV, PBOC now has the same organizational structure as the U.S. Fed (U.S. Federal Reserve) – its headquarters is in the nation's capital, and its field operations are divided among regional branches. The establishment of regional instead of provincial branches is a lesson Zhu Rongji learned from Mao Tse-tung; to reduce local government intervention in army operations, Mao Tse-tung established eight military zones, with each zone in charge of several provinces rather than just one province. Under the current organizational structure, many people contend that PBOC has significantly reduced local government interference compared to the previous structure of provincial branches, but like SBV, the independence of PBOC in relation to the central government is relatively low by international standards.

Both SBV and PBOC have not managed monetary policy by inflation targeting; instead, they have relied on controlling the money base. This is a passive policy that is not well suited to controlling inflation, and easily leads to implicit currency depreciation, current account deficits, and potential monetary financial crises. Some experts have recommended executing monetary policy more actively, as well as setting a low inflation target as a nominal anchor for monetary policy. Moreover, both central banks currently rely heavily on rather blunt administrative measures instead of open market operations to execute monetary policy. In fact, especially in Vietnam, many monetary policies seem to follow rather than lead the market, perhaps another sign of central bank's lack of independence.

For the last two decades, the Chinese economy has grown at an average annual rate of 10 percent, while money supply has increased at an average annual rate of 22 percent and the average annual inflation has been 5.5 percent. During the same period, the Vietnamese economy has grown at an average annual rate of 7.5 percent, while money supply has increased at an average annual rate of 28 percent, and the average increase in prices have been slightly lower than in China until recent rapidly accelerating inflationary pressures in Vietnam. Unlike China, a significant problem in managing monetary policy in Vietnam is that three "currencies" are used in transactions rather than a single currency. Vietnam is probably the most dollarized economy in the region, with approximately 30 percent of deposits denominated in U.S. dollars. Gold is also a popular medium of investment and exchange in Vietnam, adding yet another challenge to SBV in managing monetary policy.

Financial Sector Regulation and Supervision

Surveillance of a banking system has two principal components: remote and direct monitoring - sometimes referred to as off-site and on-site supervision. The former is a desk review based on regular and incidental reports submitted by financial institutions, while the latter entails field visits and on-the-spot inspections of these financial institutions by the central bank or bank superintendency. These two components are closely inter-related: it is difficult to ascertain the validity of secondary information without field verification, and a pre-requisite of efficient and effective field visits is adequate preparation based on submitted reports. To date, neither component is well implemented in Vietnam nor in China, creating uncertainty about the true financial condition of specific banks, as well as doubts about the overall soundness of each country's banking system.

Of particular concern is whether SBV and CBRC can quickly and accurately determine the composition and quality of a bank's loan portfolio, which is critical in interpreting whether a bank in crisis is suffering from a liquidity or a solvency problem, since the symptom of distress is the same: lack of cash to meet a bank's payment obligations. It is also difficult for both SBV and CBRC to confirm a bank's compliance with pertinent laws and regulations, given the creativity of banks and the fungibility of money, which makes it unlikely these agencies can detect an impending crisis before it arrives. Another problem facing SBV and CBRC in monitoring both banks in particular, and financial institutions in general, is the tendency in Vietnam and China to combine banking, insurance, and securities services within the single structure of a "universal bank."

Despite weaknesses in bank regulation and supervision, SBV and CBRC capacity is still greater than that of their sister institutions tasked with regulating and supervising capital markets in Vietnam and China (SSC in Vietnam, CSRC and CIRC in China). Moreover, there are even larger markets, such as the over-the-counter (OTC) market in Vietnam, which function with virtually no supervision.

Financial Intermediation

In Vietnam, the five SOCBs had a dominant market share of bank assets in late 2005, totaling 70.7 percent, with the remaining market segmented as follows: 37 joint stock commercial banks accounted for 17.2 percent; 31 foreign bank branches and 5 joint ventures had 10.7 percent; people's credit funds had only 1.4 percent; and other financial institutions (VDB, VPSC, VBSP, and local investment funds) were not taken into account. In contrast to China, Vietnam did not have 100 percent foreign-invested banks by the end of 2006, but foreign banks nevertheless had a significant market share in Vietnam.

Just as in China, foreign banks were restricted in terms of scope of operations, products, and capital to be raised when they started up in Vietnam in the early 1990s. Over time, restrictions have been phased out, and foreign banks are going to receive equal national treatment in 2010 according to WTO commitments and the Vietnam-USA Bilateral Trade Agreement (BTA).

In addition to banks, Vietnam also has non-bank financial institutions: 5 finance companies under the management of five state-owned corporations; 10 financial leasing companies under the management of SOCBs; a few joint ventures; and Foreign Direct Investment Enterprises (FDIEs). At present, these non-bank financial institutions seem to have no clear role other than acting as "financial intermediaries" for state-owned corporations. Despite having no urban banks like China, Vietnam has a similar structure in the form of the Local Development Investment Funds (LDIF). These funds operate under the provision of the Budget Law and are not governed by banking regulations.

Three other key financial institutions in Vietnam are VDB, VPSC, and VBSP. At the end of 2006, VDB's total loan balance was VND85 trillion, just slightly lower than that of VBARD, which had the highest loan balance at the time. VDB is essentially an off-budget mechanism to channel resources to state enterprise investments, primarily from VPSC. VPSC was established in 1999 under VNPT (Vietnam Post and Telecommunication Corporation); similar to the Japanese postal savings model, the operations were based at the post offices. The main duty of VPSC is to raise funds to then loan to VDB, and purchase government securities. VPSC's total raised capital was about VND50 trillion at the end of 2005, higher than half of the total average of the four SOCBs. Finally, VBSP, established in 1995 to serve policy beneficiaries, had a total capital and loan balance of approximately VND20 trillion at the end of 2005.

Compared to China, Vietnam's banking system is much smaller, both in absolute and in relative terms, as a proportion of the country's economy. At the end of 2005, the total loan balance of Vietnam's banking system was only about VND 694 trillion, or 71.3 percent of GDP. Vietnam's credit to GDP ratio, a measure of financial deepening, is very modest compared not only to China, but also to other countries in the region. However, with a more than 25 percent growth in the in the recent annual credit, the loan balance is expected to exceed GDP in a short time As noted by the IMF and the World Bank, such a high growth rate for credit can create inflationary pressures and lead to economic overheating, which can undermine macroeconomic stability and long-term development.

Similar to China, Vietnam's banking system is dominated by SOCBs. In addition, banking products and services are still meager and out of date as domestic banks' activities revolve around raising funds and then lending. Their main income comes from lending, and interest margins are even higher than those in China and Western European countries; the net interest spread is estimated at more than 2 percent in Vietnam. For example, in 2005, the interest margins of commercial banks considered to be most efficient in Vietnam – Sacombank (Saigon Thuong Tin Commercial Joint Stock Bank), ACB, and Vietcombank – were 3.9, 2.8, and 2.9 percent, respectively, and their non-lending activities were very limited. Banking operational efficiency and financial capacity are also weak, especially for SOCBs: ROA (Return On Assets) was only 0.6 percent and CAR (Capital Adequacy Ratio) was about 5 percent at the end of 2005; the SOCBs had the lowest results. According to official data, the bad debt ratio appears to be very low: except for BIDV's bad debt ratio of 10.8 percent, the ratios of other banks are safely below 5 percent, with many below 2 percent. However, several international institutions contend that this figure is 15 to 20 percent, and some independent researchers estimate the number to be closer to 30 percent.

Especially worrisome is the potential negative impact of policy banks because of their detrimental effect on the ability to allocate capital efficiently. There is considerable concern about VPSC's capital mobilization, because it may take away the funds that should have been raised by banks to lend to the growing private sector. Addressing this concern is problematic given its political dimensions: VDB only focuses on SOEs, and its operations are dominated by the Ministry of Finance - it is not subject to SBV regulations and supervision. This poses significant risks, given that VDB is now one of Vietnam's largest financial institutions, with outstanding loans estimated to be more than 10 percent of GDP.

In China, the four largest SOCBs accounted for 54.6 percent of total bank assets at the end of 2004. Not only do these banks operate in the domestic market, but they also have foreign branches. Moreover, three of them have gone public, although the State still retains majority ownership. The rest of the Chinese market was segmented as follows: three policy banks accounted for 11.4 percent of assets; 11 joint stock commercial banks had 15.0 percent; 112 urban banks, each of which is connected to a city, had 5.4 percent; 191 foreign bank branches and 100 percent foreign-invested banks (including 15 foreign-invested banks, 157 branches, and 11 sub- branches) had just 1.6 percent; approximately 35,000 rural credit cooperatives and 1,000 urban credit cooperatives had 10.4 percent; and the remaining 1.5 percent was taken by other financial institutions.

Foreign banks have been set up in China since 1981. Initially, their scope of operations and services allowed were very restricted. Over time, these restrictions have been phased out, and foreign banks, in principle, now receive equal national treatment in accordance with WTO regulations. However, foreign banks' operations are still very modest.

There are also non-bank financial institutions under the responsibility of PBOC and CBRC such as finance companies, leasing companies, trust and investment corporations, financial future companies, credit sponsoring companies, and debt resolution companies.

The Chinese banking system is quite large when compared to the Chinese economy. In 2005, total domestic credit was USD3 trillion (RMB24.8 trillion), 150% of GDP. The Chinese banking system is also big compared to the world: it is the fifth largest, after the United States, Japan, Germany, and the United Kingdom.

However, there is now considerable concern over the Chinese banking system's soundness. Since it is still dominated by SOCBs, and hence, the competition is quite low, Chinese banks have a relatively high interest margin of 1.79 percent, compared to 1.38 percent in Western European countries. Lack of competition also breeds inefficiency in operations. Loans account for 61 percent of total bank assets, with 85 percent of these loans going to firms. Within the business loan portfolio, although private firms are now generating more than a half of China's GDP, they receive only 27 percent of total credit - the remaining 73 percent is loaned to SOEs. Modern forms of lending such as mortgage loans and consumer finance comprise a very modest share of total lending, and other forms of bank investments are also a very small share of bank assets. In terms of liabilities, deposits and short-term raised capital constitute to 89.1 percent of total assets, while this figure is only 78.1 percent in Western European countries, reflecting a paucity of banking services now available for bank customers in China.

Since conventional market standards have not been widely applied, loans are of very bad quality, and the bad debt ratio is quite high. China uses the 2004 bad debt figure of USD480 billion, or 36 percent of GDP. However, Ernst & Young estimates the bad debt of the Chinese banking system to be as much as USD900 billion, or 40 percent of total loan balance and 55 percent of GDP, despite a withdrawal of its report in 2006. According to the official figure announced by CBRC, the total bad debt of the Chinese banking system (excluding what has been transferred to AMCs) was USD170 billion as of the third quarter of 2006, of which SOCBs accounted for USD132 billion. Whatever the actual number is, bad debts are certainly a very serious problem in the Chinese banking system.

Bank operations and profitability rely primarily on lending activities, which account for 80.8 percent of operating profit. Income from non-lending activities constitutes a very modest share of total bank income. In contrast, the proportion of net interest income and net non-interest income is 57-43 in Western European countries. Operational efficiency is also very low. In 2003, ROA and ROE were 0.14 and 3.05 percent respectively, while these figures were 1.43 and 13.57 percent for Western European banks. Despite the government's huge support and several rounds of recapitalization, the CAR is very low due to inefficiencies and a high bad debt ratio. At the end of 2003, the CAR was 6.73 percent, compared to 8 percent international standard and 12.35 percent Western European average. CARs of equitized banks, however, have been significantly improved.

Non-Bank Financial Institutions and Markets

Stock Markets

In Vietnam, HOSTC began operations with two listed companies on July 28, 2000. The VN-Index has frequently fluctuated since then to reflect changing and sometime volatile market conditions. After almost eight years (June 22, 2008), the VN-Index was at 368, reflecting an annual growth rate of 17.8 percent. Although this is quite high compared to other exchanges with similar conditions, it is less than 69 percent of its March 2007 peak of 1,171. By end of April 2008, there were about 300 listed companies on Vietnam's two bourses with a total capitalization of USD20 billion, equivalent to 28 percent of Vietnam's GDP. Like China, the role of stock market in Vietnam is growing, but it is still quite modest compared to the dominant role of banks. Although difficult to document, total OTC capitalization is estimated to be three to four times greater than the formal stock exchanges. Vietnam's stock market is also relatively illiquid, although the volume of transactions was growing rapidly until October 2007: the average daily turnover in August 2007 was USD51.5 million, six times greater than the 2006 figure of USD8.3 million. However, in the first half of 2008, during which time the government narrowed the trading band, the daily turnover has fallen to less than USD 10 million.

In China, the stock markets were created in early 1990 with establishment of two stock exchanges: the Shanghai Stock Exchange in 1990 and the Shenzhen Stock Exchange in 1991. There are two kinds of shares traded on these exchanges: A-shares in domestic currency that are bought by domestic investors and foreign investors who meet China's requirements as specified in the Qualified Foreign Instutional Investors regulation; and B-shares in foreign currency (US dollars in Shanghai and Hong Kong dollars in Shenzhen), only for foreign investors until 2001, but now open to domestic investors with legitimate foreign accounts. After almost seventeen years (June 22, 2008), the Shanghai composite – one of main indices, was at 2,760, reflecting an annual growth rate of 21.5 percent, quite high compared to other exchanges with similar conditions, but still less than 55 percent of its October 2007 peak of 6,092. As of June 1, 2007, market capitalization was 17.21 trillion yuan (USD2.25 trillion), 89.3% of China's GDP in 2006. Although the role of the securities market is growing in China, it is still quite modest compared to the role of banks.

A key characteristic of stock market transactions and trends in both Vietnam and China is that share prices and investor behavior are driven more by speculation than by the fundamental values of listed firms, as indicated by: extremely high turnover velocity with relatively low concentration; synchronous stock prices; and a high correlation between buy and sell trades. This is commonly attributed to weak protection of minority shareholders and poor market regulation and supervision, resulting in insider manipulation and trading.

Bond Markets

In Vietnam, at the end of 2007, outstanding bonds totaled USD9.79 billion, equivalent to 13.7 percent of GDP, of which government bonds accounted for USD8.28 billion, or 84.6 percent. The remaining debt securities consisted of education and infrastructure bonds, Ho Chi Minh City and Hanoi municipal bonds, DAF/VDB (Development Assistance Fund/Vietnam Developmen Bank) bonds, SOCB recapitalization bonds, BIDV bonds, Vietcombank convertible bonds, and other corporate bonds.

In China, also at the end of 2007, outstanding bonds totaled USD1.69 trillion, equivalent to about 50 percent of GDP, of which government bonds accounted for USD1.53 trillion, or 90.7 percent of all outstanding bonds.

In both Vietnam and China, the bond market is quite small compared to bank loans (especially in Vietnam), and in both countries, most bonds have been issued by the government. The liquidity of bond markets in both countries is very low, as most investors hold bonds until maturity given the lack of comparable alternative investment opportunities. In Vietnam, most long-term bonds (10 to 15 years), comprising roughly 40 percent of the total, are purchased by insurance companies; short-term bonds (mostly 5-year bonds) are purchased by SOCBs.

Insurance Markets

China started to open its insurance market in the 1980s, and Vietnam did the same in the 1990s. Since joining the WTO (China in 2001 and Vietnam in 2007), both countries have committed to opening their domestic insurance markets more to foreign participation. The insurance markets in Vietnam and China are quite small when compared with their potential, based on internal demographic and economic trends, as well as the size of insurance markets in other countries. So far, the total revenue in both life and non-life insurance is less than 2 percent of GDP in Vietnam and less than 3 percent of GDP in China. Insurance revenue per capita in Vietnam in 2007 was about USD13, one-third of China in 2006 and one-eight of Thailand and 1/131 of South Korea in 2005.

Microfinance

In Vietnam, microfinance is a mixture of formal, semi-formal, and informal activity. The government views microfinance as poverty alleviation rather than financial intermediation. It believes that it can best help the poor by income transfers via subsidized credit and savings programs, rather than by promoting sustainable financial services for low-income households and family businesses. Thus, the government tries to help poor people through special programs implemented by state-owned financial institutions and its credit fund system, comprised of semi-state controlled institution. NGOs (Non-Governmental Orgaisations) also play a significant role: according to the ILO, there are 57 international NGOs now supplying microfinance services, mostly credit, in Vietnam. Although NGO implemented microfinance is a fertile ground for experimentation and innovation, these initiatives are often not sustainable and they are difficult to scale-up for greater geographic coverage. A large part of microfinance consists of informal activity called *hụi* or *họ*; these are Vietnamese ROSCAs - Rotating Savings and Credit Associations for relatives, friends, and neighbors to pool and distribute their savings. ROSCAs were once illegal in Vietnam, but are now permitted. Although *hụi* or *họ* do help to mobilize savings, their function is as much social as financial, and they complement rather than substitute for formal financial services. 1,000 people's credit funds with about VND 10 trillion in loans outstanding have also had a role in supplying microfinance services (mostly loans) for the poor. In sum, Vietnam does not yet have a commercially-based model for the delivery of essential savings, credit, and payment services for most of its population, known elsewhere as the "unbanked majority." Thus, there remains considerable potential in Vietnam to develop a much more inclusionary financial sector.

In China, the situation is similar to Vietnam, being a mixture of formal, semi-formal, and informal activity. Most spending is done by the government as part of its poverty alleviation efforts, primarily channeled through state institutions. NGOs, working with the government and foreign donors, have also implemented many microfinance pilot projects. However, these pilots face the same problem as they do in Vietnam: how to sustain and replicate these models when donor and government funding runs out?. China has ROSCAs as well, also called *hui*, which function much like they do in other countries.

However, in China, *hui* have periodically been transformed from a grassroots mechanism to provide low-income households with a community-based source of savings and credit to pyramid investment schemes. A national network of rural financial institutions provides the foundation for the large-scale, and helps in sustainable provision of microfinance: the RCCs (Rural Credit Cooperatives). Reform of the RCCs is a high government priority, as indicated by the recent USD20 billion injection of recapitalization funds, together with efforts to consolidate RCCs at the county level and strengthen their ownership and governance structures. Although RCC micro-credit delivery has had the same problem at the local level as SOCBs have had at the national level, namely policy or political based lending to TVEs (Township and Village Enterprises), the RCCs have been very successful at savings mobilization. At the end of 2001, the RCCs had USD210 billion in savings, 12 percent of all financial institution deposits in China, and 80 percent of these savings came from rural households.

Bank versus Non-Bank Financial Institutions and Markets

In Vietnam, the securities market did not take off until 2006, and even then the USD14 billion total value of all listed companies plus an additional USD5 billion in government and corporate bonds accounted for only 20 percent of total financial assets and 30 percent of GDP. In China, the securities market was set up in the early 1990s, but by the end of 2005, the market value of all listed companies and outstanding bonds was only 20 percent of total financial assets and 40 percent of GDP. Moreover, the State held as much as two-thirds of total shares of listed companies, and these shares were almost never traded.

IV. Financial Sector Reform in Vietnam and China

a. Financial Sector Liberalization

Interest Rate Controls

In Vietnam, banking system liberalization in the late 1980s was quite extensive, as most "economic organizations" were allowed to raise capital from the public and lend these funds at self-determined loan terms and conditions. This dramatic break with the past was too successful, highlighting the dangers of financial liberalization with inadequate regulation and supervision. After a series of destabilizing disruptions, credit activities were severely tightened, and both loan and deposit rates were curbed. Since 1992, SBV has tried to tie nominal interest rates to the consumer price index in an attempt to secure positive real interest rates. Loan rate differentiation among various sectors was eliminated in 1993. Beginning in 1995, SBV allowed commercial banks to set deposit rates freely to increase competition in raising capital but the maximum loan-deposit rate spread was restricted to 0.35 percent per month, so indirectly, banks were still subject to both loan and deposit rate ceilings. When interest rate competition started increasing between banks, the restriction of 0.35 percent per month gradually became ineffective, and was finally formally removed. As banks became more commercialized in their operations, they began to focus more on meeting market demand rather than channeling directed credit. This created severe competition between banks and difficulties in finding bankable projects, putting a downward pressure on deposit and loan rates.

A new interest rate mechanism was adopted in August 2000: domestic currency loan rates were adjusted based on the prime rate announced by the SBV. Banking operations during this period were virtually unaffected by this new regulation on prime rate-based lending due to rigorous competition and the relatively large interest rate band. The ceilings on foreign currency loan rates were eliminated in November 2001, and the last restrictions on interest rates were removed in June 2002. Since then, at least according to the banking law and accompanying implementation regulations, banks have been fully free in deciding all loan and deposit rates. However, according the civil code, this is not correct, and interest rate ceilings are still in effect. The situation is made even more opaque because of the difference between "base rate" as defined in Vietnam banking laws.

In sum, despite significant improvements in interest rate policy management over the past two decades, implementation of interest rate liberalization decisions has often fallen well short of the stated objectives of these policy reforms because of the considerable confusion surrounding interest rates and interest rate liberalization in Vietnam. SBV undercuts its own interest rate liberalization policy through a combination of promulgation of its base rate, utilization of the above-cited civil code provisions, and an interest rate agreement with the Vietnam Bankers Association - an industry cartel in which the SOCBs still play a dominant role. This has been especially evident during the current surge of inflation.

The next steps in interest liberalization in Vietnam are to: gradually raise SBV's base rate to at least the inflation rate so that banks can offer a positive real interest rate to depositors and thus, offer a strong incentive to bring funds into the formal financial sector; and after bank oversight capacity has been enhanced enough to prevent destructive competition in funds mobilization, amend the civil code to remove the 150 percent of base rate ceiling.

<u>In China</u>, interest rates have gradually but steadily been liberalized over the past twelve years, but, like Vietnam, the process is not yet complete. Interest rates were first liberalized in the money and bond markets; this was followed by liberalization of lending rates; and finally, deposit rates were liberalized. However, deposit rates are still negative in real terms, offering a disincentive to deposit money in the banking system, and the spread for lending rates is still too small to cover the transaction costs of commercially sustainable microfinance. PBOC plans to remove the interest rate ceilings on RMB (Remimbi – Chinese currency) deposits and liberalize interest rates on small deposits of less than one year maturity in the future. In this context, PBOC has also introduced market-based monetary policy tools.

Credit Lines and Directed Credit

<u>In Vietnam</u>, extensive use was made of credit lines to manage monetary policy beginning in 1994, but the government notionally eliminated this practice in 1998. Nonetheless, SBV continues to set target credit growth rates for the banking system, of which the SOCBs comprise the largest share. In fact, directed credit and credit to SOEs have indeed been significantly reduced, falling from 90 percent of total credit in the early 1990s to 31.4 percent by March 2007. This suggests that commercial banks, including SOCBs, are now facing declining pressure to grant credit to the public sector. However, the story is

dramatically different if the loan balances of the policy banks, especially VDB, as well as the local investment funds and VBARD loans to farmers, are taken into account.

"Quarantining" directed credit outside of the mainstream banks helps to improve the market orientation and commercial performance of Vietnam's banking sector, thus reducing its vulnerability to systemic credit risk, but it also poses considerable opportunities for misallocation of capital and institutional corruption. These institutions are off-budget mechanisms to channel resources to public enterprises, with little transparency and minimum disclosure requirements; they are essentially political institutions masquerading as banks, beyond the purvue of SBV.

In China, SOCBs have had more autonomy and accountability in their lending decisions since the early 1990s. Credit quotas have been removed, and the government's intervention in credit allocation has been prohibited, at least formally. However, the fact that most of bank loan balances, especially for SOCBs, are on the balance sheets of SOEs suggests that directed credit seems to be pervasive in Chinese SOCBs *de facto*, in addition to special-purpose financial institutions conducting directed lending *de jure*. This remains is a big problem in reforming the banking system, especially the SOCBs in China, and can only be fully resolved as the SOEs themselves are commercialized, equitized, or liquidated. It appears that directed credit and credit to SOEs is more pervasive in China than in Vietnam.

Reserve Requirements

In Vietnam, required reserves have never been a source of budget revenue, because although the required reserve ratio may be as high as 35 percent, it has never been above 10 percent in practice. Instead, required reserves have been used solely as a tool to execute monetary policy. SBV has utilized the USD required reserve ratio in a similar manner. In China, treatment of required reserves is similar to Vietnam's, namely as a tool to execute monetary policy rather than as a way to finance budget deficits.

Foreign Exchange Policy and Exchange Rate Management

In Vietnam, both foreign exchange and the exchange rate are tightly controlled, although the fixed exchange rate regime has been replaced by a pegged float exchange rate regime. According to current laws, "the exchange rate of the Vietnamese currency is created by the demand for and the supply of foreign currencies in the market under the government's regulation." In practice, SBV announces the so-called inter-bank exchange rate of the VND against the USD every day. Based on this rate, banks decide their trading rates within a specified band around the announced rate. For other foreign currencies, banks are fully free to decide the exchange rates. If necessary, the government can "apply the regulations on the obligation to sell foreign currencies for institutional residents," as well as some other administrative measures. At present, the IMF considers that Vietnam has implemented Article 8 of IMF regulations on the capital account and exchange rate controls.

There have been several types of exchange rates during the reform process: the official rate announced by SBV, the rate at which commercial banks make transactions (nominal and effective), and the rate in the free market (black market). During the early years of reform the official and free market rate spread was very large, but the gap had closed significantly by the end of 2006. However, the spread has begun to widen again during the current financial crisis, as has the difference between the nominal and effective exchange rates of commercial banks when SBV's official trading band does not reflect market prices.

In China, the RMB was first issued just before the collapse of the Kuomintang regime in 1949 amidst a macroeconomic meltdown that accompanied the bloody political transition. Thus, one of the new Communist government's most urgent challenges was to tame hyperinflation. For the next three decades, during the era of China's command economy, the RMB was set to unrealistically high exchange values vis-à-vis foreign currencies, and thus, severe currency exchange regulations were promulgated to try to enforce adherence to a very overvalued RMB. When China began its transformation in 1978 to a more market oriented economy, it introduced a dual track currency system under which only the RMB could be used domestically and foreigners had to use foreign exchange certificates. This system, which continued to peg the RMB exchange rates at terribly overvalued levels, created ripe conditions for a thriving black market in currency transactions.

From the late 1980s to the mid 1990s, China made the RMB more convertible, abolished the dual track currency system, and brought the RMB down closer to market values through the use of swap centers. Through a series of "managed devaluations" the RMB-USD exchange rate gradually fell from 3.7 to 8.6 over a period of about five years. The RMB remained almost fixed at 8.27 per USD until July 2005. The RMB is now undergoing "managed appreciation"; it had risen 6 percent against the USD by the end of 2006, and the trend has continued through the first half of 2008, rising to 6.9 per USD.

Capital Flows Policy and Capital Account Management

As the last step of financial liberalization, and in the aftermath of the 1997-98 East Asian financial crisis, which was exacerbated at least in Thailand by opening the capital account too quickly, capital account liberalization has been the slowest component of financial sector reform in both Vietnam and China. Given the risks of mismanaged capital account liberalization, this is not necessarily a bad thing.

b. Financial Sector Deregulation

Barriers to Entry, Expansion, and Diversification

In Vietnam, shortly after the banking system began to operate formally as a two-tier banking system in 1990, the government began to gradually reduce administrative and legal barriers to entry, expansion, and diversification of its newly structured banking system. The market was slowly opened to both JSCBs and foreign banks; the latter were permitted to either open branches or establish joint ventures with domestic banks.

Opening up the Vietnamese banking system was a mixed success. Competition did increase dramatically, as the number of JSCBs grew from only 4 in 1991 to 51 in 1997. However, this rapid growth also created a bifurcated and imbalanced market in which most of the assets were concentrated among the SOCBs and the rest of the market was extremely fragmented and characterized by destructive competition among the JSCBs. This led to a market consolidation via bank restructuring and mergers, particularly during 1999-2001, so that by 2006 the number of JSCBs had fallen to 37. However, SBV recently has allowed the establishment of new banks.

Another more recent problem with expansion of Vietnam's banking system is the issuance of bank licenses to SOE conglomerates, as well as the acquisition of JSCBs by SOEs, which poses the same systemic risks that affiliated lending created in Japan, Korea, and Indonesia prior to their respective banking crises. This risk is heightened by SOE and SOCB ownership of non-bank financial institutions such as finance companies and leasing companies, and what is believed to be extensive but non-transparent cross-institutional shareholdings among SOEs, SOCBs, and affiliated financial entities. The risk of SOE diversification into the financial sector has been compounded by the desire of many of the banks themselves to diversify their operations by becoming universal banks.

So now Vietnam is both well banked and poorly banked. In terms of number of institutions and their retail distribution networks, the growth has been encouraging: there are now 80 banks and 924 credit cooperatives in Vietnam, and the SOCBs alone have over 3,000 offices around the country. In terms of market composition, though, the figures indicate there are still significant structural weaknesses in the competitive position of JSCBs vis-à-vis SOCBs: in 2006, the market share of SOCBs was still nearly 70 percent of total deposits and 65 percent of outstanding credit, while the top 15 banks in Vietnam together had 92.4 percent of market share by assets, excluding foreign bank branches. Furthermore, the majority of Vietnamese businesses and households still do not have access to formal financial services, as most of the banks in Vietnam are chasing the same small subset of formal businesses and relatively high-income urban consumers.

In China, the saga of falling barriers to entry, expansion, and diversification is similar to Vietnam's story, but beginning about a decade earlier. For most of the 1980s, the most significant development of China's financial system was the growth of non-SOCB financial intermediaries: regional banks, partially owned by local governments, were formed in the coastal SEZs (Special Economic Zones); RCCs were established in rural areas and UCCs in urban areas; other non-bank institutions were also established, such as Trust and Investment Corporations; and foreign banks set up branch offices in SEZs for currency exchange operations. All of these new financial intermediaries began to take deposits and make loans, which was healthy for enhancing market competition and was extremely successful in mobilizing savings. However, this also contributed to higher levels of inflation, and most of the credit was directed at either SOEs or TVEs, simply replacing financing via budget allocations with financing via the channeling of funds through the banking system. This off-budget financing mechanism, while attractive politically, not only undermined the soundness of China's financial intermediaries, but was also illusionary. When many of these loans were not repaid and the lenders became insolvent, the burden reverted to the budget in the form of allocations to recapitalize these financial intermediaries.

The inflationary pressures created by this rapid expansion led to a slowdown of financial reforms from 1988 to 1991, during which time the government also consolidated many of the new institutions, but financial sector deregulation resumed with the beginning of another economic boom in 1992. The results are similar to those of Vietnam: a relatively large number of financial institutions, some with extensive retail distribution networks, but a banking system still dominated by SOCBs and lending to SOEs.

Privatization/Equitization

Vietnam is just beginning its SOCB privatization program: the first and only IPO to date for VCB, was undertaken in December 2007, after many delays. Although the other four SOCBs (BIDV, ICB, VBARD, and MHB) still plan to go public, their IPOs have been postponed until 2009 at the earliest. Furthermore, VCB's IPO was disappointing because: the IPO was not preceded by collaboration with a strategic investor; and public confidence has fallen significantly since the IPO, reflected in more than 70 percent drop it VCB's share price.

In China, as a result of IPOs in 2005 and 2006, three of the "big four" SOCBs are already listed on the Hong Kong and Shanghai Securities Exchanges (BOC, CCB, and ICBC), and it is planning an IPO for ABC (Agriculture Bank of China) in 2008 or 2009, after it is recapitalized with a $100 billion injection of state money. The primary difference between China's three IPOs and Vietnam's IPO for VCB is that to date, China has adhered to the concept of two-stage equitization. China's SOCBs not only raised substantial sums of capital from their strategic investors, but these strategic investors also participated in SOCB governance and management, and provided many forms of technical assistance.

Participation of Foreign Financial Institutions

Vietnam has been gradually opening its financial sector to foreign institutions in accordance with the BTA it signed with the United States in 2000 (effective in 2001), and the terms of its WTO ascension in 2007. In response to Vietnam's opening up of its financial sector, there has been a stream of foreign investment in domestic JSCBs. Some of these have been very high-profile transactions, such as ANZ's purchase of 10 percent of Sacombank and Standard Chartered's purchase of 8.6 percent of Asia Commerce Bank – not only are these blue-chip investors, but they are buying stakes in two of Vietnam's largest and most profitable JSCBs. Recently there has been a heated debate on whether to increase the ceiling on foreign ownership in a domestic bank to 49 percent, but this issue has not yet been resolved. Given the relatively small size of Vietnamese banks and the Vietnamese economy compared to China, there is greater fear of the impact of foreign ownership on national sovereignty in Vietnam than in China.

In China, an important milestone of financial sector liberalization was WTO ascension in late 2001. According to its WTO commitments, China had a five-year timetable similar to the one Vietnam is now following. China has worked steadily to meet this objective, although progress has been slow given the complexity and sensitivity of foreign participation in China's domestic banking market. The process has been incremental and actually started more than two decades ago. The number of foreign bank branches indeed increased from 157 in 2001 (WTO accession) to 192 in 2004. Most of these bank offices are from Asian economies (Taiwan, Hong Kong, and Korea). The number of representative offices also increased, from 184 to 223. Although not part of its WTO commitments, China has also increased the single foreign investor ownership ceiling in a domestic bank from 15 to 20 percent, and the total foreign investors' ownership ceiling 25 percent. This is consistent with a common perception that China's banking system is in need of capital, as well as banking governance and management expertise. By October 2005, 17 foreign banks had bought shares in domestic banks totaling USD20.88 billion.

c. Financial Sector Stabilization

Restructuring

In Vietnam, the focus of most bank restructuring efforts has been on SOCBs in preparation for their IPOs. Responding to the relatively low level of SOCB efficiency and profitability, the government's efforts have focused on trying to improve governance and management systems, capital structure and asset quality, and effective application of banking technology. Significant progress has been made in reducing formal preferential lines of credit and officially directed credit as part of financial sector liberalization, but there is still considerable informal government interference in SOCB operations. There have also been some significant reforms of Vietnamese JSCBs, such as institutional consolidation and financial capacity enhancement during the late 1990s. One tangible result of these efforts is that the Sacombank and ACB JSBCs are officially listed in the securities market, and have two of the highest values of all listed firms. However, the process still has a long way to go, as evidenced by growing financial sector distress.

China has also focused most of its attention on restructuring its SOCBs to prepare them for their IPOs. Other significant reforms in China have been launched to address structural weaknesses in the financial sector, especially regarding the credit cooperative system. Those credit cooperatives that meet a series of conditions specified by the government are entitled to receive additional capital or tax incentives from PBOC or local governments. In addition, loss-making credit cooperatives might have to shut down. The objective is to reduce the 36,000 credit cooperatives in China in 2004 to only 10,000 credit cooperatives by 2007, mostly through consolidation at the county level. To date, the government has supported this consolidation effort by injecting USD40 billion into restructured credit cooperatives, coupled with improved ownership and governance practices. The key shortcoming of these reforms is lack of attention to the operational side of the credit cooperatives, particularly for credit services.

Bad Debt Resolution

In Vietnam, unlike China, which established independent, the four largest SOCBs established internal AMCs in 2000 as part of a national plan to restructure commercial banks. The charter capital of each AMC was VND30 billion, so the total charter capital of VND120 billion was only 0.5 percent of total commercial bank bad debt in late 2000. Because of the institutional affiliation of AMCs with their respective SOCBs, as well as the small amount of AMC charter capital, it is believed that the role of AMCs to date has not been significant, and that they have primarily served as debt workout departments within the SOCBs. However, no official data is available to corroborate this perception. In any case, to date, no bad debt has been transferred from banks to AMCs.

The internal status of AMCs in Vietnam also has significant accounting ramifications. In China, although AMCs are closely related to banks, they are formally independent, so banks write off debts transferred to AMCs. In Vietnam, however, bad debts transferred to AMCs still appear on the bank's consolidated balance sheet, negatively affecting many key performance indicators related to bank solvency and profitability. This, in turn, provides powerful incentives to under-report bad debts using techniques such as: rolling over non-performing loans with capitalization of unpaid interest (evergreening); restructuring non-viable loans with lower interest rates and longer repayment periods (rescheduling); and artificial inflation of loan disbursements that either never actually leave the bank but instead are transferred to the borrowers current account, or that quickly "round-trip" to the bank after the close of the reporting period (window dressing).

In addition to the four SOCB AMCs, Vietnam also established a DATC in 2003 with VND2 trillion in charter capital. DATC is a commercial enterprise with the long-term mandate to generate profits from the purchase and sale of bad SOE assets, unlike a conventional AMC.

In China, bad debts of banks have been resolved either by AMCs, or by the banks themselves, by liquidating collateral, converting debt into equity, and selling debt to investors, including foreign investors. Total SOCB bad debt received by AMCs was around USD323 billion. As of the end of March 2006, AMC had resolved USD111 billion in bad debt and collected USD23.1 billion; the recovery ratio was very small, only 24.2 percent. Data on resolution of USD153 in bad debt that was transferred recently is not yet available. The AMCs have been operating for almost ten years, which is their expected lifetime, but their performance has been very limited, and many have questioned the rationale and role of the Chinese AMCs.

In addition to the bad debts transferred to AMCs, Chinese SOCBs still have very large bad debts to be resolved on their own. The total bad debt of the "big four" SOCBs fell from USD232 billion in 2003 to USD140 billion in 2006, and the SOCBs themselves had resolved USD157 billion by the end of 2005. Detailed data is not available, but it is likely that debts have been resolved using the bad debt provision to write them off the SOCB balance sheets, which poses other problems for banks. It should be noted that NPLs in China are widely believed to be significantly underreported.

By the end of August 2004, Chinese banks and AMCs had sold debt with a face value of about USD6 billion to foreign investors, of which Citigroup took the highest proportion at a purchase price of almost USD2.2 billion. This figure is a small proportion of the total bad debt of Chinese domestic banks, but it is significant for a single foreign bank, perhaps part of a strategy to increase their market share in China.

Recapitalization

In Vietnam, the SOCBs received almost no official capital from the government in the 1990s. The government's main SOCB activity during this period was restructuring bank operations and separating directed credit from commercial activities via establishment of VBSP and VDB. From 2001 to 2005, the government granted approximately VND15 trillion in charter capital to the SOCBs to strengthen the financial structure of these banks. Most of this additional charter capital was granted in the form of non-transferable government bonds at an annual coupon rate of 3 percent. If bad debt resolution is taken into account, the amount granted to SOCBs is about USD2 billion, or 4 percent of 2005 GDP, much smaller than in China.

In China, the first wave of SOCB restructuring began in 1998 when the government poured USD33 billion into the big four SOCBs in the form of non-transferable RMB-dominated bonds. One year later, USD170 billion in bad debt was transferred to four AMCs.

The second wave started in 2003 as another USD45 billion was granted to BOC and CCB, the two SOCBs that had best resolved their bad debt. This amount was granted in the form of ownership transfer of US government bonds from the national foreign exchange reserves to these banks. Just like the above-mentioned non-transferable bonds, the banks were not allowed to convert these bonds into RMB for a specified time period. However, bank capitalization increased, since the bad debt provision was used to write off bad debt worth USD23.4 billion. In June 2004, BOC received USD18.1 billion and CCB received USD15.6 billion from selling to AMCs bad debt whose face value was double the proceedings. In addition, BOC and CCB increased tier-2 capital through issuing subordinate debt worth USD7.8 billion and USD4.8 billion, respectively. The last steps of this second wave were the IPOs of CCB and BOC, who were listed on the Hong Kong Securities Exchange in late 2005 and June 2006, respectively.

The third wave started in April 2005, when the government granted USD15 billion to ICBC in the same form as funds it had granted earlier BOC and CCB. The process of restructuring ICBC went on until June 2005, when the bank was allowed to transfer USD85.5 billion in bad debt to an AMC, as well as issue USD12.1 billion in subordinate debt. In October 2006, ICBC held its IPO and achieved resounding success, like CCB and BOC previously. The largest bank still in difficulty is ABC; the government will spend USD100 billion to strengthen the bank's financial condition before ABC's IPO in 2008.

Thus, China has spent more than USD200 billion, or 10 percent of 2005 GDP, over almost 10 years to clean up the SOCB balance sheets. If the amount transferred to AMCs is taken into account, the spending totals almost USD500 billion, or half of China's foreign exchange reserves as of late 2006.

Regulation and Supervision

In Vietnam, although promulgation and enforcement of regulations based on international standards has been very difficult to achieve and much work still remains in bringing Vietnam's regulatory and supervisory system up to international banking norms, considerable progress has been made nonetheless in construction of an effective legal framework for banking operations. At present, while the legal framework for bank operations has been considerably strengthened, two key problems remain: weak SBV technical capacity to determine the true soundness of banks, in terms of both individual bank weaknesses and vulnerabilities, as well as the systemic risk of banks collectively;

and lack of SBV independence to intervene in bank operations to mitigate shortcomings that it is able to detect. To address these problems, Vietnam plans to transfer bank oversight responsibilities from SBV to a separate bank supervisory agency, similar to the model adopted by China, as the next step in improving both the legal and operational framework for Vietnam's banking system.

In China, the first step to reform the soft infrastructure of its banking system was taken in 1984, when the two-tier banking system was established. In 1995, several more significant steps were taken: the central bank's position was elevated as it was granted greater authority; and regulations on capital adequacy, financial safety ratios, and the structure of liquid loans were applied to all commercial banks. Furthermore, in 2002, PBOC adopted the internationally-applied five-group loan classification system, codified by Chinese legislators in 2003. However, this regulation was not strictly enforced because PBOC had no viable sanctions to impose on violators of the law. Fortunately, there have been many regulatory improvements since CBRC was established in 2003. These improvements are reflected in newly adopted asset quality, capital adequacy, and supervisory standards.

V. Conclusions and Recommendations

a. Synthesis of Similarities and Differences Between Vietnam and China

Three important conclusions can be drawn from the preceding comparison of the Vietnamese and Chinese banking systems. First, the structure, development, and reform sequence of Vietnamese and Chinese banking system reform are basically quite similar, and both countries have made significant progress in their reform programs. Second, the reform process is far from over. Third, a closer look at financial sector reforms in Vietnam and China reveals key differences in the progress to date in each country.

There are many reform similarities. For *financial sector liberalization*, they include: partial interest rate liberalization to more closely reflect market prices; transfer of the bulk of directed credit from commercial banks to special policy-based banks and increase in the lending discretion of SOCBs; no use of reserve requirements as a budget financing tool; and more flexible and market-influenced foreign exchange policies and the prudent incremental opening of capital accounts. For *financial sector deregulation*, they include: reduced barriers to entry, expansion, and diversification to promote competition; greater participation of the private sector through the equitization of SOCBs and establishment of JSCBs; greater participation of foreign financial institutions in domestic banking; and growth of financial sector institutions, products, and retail networks. For *financial sector stabilization*, they include: substantial bank restructuring, focused on the SOCBs in preparation for their IPOs and on JSCB consolidation in the aftermath of overexpansion; modest resolution of bad debt; stronger financial structures through periodic bank recapitalization; and enhancement of financial sector regulation and supervision capacity.

Much remains to be done in both Vietnam and China. For *financial sector liberalization*, this includes: complete interest rate liberalization to accurately reflect market prices; elimination of directed credit and preferential credit lines; use of reserve requirements solely to strengthen the soundness of banks rather than to conduct monetary policy; and market-based foreign exchange policies and the further incremental opening of capital accounts. For *financial sector deregulation*, this includes: further reduction of barriers to entry, expansion, and diversification to promote more competition; increased participation of the private sector through further equitization of SOCBs and equal regulatory treatment of JSCBs; increased participation of foreign financial institutions in domestic banking through a lifting of foreign investment restrictions; and further growth of financial sector institutions, products, and retail networks, especially for low income households and family businesses, as well as in the provision of non-bank financial intermediation. For *financial sector stabilization*, this includes: more bank restructuring, still focusing on the SOCBs as they are further equitized and on another round of JSCB consolidation; more effective resolution of bad debt; additional bank recapitalization as necessary to meet Basel standards; and further enhancement of financial sector regulation and supervision capacity of financial and capital markets, especially regarding affiliations between SOEs and both bank and non-bank financial institutions, and protection of minority shareholders and small-scale investors.

Despite many similarities, there are also key differences between financial sector reform in Vietnam and China. Vietnam has performed relatively better than China in the following areas: faster liberalization of interest rates; less dependency on the use of bank reserve requirements to implement monetary policy; smaller ratio of directed credit to total bank credit, and a smaller ratio of SOE assets to total bank assets; more flexible exchange rate management and a more open capital account; greater market participation of both foreign banks and JSCBs; and less costly SOCB restructuring. In contrast, China has performed relatively better than Vietnam in the following areas: enhancement of regulatory and supervisory capacity, including central bank reform and creation of a separate banking supervisory agency; equitization of SOCBs; and overall financial sector growth and diversification.

In many ways, Vietnam's quicker movement to more market-based policies while at the same time making little progress on improving the legal framework and implementation capacity for effective financial sector regulation and supervision is very risky, as it creates substantial monetary and financial system vulnerabilities. Policy makers in Vietnam need only to recall the credit cooperative crisis in the late 1990s to appreciate the risks of financial sector reform that is too hasty and not well sequenced. Nonetheless, Vietnam can continue to reform its financial sector faster and at a relatively lower cost than China if it does so prudently, mainly because the size of Vietnam's financial sector in general, and the banking system in particular, is much smaller than China's in both absolute terms and in relative terms when compared with the size of the economy.

As Vietnam and China continue to pursue their respective financial sector reform programs, especially to fulfill their WTO commitments, regardless of the pace and sequencing of reform, they must both address a series of daunting challenges, including: inherent weakness of SOCB domination; general banking system instability and fragility; and the threat of being taken over by foreign financial institutions.

b. Policy Recommendations for Further Financial Sector Reform in Vietnam

Reform must continue in all three domains of financial sector liberalization, deregulation, and stabilization. However, to accelerate the speed of reform while at the same time redress current reform imbalances, the government's priorities should be in reverse order. Further financial sector liberalization without adequate capacity to regulate and supervise a market-based financial sector is a recipe for disaster similar to the problems faced by Thailand and Indonesia a decade ago during the East Asian financial crisis.

Priorities of further financial sector reform in Vietnam should be, in descending order of importance:

1) *Establishment of a strong banking supervisory agency with effective monitoring tools to secure the stability and sustainability of the banking system.*

   This entails reform of SBV, including consolidation from provincial to regional branches, establishment of a new agency for banking oversight, and adoption of appropriate financial sector regulations and effective off-site and on-site monitoring tools. The government should also bring its policy banks, especially VDB, as well as its many quasi-bank financial institutions now run by sectoral ministries and local governments, under the formal bank regulation and supervision apparatus.

2) *Promotion of domestic bank restructuring, especially SOCBs, to create strong, competitive banks that can serve as true financial intermediaries.*

   This should focus on commercialization and two-step equitization of SOCBs, reduction of the substantial bad debt overhang now preventing the banking system from reaching a new equilibrium, recapitalization of insolvent banks to maintain confidence in the banking system, and consolidation of JSCBs.

3) *Development of institutions, products, and delivery systems to provide formal financial services to Vietnam's low-income households and family businesses.*

   The government's highest priority to improve the quantity, quality, and accessibility of formal financial services in Vietnam should be promotion of nationwide, sustainable microfinance. Most families and businesses in Vietnam still do not have access to basic financial services such as savings, credit, and payment facilities, despite Vietnam's rapid economic growth over the past two decades – this "unbanked majority" needs to be provided these financial services if its full potential is to be realized. Most microfinance efforts to date are either government and donor-sponsored poverty alleviation initiatives, or NGO-based pilot projects that are difficult to replicate nationwide; the government should try to adapt successful microfinance models, such as Bank Rakyat Indonesia, to Vietnam.

4) *Prudent liberalization, in keeping with capacity to identify and mitigate the risks of a market-based financial sector.*

   The most important next step for financial sector liberalization in Vietnam is complete elimination of interest rate caps and directed credit, so that savings and lending rates accurately reflect the market price of capital, and thus, formal financial institutions can effectively mobilize funds from the public and then allocate this capital to the highest return investments. However, the government should proceed with capital account liberalization, the last step of the financial liberalization process, with great caution. Free capital inflows and outflows create significant risks when market institutions have not been fully established.

CHAPTER ONE:

INTRODUCTION

I. Study Objectives

Although there is considerable debate among economists as to the impact of financial sector development on economic growth, empirical evidence indicates a strong, direct link between the two. A recent comprehensive review of both the theory and research on this link between financial sector policies and economic development had a clear and unambiguous conclusion on the causal relationship between the two:

> A growing body of empirical research produces a remarkably consistent narrative: The services provided by the financial system exert a first-order impact on long-run economic growth. Building on work by Bagehot (1873), Schumpeter (1912), Gurley and Shaw (1955), Goldsmith (1969), and McKinnon (1973), recent research has employed different econometric methodologies and data sets in producing three core results. First, countries with better-developed financial systems tend to grow faster. Specifically, countries with (i) large, privately-owned banks that funnel credit to private enterprises and (ii) liquid stock exchanges tend to grow faster than countries with corresponding lower levels of financial development. The level of banking development and stock market liquidity each exerts an independent, positive influence on economic growth. Second, simultaneity bias does not seem to be the cause of this result. Third, better-functioning financial systems ease the external financing constraints that impede firm and industrial expansion. Thus, one channel through which financial development matters for growth is by easing the ability of financially constrained firms to access external capital and expand.[3]

This rationale might seem a bit puzzling in the context of Vietnam's remarkable economic performance over the past two decades, with an average annual GDP growth rate of 7.2 percent, a four-fold increase in GDP, and a decline in poverty levels from three-quarters to one-fourth of the population.[4]

However, this performance could have been even better with a more efficient allocation of capital, for example, achieving GDP growth rates more in the range of China's 9 to 10 percent per year - 2 percent of GDP per year is a high price to pay for low-return investments.[5] Vietnam's extremely high Incremental Capital Output Ratio (ICOR), rising from 3 to 5 since the early 1990s, well above the ICOR for high-growth economies (see Table 1 below), provides further cause for alarm in the current allocation of capital.

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[3] Asli Demirgüç-Kunt and Ross Levine, *Finance, Financial Sector Policies, and Long-Run Growth*, Policy Research Working Paper 4469 (Washington, D.C.: World Bank, January 2008), p. 2.
[4] Huỳnh Thế Du, *Vietnam's Banking Reform: A Comparative Study With China's Banking Reform*, Master's Thesis, Economics University of Ho Chi Minh City, 2007, p. 1.
[5] David Dapice interview; see: http://www1.dantri.com.vn/kinhdoanh/2006/6/123916.vip.

Table 1: ICOR for Selected Asian Countries

Country	Investment (% GDP)	GDP growth (%)	ICOR
Vietnam ('00-'06)	38.3	7.5	5.1
China ('91-'03)	39.1	9.5	4.1
Japan ('61-'70)	32.6	10.2	3.2
Korea ('81-90)	29.6	9.2	3.2
Taiwan ('81-90)	21.9	8.0	2.7

Source: Based on countries' statistics and the author's calculations.

While there are many reasons for inefficient capital allocation and poor investments, a weak financing system dominated by relatively uncompetitive state-owned commercial banks (SOCBs) has certainly contributed to growth rates well below Vietnam's potential. The need to address the shortcomings of Vietnam's financial sector is especially time-sensitive in light of the time frame for Vietnam's commitment to open this sector to foreign competition as a condition of its WTO accession.

Given the importance of financial sector development for sustained economic growth, both in general and in the specific context of Vietnam's own performance since embarking on *Đổi Mới* economic reforms twenty years ago, the objective of this study is to contribute to Vietnam's future growth prospects by:

- analyzing the development of the financial sectors in Vietnam and China within the framework of financial sector reform to understand progress to date and future challenges in each country;

- comparing and contrasting financial sector reform strategies and performance in both Vietnam and China to highlight similarities and differences between the two countries; and

- formulating policy recommendations for further financial sector reform in Vietnam.

II. Study Methodology

Drawing on the literature on financial development, the authors develop a conceptual framework with which to analyze financial sector reform in Vietnam and China, focusing on the three key dimensions of reform: Financial sector liberalization, financial sector deregulation and financial sector stabilization.

The authors then apply this conceptual framework to a comparative review of financial sector development in Vietnam and China, relying on secondary sources for most descriptive data and on interviews for both supplementary data and for assistance in interpreting this information.

The same conceptual framework is used to formulate suggestions for future financial sector reform in Vietnam, linking the authors' policy analysis to their policy recommendations.

III. Study Limitations

The topic of this paper is extremely sensitive, which the authors consider a good indication of its importance and relevance. But this sensitivity also makes the subject quite difficult to research and analyze. Many financial institutions consider their data proprietary, and are thus reluctant to share information with external parties for fear of breaching client confidentiality, exposing internal weaknesses to customers and regulators, and giving away trade secrets to competitors. From their perspective, there is no obvious direct benefit to sharing financial data with outsiders, only tremendous potential risk. Financial sector policy makers and supervisors share this reluctance to share information for fear of exposing their institutional shortcomings and national vulnerabilities.

In spite of these constraints, the authors have done their best to collect as much relevant data as necessary to understand financial sector policies and practices in Vietnam and China, and have taken great care to present these data as fairly as possible.

Nonetheless, there are still significant data gaps, which when filled, could alter some of the authors' findings and recommendations; these gaps are duly noted as they appear in the text. The authors also suggest topics meriting further research and analysis in their policy recommendations at the end of this paper.

It should also be noted that although this paper provides a comprehensive assessment of financial sector reform, comprising both bank and non-bank institutions as well as both financial markets and capital markets, the focus is on banking systems given their dominant role in the economies of Vietnam and China.

The reader should also keep in mind that cross-country comparisons are often misinterpreted as proposals for replicating practices in one nation that might be inappropriate in another country, due to different historical and economic contexts and dissimilar political, social, and institutional environments. Thus, similarities and differences between Vietnam and China should be viewed not as "best and worse practices," but rather, as a source for discussion and reflection in the hope that experiences elsewhere might help us to better understand our own situation, as well as provide us with ideas that might be adapted to our own requirements and capabilities.

CHAPTER TWO:

CONCEPTUAL FRAMEWORK FOR ASSESSING FINANCIAL SECTOR REFORM IN VIETNAM AND CHINA

As noted in the "Study Methodology" section of Chapter One, this paper eschews the traditional approach to a cross-country study. Rather than analyze financial sector reform in Vietnam and China sequentially, with a chapter devoted to describing reform in each country followed by a chapter comparing and contrasting reform in the two countries, this paper is constructed thematically. Vietnam and China are examined in parallel through a prism that distills the three key dimensions of financial sector reform, as follows:

A. financial sector liberalization;

B. financial sector deregulation; and

C. financial sector stabilization.

This structure highlights the respective policy responses of two different countries to fundamentally similar policy challenges in similar historical contexts, and enables a comparison and contrasting of implementation results in environments characterized by similar implementation constraints. This structure also facilitates a tighter linkage between the authors' policy analysis and their subsequent policy recommendations.

Financial sector liberalization describes moving from administration-based to market-based financial systems. When applied to banking systems, this means that instead of administratively-dictated interest rates and credit allocation, prices are used to determine the value of funds and return on capital is used to allocate these funds. It also entails the use of reserve requirements to enhance the soundness of depository institutions rather than as a fiscal tool to tax capital or finance budget deficits, or as a monetary tool to control money supply in lieu of open market operations. When applied more broadly to financial systems, it refers to market-determined foreign exchange rates and open capital accounts.

Financial sector deregulation describes moving from a closed to a competitive financial system. When applied to banking systems, this means transitioning from a banking monopoly or oligopoly where legal or administrative barriers limit competition for market entry, expansion, and diversification to an open and competitive banking system where market performance rather than preferential treatment determines market share and bank profitability. This entails creation of "a level playing field" for privately owned banks to compete with public sector banks, as well as for foreign banks to compete with domestic banks. In the broader context of entire financial systems, it refers to application of the same principles to non-bank financial institutions as well as to capital markets.

Financial sector stabilization describes ensuring the long-term soundness of a nation's financial system. Most often, this means restoring liquidity and solvency to the banking system after a banking crisis by resolving bad debt overhang and if necessary, subsequent bank recapitalization, together with improvement of bank regulation and supervision capacity to maintain the future safety and health of banks. When applied more broadly to financial systems, it entails mitigation of market failures in the financial sector like asymmetries of information and incomplete markets to address potentially destabilizing behavior such as adverse selection, moral hazard, and fraud.

CHAPTER THREE:

FINANCIAL SECTOR OVERVIEW IN VIETNAM AND CHINA

I. Establishment and Structure of the Formal Financial Sector

a. Vietnam[6]

The State Bank of Vietnam (SBV) was established on 6 May 1951, after the National Day and before Northern Liberation (1954). At that time, it was called Vietnam National Bank and acted as a monobank, whereby it played the role of both a central bank (issuing money) and a commercial bank (raising and lending funds).

The State also owned and controlled directly two specialized banks, commonly referred to as SOCBs (state-owned commercial banks). The Bank for Investment and Development of Vietnam (BIDV) was founded in 1957 under the initial name of Bank for Reconstruction of Vietnam to provide long-term capital to infrastructure projects and public works. It was renamed Bank for Investment and Construction of Vietnam in 1981, and has been operating under its current name (BIDV) since 1990; And the Bank for Foreign Trade of Vietnam (Vietcombank, or VCB) was established in 1963 to finance foreign trade activities, manage foreign exchange, and support state-owned enterprises (SOEs).

Under the mono-banking model, Vietnam's banking system served as a vehicle for implementation of government policies by providing fiscal resources to the State and funding for SOEs. The key development financing instrument was directed credit at highly subsidized interest rates.

The shortcomings of this approach became evident during the 1980s, as SBV could control neither money supply nor credit quality. This resulted in high inflation, negative real interest rates so low that they were less than deposit rates, and substantial non-performing loans (NPLs), leaving Vietnam with acute vulnerability to both a banking crisis and macroeconomic instability.

Thus, in 1988, Vietnam launched the first major reform of its financial sector by:

- transferring SBV's fiscal management function to the newly created State Treasury;
- transferring SBV's commercial banking function to the SOCBs;
- establishing two more SOCBs, Vietnam Bank of Agriculture and Rural Development (VBARD), and Industrial and Commercial Bank of Vietnam (ICB), to provide financing to their respective economic sectors; and

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[6] This section draws heavily on: Nguyễn Xuân Thành, *Vietnam: The Road to Interest Rate Liberalization, FETP Case Study]*, March 2003; see: http://www.fetp.edu.vn/index.cfm?rframe=/research_casestudy/facresearchlist.htm.

- allowing all economic organizations, including private entities, to borrow and raise money from the public, precipitating a Credit Cooperatives and Credit Funds crisis in 1990, together with a more general loss of public confidence in the nation's banking system.[7]

This effectively shifted Vietnam from a mono-banking system to a two-tier banking system, whereby the central bank's functions are restricted to monetary policy (issuing money and controlling inflation) and oversight of commercial banks (regulation and supervision of banking operations), and financial intermediation (funds mobilization and allocation) is shifted to commercial banks, together with transfer and payment services.

However, the SOCBs were not market-based commercial banks: both their lending and deposit rates were set by SBV; lending rate differentials were determined by relative investment priority (economic sector) and loan use (working capital or fixed asset investment) rather than relative loan risk; loan eligibility criteria reflected government policy preferences rather than market potential; and savings rates were based on type of depositor (household or business) and currency (VND or foreign) instead of market prices and a bank's liquidity needs.

Three points are worth noting regarding the period from 1986 to 1988:

- This was a very unstable period. As the government printed money to finance its budget deficit, hyperinflation surged up to triple-digit rates.

- The financial liberalization initiatives were conducted without reform of SOEs, manufacturing, or trade. Only the agriculture sector had been liberalized, and prices of many goods were seriously distorted.

- Liberalization went so far that all economic organizations were allowed to trade currency, without any financial monitoring system. Organizations that raised capital in the form of deposits and then loaned these funds out were not required to follow the traditional banking regulations such as required reserves or standard capital adequacy ratios.

However, the Vietnamese banking system did not begin to operate formally as a two-tier banking system until two years later, when the Vietnam State Council promulgated the banking ordinances of 1990. At this time, due to their collapse, credit cooperatives were renamed people's credit funds.[8]

Other key developments in the evolution of Vietnam's banking system are:

- Since 1990, joint stock commercial banks (JSCBs) have been permitted and foreign banks have been allowed to enter the market via the opening of branches or establishment of joint ventures with domestic banks.

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[7] See: http://www.sbv.gov.vn/home/gioithieu.asp.
[8] Thomas Dufhues, *Transformation of the Financial System in Vietnam and its Implications for the Rural Financial Market – an update*, 2003, p.31; see: http://www.gov.si/zmar/apublic/jiidt/jiidt03/4dufhues.pdf.

- Three policy banks have been established, namely: Vietnam Bank for the Poor in 1995 (renamed Vietnam Bank for Social Policy, or VBSP in 2002); Development Assistance Fund (DAF) in 1999 (first called the Development Investment Office until separated from BIDV in 1993 and re-named the National Investment Assistance Fund – it was later restructured as the Vietnam Development Bank, or VDB, in 2006); and the Vietnam Postal Savings Service Company (VPSC), a subsidiary of Vietnam Post and Telecommunications Corporation, in 1999.

- Another SOCB, Mekong Housing Bank (MHB) was established in 1997 with the initial function as reflected in its name, but it has since become a pure commercial bank, probably due to failures in the Mekong Delta housing development programs.[9]

- Relations with international financial institutions (IMF, World Bank, and ADB) were normalized in 1993.

- The Law on the State Bank of Vietnam 1997 confirmed the role of SBV as the central bank.

- Vietnam Deposit Insurance was established in 1999.

- During the course of bad debt resolution and SOCB restructuring in 2000, four asset management companies (AMCs) were established as wholly-owned subsidiaries of the SOCBs, with the charter capital of only VND30 billion each to resolve bad debt for each SOCB. This figure did not match with the huge debts of more than VND21 trillion at the end of 2000.

- This same model was followed as other AMCs were established under JSCBs, with the charter capital of only VND3 billion.

- In addition to these AMCs, the Debt and Asset Trading Corporation (DATC) was established in 2003 as a commercial enterprise with the mandate to generate profits from the purchase and sale of bad SOE assets.

- The State Capital Investment Corporation (SCIC) was established in 2005 to manage State capital in all but the 19 largest SOEs.

- Vietnam has continued to gradually open its financial sector to foreign institutions by signing a bilateral trade agreement with the United States in 2001 and joining the WTO in 2007.

At present, Vietnam is planning to equitize its SOCBs in a manner similar to China's equitization program (see next section). However, the process has been relatively slow to date. Only VCB has had an IPO (December 2007); the other four SOCBs (BIDV, ICB, VBARD, and MHB) hope to go public by the end of 2009. In addition, unlike China, VCB had its IPO without first finding a strategic investor, so although the sale went

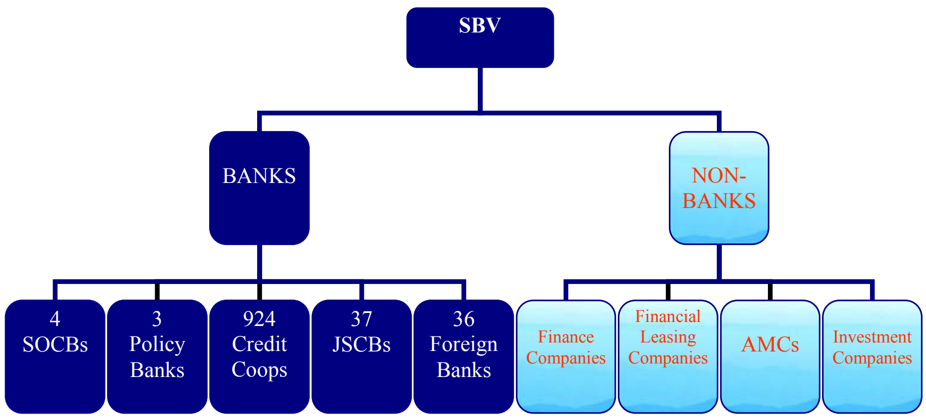
[9] See: http://www.mhb.com.vn/?p=gioi_thieu_mhb.asp&r=0, 28/12/2006.

reasonably well, public confidence in VCB has fallen sharply since the IPO, as indicated by a roughly 70 percent drop in its share price.

To foster capital markets development, the State Securities Commission (SSC) was established in 1995, followed by creation of the Ho Chi Minh City Securities Trading Center (HOSTC) in 2000 (which became the Ho Chi Minh City Stock Exchange in 2007) and the Hanoi Securities Trading Center (HASTC) in 2005.

Figure 1 below depicts the organizational structure of Vietnamese banks.

Figure 1: Organizational Structure of Vietnamese Banks



b. China

The People's Bank of China (PBOC) was established on 1 December 1948 (before China's National Day) as a merger of Bei Hai Bank, Hua Bei Bank, and Xi Bei Farmers Bank. PBOC was under the Ministry of Finance, and like SBV in Vietnam, operated as a monobank.

Shortly thereafter, three specialized banks were created to serve the function of financing the economy:

- In 1949, nationalization of Bank of China (BOC), which was first established in 1912;
- In 1949, establishment of Agriculture Bank of China (ABC); and
- In 1954, establishment of People's Construction Bank of China, which was renamed China Construction Bank (CCB) in 1996.[10]

[10] See: http://www.pbc.gov.cn/english/renhangjianjie/history.asp and http://en.wikipedia.org/wiki/People's_Bank_of_China , 26/12/2006.

China also issued a new currency in 1951, called the remimbi or yuan.

One of the reforms launched by Deng Xiaoping in 1978 as part of his plan to transform China from a centrally planned economy to a "socialist market economy" was the Chinese State Council's decision that PBOC should become the country's central bank in September 1983. BOC and ABC were also made SOCBs in 1979. These two key decisions formally converted China to a two-tier banking system.

In addition, another bank, Industrial and Commercial Bank of China (ICBC), was founded in 1984 to join the other three specialized banks listed above – these four banks are now the largest commercial banks in China. At that time, these banks were responsible for financing their assigned economic sectors, working closely with PBOC. Regional banks and JSCBs were also established, and foreign banks were allowed to participate in the form of joint ventures, branches, or 100% foreign-invested banks.[11]

In 1994, three policy banks were established to separate directed credit from trade credit, namely China Development Bank, China Export-Import Bank, and China Agriculture Development Bank. The following year, China's National Assembly passed two key statutes as the next steps in financial sector development: the Law on the People's Bank of China confirmed the role of PBOC as the central bank, and the Law on Commercial Banks formally designated the "big four" SOCBs as commercial banks, and separated banking, securities, and insurance activities.

As part of capital markets development, the Shanghai and Shenzhen Securities Exchanges were established in 1990 and 1991, respectively, and the China Securities Regulatory Commission (CSRC) was established in 1992. The China Insurance Regulatory Commission (CIRC) was established in 1998.

Also in 1998, PBOC was restructured, consolidating its provincial branches into nine regional offices.[12]

In 1999, four AMCs were established (China Xinda, China Oriental, China Great Wall, and China Huarong) with $20 billion funded by the Chinese government to resolve $169 billion in bad debts of the "big four" SOCBs, under the joint management of the Ministry of Finance and PBOC.[13] These were separate institutions from the SOCBs, unlike the AMC model in Vietnam whereby the AMCs were still part of the SOCBs (see previous section).

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[11] James R. Barth, Rob Koepp, and Zhongfei Zhou, *Banking Reform in China: Catalyzing the Nation's Financial Future*, Milken Institute Working Paper, 2004, p. 6; and Christian Roland, *Banking Sector Reform in India and China – A Comparative Perspective*, p. 13. See: http://unpan1.un.org/intradoc/groups/public/documents/APCITY/UNPAN024226.pdf, 26/12/2006.

[12] Laurence J Brahm, *Zhu Rongji and the Transformation of Modern China* (John Wiley & Sons (Asia) Pte. Ltd.: Singapore, 2002), p. 178.

[13] A. García-Herrero and D. Santabárbara, *Where is the Chinese Banking System Going with the Ongoing Reform?*, CESifo Economic Studies, 2004, p. 10 at: http://ideas.repec.org/p/wpa/wuwpma/0408001.html; and J. Bartel and Y. Huang, *Dealing with the Bad Loans of the Chinese Banks*, 2000, p.4, at: www.columbia.edu/cu/business/apec/publications/boninhuang.pdf.

In the first meeting of the tenth National Assembly in 2003, China decided to establish the China Banking Regulatory Commission (CBRC) to separate the regulation and supervision function from PBOC. The establishment of CBRC has helped PBOC focus more on the function of monetary policy execution.[14]

During the course of restructuring the banking system, especially the SOCBs, BOC and CCB were transformed into single-member limited liability companies under the State Capital Investment Corporation of Huijin in August 2004. In October 2005, CCB went public and conducted an IPO on the Hong Kong Securities Exchange, followed by BOC in June 2006, and finally ICBC in October 2006. These three banks have been listed on the Hong Kong and Shanghai Securities Exchanges up to now. As planned, the Chinese government is going to spend about $100 billion to strengthen the financial condition of ABC before it goes public in 2008 or 2009.

An important subject in the development of China's banking system is credit cooperatives. Numbering approximately 60,000 at their peak, both rural and urban cooperatives have become an integral part of China's banking system. They now play a critical role, as well as create significant vulnerabilities in the Chinese banking system.[15] Reforming credit cooperatives, especially the rural ones (RCCs), is considered a high priority of the Chinese central government over the next five years, beginning with a reform of ownership and governance structures and an injection of $20 billion in recapitalization funds.[16]

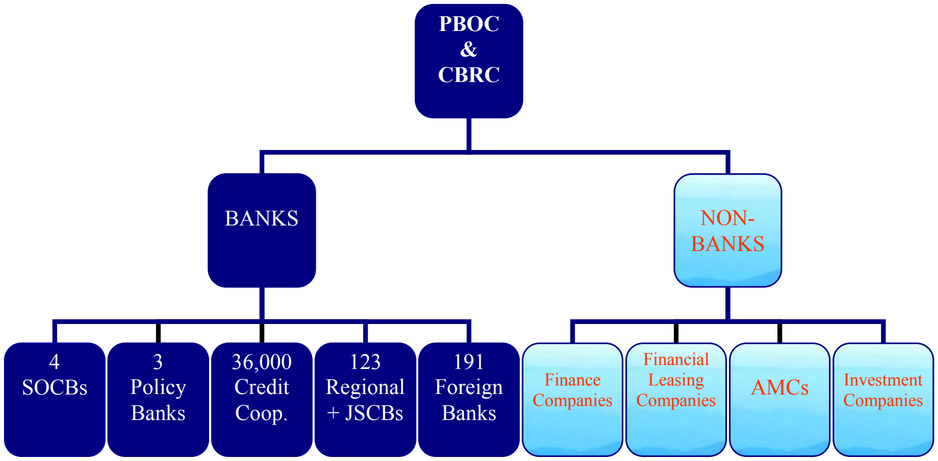
During economic reform and fiscal decentralization, the regional banks, most of which are owned by local governments, have been established; their primary role has been to act as "sponsors" of local development schemes. This is one of the greatest concerns of China's banking officials, since many regional banks are unsound. Hence, they are also a focus of the plan to reform the banking system.

Regarding China's interactions with the international financial community, it: rejoined the IMF and the World Bank in 1980; and joined the WTO in 2001, agreeing to incrementally open its financial sector to international institutions within five years.

Figure 2 depicts the organizational structure of Chinese banks.

[14] See: http://www.cbrc.gov.cn/mod_en01/jsp/en010001.jsp, 26/12/2006; García-Herrero and Santabárbara, op.cit., p. 8; and Barth, Koepp, and Zhou, op.cit., p. 8.
[15] Barth, Koepp, and Zhou, op.cit., p. 5; García-Herrero and Santabárbara, op.cit., p. 11.
[16] See: http://www.ft.com/cms/s/31f2aba6-a1ce-11db-8bc1-0000779e2340,dwp_uuid=9c33700c-4c86-11da-89df-0000779e2340.html, 13/01/2007. Also based on discussions of the authors with Chinese authorities.

Figure 2: Organizational Structure of Chinese Banks



The development of the Vietnamese and Chinese banking systems is summarized in Table 2, with Vietnam clearly pursuing a strategy quite similar to China's.

Table 2: Milestones in Development of the Chinese and Vietnamese Banking Systems

	Milestones	China	Vietnam
1	Mono-banking system	1948-83	1951-90
2	Establishment of specialized banks[17]	1980s	1990s
3	Pilot of credit cooperative model	1980s	1987
4	Establishment of policy banks	1995	1995
5	Restructuring the central bank	1998	Now to 2010
6	Establishment of AMCs	1999	2000
7	Establishment of banking regulatory commission	2003	Now to 2010

Source: Compiled by the authors from various sources.

[17] In fact, these are reorganizations, because the banks had been previously established.

II. Provision of Key Financial Sector Functions

a. Monetary Policy

1. Organization

In Viet Nam, SBV is responsible for monetary policy as well as bank regulation and supervision. SBV is a ministerial agency under the government's executive branch, with its headquarters in Hanoi and offices in most cities and provinces. The SBV governor is appointed by, and serves at the will of the government, like a cabinet minister.[18]

Given its legal status and organizational structure, SBV's policies and operations are significantly influenced by the central and local governments. This was evident during the macroeconomic crisis that hit Viet Nam in 2008, first in SBV's failure to sterilize the surge of foreign capital into Vietnam, propelling a credit-fueled loose monetary policy, and then in the confusion of its contradictory and generally ineffective attempts to reverse course and implement a tight monetary policy.[19]

In respect to SBV's administrative structure, its provincial branches are considered departmental agencies similar to other sectoral offices of the government, and a standard branch template is applied regardless of location. For example, an SBV branch in Yen Bai, a small province with limited economic activity, is the same as branches in much larger locations such as Haiphong and Danang. This system is prone to overstaffing and local political interference.

A plan to transform SBV into a modern central bank has been approved by the Prime Minister, and both the Law on the State Bank and the Law on Credit Institutions are expected to be amended in 2007 to reform SBV similar to the Chinese strategy (see next section). This entails moving the function of banking supervision to a new departmental agency, thereby leaving SBV to focus only on managing monetary policy. [20]

In China, responsibility for bank supervision was shifted out of PBOC with establishment of CBRC in 2003, allowing PBOC to focus exclusively on managing monetary policy. The objective of this initiative was to improve the quality of both bank supervision and monetary policy execution by allowing CBRC and PBOC to specialize in their respective responsibilities.

Unlike SBV, PBOC now has the same organizational structure as the United States Federal Reserve (central bank) – its headquarters is in the nation's capital, and its field operations are divided among regional branches. The establishment of regional instead of

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[18] The Law on State Bank of Vietnam 1997, amended in 2002, Article 1.

[19] For example, see: Jonathan Pincus and Vu Thanh Tu Anh, "Vietnam: A Tiger in Turmoil" and Tran Le Thuy, "Defusing Vietnam's Hidden Detonators," in *Far Easter Economic Review*, vol. 17, no. 4 (May 2008), pp. 28-34 and pp. 34-36; Helen (Hong) Qiao, "Vietnam: Rising Inflation, Growth Setback and a Likely Roadmap of Policy Response," *Asia Economics Flash*, Goldman Sachs Global Economic Website, May 19, 2008; and Stewart Newnham, "VND: Beyond the Tipping Point," *Morgan Stanley Research*, May 28 2008.

[20] The Banking Sector Development Plan to 2010 and Orientation to 2020.

provincial branches is a lesson Zhu Rongji learned from Mao Tse-tung; to reduce local government intervention in army operations, Mao Tse-tung established eight military zones, with each zone in charge of several provinces rather than just one province.[21] Under the current organizational structure, many people contend that PBOC has significantly reduced local government interference compared to the previous structure of provincial branches. However, like SBV, the independence of PBOC in relation to the central government is relatively low by international standards.

2.Operations

Both SBV and PBOC have not managed monetary policy by inflation targeting; instead, they have relied on controlling the money base. This is a passive policy that is not well suited to controlling inflation, and easily leads to implicit currency depreciation, current account deficits, and potential monetary financial crises.[22] Some experts have recommended executing monetary policy more actively, as well as setting a low inflation target as a nominal anchor for monetary policy. [23]

Moreover, both central banks currently rely heavily on rather blunt administrative measures rather than open market operations to execute monetary policy. In fact, especially in Vietnam, many monetary policies seem to follow rather than lead the market, perhaps another sign of central bank lack of independence.

For the last two decades, the Chinese economy has grown at an average annual rate of 10 percent, while money supply has increased at an average annual rate of 22 percent and the average annual inflation has been 5.5 percent.[24] During the same period, the Vietnamese economy has grown at an average annual rate of 7.5 percent, while money supply has increased at an average annual rate of 28 percent, and the average increase in prices has been slightly lower than in China until recent rapidly accelerating inflationary pressures in Vietnam.

Unlike China, a significant problem in managing monetary policy in Vietnam is that three "currencies" are used in transactions rather than a single currency as in most countries. Vietnam is probably the most dollarized economy in the region, with approximately 30 percent of deposits denominated in U.S. dollars.[25] Gold is also a popular medium of investment and exchange in Vietnam, adding yet another challenge to SBV in managing monetary policy.

Figure 3 summarizes monetary policy management in Vietnam and China.

[22] Comment by Mr. Le Xuan Nghia, the Head of Banking Development and Strategy Administration, SBV.

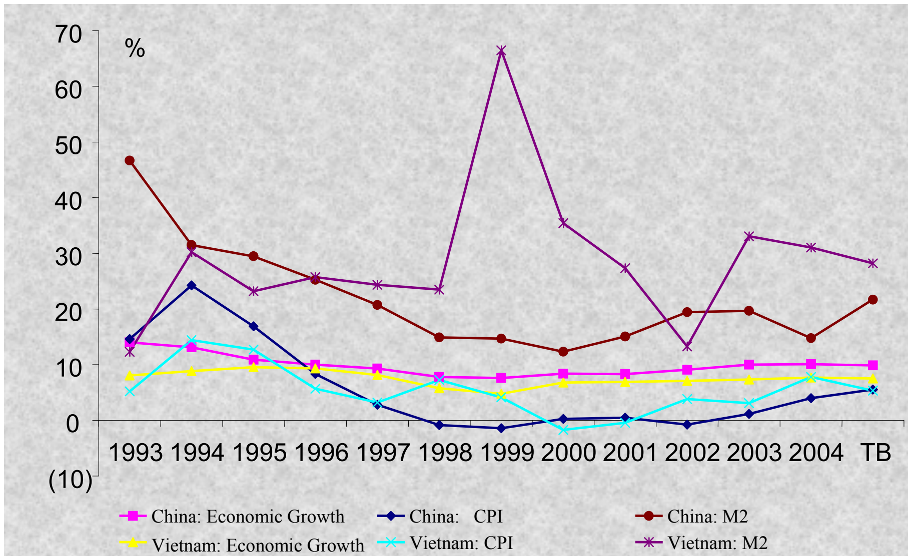
Deleted: 178.¶

[23] Marvin Goodfriend and Eswar Prasad, *Monetary Policy Implementation in China*, BIS Paper No. 31, p. 30; see: http://www.bis.org/publ/bppdf/bispap31c.pdf.

[24] The inflation rate is much lower if the fluctuations of the early 1990s are excluded.

[25] International Monetary Fund, *Vietnam: Statistical Appendix*, 2006, p. 22; see: http://www.imf.org/external/pubs/ft/scr/2006/cr06423.pdf. The authors' believe this figure is much higher now.

Figure 3:
Economic Growth, Money Supply Growth, and Inflation in Vietnam and China



Sources: WDI and SBV.

b. Financial Sector Regulation and Supervision

Surveillance of a banking system has two principal components: remote and direct monitoring, sometimes referred to as off-site and on-site supervision. The former is a desk review based on regular and incidental reports submitted by financial institutions, while the latter entails field visits and on-the-spot inspections of these financial institutions by the central bank or bank superintendency.

These two components are closely inter-related: it is difficult to ascertain the validity of secondary information without field verification, and a pre-requisite of efficient and effective field visits is adequate preparation based on submitted reports. To date, neither component is well implemented in Vietnam or China, creating uncertainty about the true financial condition of specific banks, as well as doubts about the overall soundness of each country's banking system.

Of particular concern is whether SBV and CBRC can quickly and accurately determine the composition and quality of a bank's loan portfolio, which is critical in interpreting whether a bank in crisis is suffering from a liquidity or a solvency problem, since the symptom of distress is the same: lack of cash to meet a bank's payment obligations. However, the appropriate response is quite different, depending on the diagnosis: a liquidity crisis is a temporary treasury problem requiring an emergency infusion of funds, but a solvency crisis is the result of non-performing assets and requires fundamental bank restructuring. It is also difficult for both SBV and CBRC to confirm a bank's compliance with pertinent laws and regulations, given the creativity of banks and the fungibility of money, which makes it unlikely these agencies can detect an impending crisis before it arrives.

Another problem facing SBV and CBRC in monitoring both banks in particular, and financial institutions in general, is the tendency in Vietnam and China to combine banking, insurance, and securities services within the single structure of a "universal bank." This is a tremendous challenge for both countries when the capacity of supervisory agencies is still relatively weak and this combination of activities makes financial institutions more complicated and riskier. Without good monitoring tools and risk hedging instruments, the confusion between creditors and owners may lead to conflicts of interest and resultant risks in financial institutions, with domino effects creating systemic risk for the financial sector and the economy.

Despite weaknesses in bank regulation and supervision, SBV and CBRC capacity is still greater than that of their sister institutions tasked with regulating and supervising capital markets in Vietnam and China, namely SSC in Vietnam and CSRC in China to oversee securities markets, and CIRC in China to oversee insurance markets. Moreover, there are even larger markets, such as the over-the-counter (OTC) market in Vietnam, which function with virtually no supervision.[26]

c. Financial Intermediation

Vietnam

In late 2005, the five SOCBs had a dominant market share of bank assets totaling 70.7 percent, with the remaining market segmented as follows: 37 joint stock commercial banks accounted for 17.2 percent; 31 foreign bank branches and 5 joint ventures had 10.7 percent[27]; people's credit funds had only 1.4 percent; and other financial institutions (VDB, VPSC, VBSP, and local investment funds) were not taken into account.[28] In contrast to China (see next section), Vietnam did not have 100 percent foreign-invested banks by the end of 2006,[29] but foreign banks nevertheless had a significant market share in Vietnam (see footnote 25).

JSCBs were set up in the early 1990s as part of the restructuring of the credit cooperatives that survived the crisis of the late 1980s. Their operations were not good during the 1990s, as many were in distress and under special supervision. However, after overcoming their early difficulties, joint stock commercial banks have grown quickly and have become a new power in Vietnam's financial system.[30]

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[26] Nhat Linh, "SSC Publicizes IMF's Report on Vietnam's Stock Market," *VietNamNet Bridge*, March 2, 2007 (http://english.vietnamnet.vn/biz/2007/03/668812/) and Kay Johnson, "Vietnam's Stock-Market Madness," *Time*, February 22, 2007 (http://www.time.com/time/magazine/article/0,9171,1592579,00.html).
[27] Foreign banks do not yet hold shares in SOCBs, but they do have shares in joint stock commercial banks. If included, the market share of foreign banks could be as high as 20 percent in Vietnam.
[28] SBV, IMF, and the authors' calculations.
[29] According to WTO commitments, the establishment and operations of 100 percent foreign-invested banks will be permitted in Vietnam from April 1, 2007.
See: Joint Stock Banks show off their role, [30] http://vietnamnet.vn/kinhte/2007/12/761139/

Just as in China, foreign banks were restricted in terms of scope of operations, products, and capital to be raised when they started up in Vietnam in the early 1990s. Over time, restrictions have been phased out, and foreign banks are going to receive equal national treatment in 2010 according to WTO commitments and the Vietnam-USA bilateral trade agreement (BTA).[31]

In addition to banks, Vietnam also has non-bank financial institutions[32]: 5 finance companies under the management of five state-owned corporations; 10 financial leasing companies under the management of SOCBs; a few joint ventures; and Foreign Direct Investment Enterprises (FDIEs).[33] At present, these non-bank financial institutions seem to have no clear role other than acting as "financial intermediaries" for state-owned corporations.

In addition, despite having no urban banks like China (see following section), Vietnam has a similar structure in the form of the local development investment funds. These funds operate under the provision of the Budget Law and are not governed by banking regulations.

As mentioned in Section I above, three other key financial institutions in Vietnam are VDB (Vietnam Development Bank), VPSC (Vietnam Postal Savings Service Company), and VBSP (Vietnam Bank for Social Policy).

At the end of 2006, VDB's total loan balance was VND85 trillion,[34] just slightly lower than that of VBARD, which had the highest loan balance at the time. VDB is essentially an off-budget mechanism to channel resources to state enterprise investments, primarily from VPSC. As mentioned earlier, VPSC was established in 1999 under Vietnam Posts and Telecommunications Corporation, with operations based at post offices similar to the Japanese postal savings model. The main duty of VPSC is to raise funds to then loan to VDB, and purchase government securities. VPSC's total raised capital was about VND50 trillion at the end of 2005, higher than half of the total average of the four SOCBs. Finally, VBSP, established in 1995 as the Vietnam Bank for the Poor to serve policy beneficiaries, had a total capital and loan balance of approximately VND20 trillion at the end of 2005.[35]

Compared to China, Vietnam's banking system is much smaller both in absolute terms and in relative terms as a proportion of the country's economy. At the end of 2006, the total loan balance of Vietnam's banking system was only about VN693 trillion,[36] or 71.3 percent of GDP. Vietnam's credit to GDP ratio, a measure of financial deepening, is very modest compared not only to China, but also to other countries in the region.[37] However, with the recent annual growth rate of credit more than 25 percent, the loan balance is

[31] Appendix on Vietnam's service commitments to WTO accession, p. 48.
[32] Financial institutions are usually classified as bank and non-bank institutions. However, Vietnamese Law classifies financial institutions as bank credit and non-bank credit institutions.
[33] See: http://www.sbv.gov.vn/home/hethongTCTD.asp, August 25, 2006.
[34] See: http://www.sbv.gov.vn/home/TinThoibao.asp?tin=717, August 25, 2006.
[35] See: http://www.mof.gov.vn/Default.aspx?tabid=612&ItemID=34869.
[36] SBV statistics, 2005.
[37] In 2007, the credit growth2006, for the first time, total bank assets exceeded GDP, but the total loan balance was still less than 70% percent of GDP.

expected to exceed GDP in a short time; given an increase in money supply of 46 per cent and a 53 percent growth in credit in 2007 when compared with 2006, total outstanding loans of the Vietnamese banking system are now equal to GDP. As noted by the IMF and World Bank, such a high growth rate for credit can create inflationary pressures and lead to economic overheating, which can undermine macroeconomic stability and long-term development. This becomes true now as money supply increased by 46 per cent in 2007 against 2006 and credit growth has increased by 53 per cent in 2007 against 2006 "helping" total outstanding loan of Vietnam banking system be equal to GDP.

Similar to China, Vietnam's banking system is dominated by SOCBs. In addition, banking products and services are still meager and out of date; domestic banks' activities revolve around raising funds and then lending. Their main income comes from lending, and interest margins are even higher than those in China and Western European countries. Although aggregate data is not available, the net interest spread is estimated at more than 2 percent in Vietnam. For example, in 2005, the interest margins of commercial banks considered to be most efficient in Vietnam – Sacombank, ACB (Asia Commercial Bank), and Vietcombank – are 3.9, 2.8, and 2.9 percent, respectively,[38] and their non-lending activities are very limited.

In addition, banking operational efficiency and financial capacity are weak, especially for SOCBs. According to Fitch's assessment of SOCBs, at the end of 2004, return on equity (ROA) was only 0.3 percent and the capital to asset ratio was only 4.07 percent.[39] As compiled by the authors for Vietnam's banking system and depicted in Figure 5 below, ROA was only 0.6 percent and the ratio of equity to risk-adjusted assets (capital adequacy ratio, or CAR) was around 5 percent at the end of 2005; the SOCBs had the lowest results. However, the CARs of some banks have improved recently due to a substantial increase in equity, especially in 2007 when the stock markets went up rapidly and the SOCBs were preparing for their IPOs.

It is worth noting that banks, especially SOCBs, have the same strategy to develop as financial holdings, creating a potential risk that four SOCBs with the same strategy may weaken one another through destructive competition.

According to official data, the bad debt ratio in Vietnamese banks appears to be very low: except for BIDV's bad debt ratio of 10.8 percent, the ratios of other banks are safely below 5 percent, with many even below 2 percent.[40] However, several international institutions contend that this figure is 15 to 20 percent, and some independent researchers estimate the number to be closer to 30 percent.[41]

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[38] "Finding the mystery of banks' profit", *Saigon Economic Times*, no. 2/2007, on 25/01/2007, p. 12.
[39] Fitch Ratings, *Country Report: The Vietnam Banking System*, 2006, p. 5.
[40] See: http://www.hvnh.edu.vn/modules.php?name=News&op=detailsnews&mid=452&mcid=5 ; http://www.dddn.com.vn/Desktop.aspx/TinTuc/Tintuc-Sukien/BIDV_cong_bo_ty_le_no_xau_theo_thong_le_quoc_te/ ; 08/02/2007.
[41] Huỳnh Thế Du, *Dealing with NPLs in Vietnamthe Vietnamese banking system,; experience from China and other countries, 2004, p. 2;*
http://www.fetp.edu.vn/index.cfm?rframe=/research_casestudy/facresearchlist.htm.

Especially worrisome is the potential negative impact of policy banks because of their detrimental effect on the ability to allocate capital efficiently. According to the World Bank, there is considerable concern about VPSC's capital mobilization, because it may take away the funds that should have been raised by banks to lend to the growing private sector.[42] Addressing this concern is problematic given its political dimensions: VDB only focuses on SOEs, and its operations are dominated by the Ministry of Finance - it does not seem to be subject to SBV regulations and supervision. This poses significant risks, given that VDB is now one of Vietnam's largest financial institutions, with outstanding loans estimated to be more than 10 percent of GDP.

Table 3 summarizes the size, composition, and performance of Vietnamese banks.

Table 3: A Snapshot of Vietnamese Banks in 2005

Amounts in trillions of VND

No.	Item	SOCBs	JSCBs	Foreign Banks	Joint Venture Banks	Credit Funds	Policy Banks	Total
1	Equity	29.4	11.4	8.9	1.5	n.a.	n.a.	51.2
2	Total assets	622.8	151.7	81.2	13.1	12.3	150.0	1.031
3	Earnings Before Taxes	4.4	2.2	1.1	0.2	0.2	n.a.	7.9
4	Customer's deposits	453.0	95.1	42.0	6.1	n.a.	----	596.2
5	Loans to customers	392.3	80.4	45.8	6.5	n.a.	n.a.	525.0
6	Return on Assets	0.6%	1.2%	1.1%	1.3%	n.a.	n.a.	0.6%
7	Return on Equity	11.9%	15.8%	9.7%	11.1%	n.a.	n.a.	12.3%
8	Market share of assets	60.4%	14.7%	7.9%	1.3%	1.2%	14.5%	100%
9	Equity/Total assets (1/2)	4.7%	7.5%	10.9%	11.4%	n.a.	n.a.	5.0%

Source: Compiled by the authors from various sources.

China

At the end of 2004, China's four SOCBs accounted for 54.6 percent of total bank assets. Not only do these banks operate in the domestic market, but they also have foreign branches. Moreover, three of them have gone public, although the State still retains majority ownership.

The rest of the Chinese market was segmented as follows: three policy banks accounted for 11.4 percent of assets; 11 joint stock commercial banks had 15.0 percent; 112 urban banks, each of which is connected to a city, had 5.4 percent; 191 foreign bank branches and 100 percent foreign-invested banks (including 15 foreign-invested banks, 157 branches, and 11 sub- branches) had just 1.6 percent;[43] approximately 35,000 rural credit

[42] World Bank, *Banking Sector Review: Vietnam*, June 2002, pp. 46-7; Dufhues, op.cit., p. 35; Fitch, op.cit., p. 5.

[43] If foreign financial institutions holding shares in equitized SOCBs are considered having corresponding market share, then their market share is about 10 percent. However, since the change in ownership has just happened within the past year, the role of foreign financial institutions has not yet been assessed.

cooperatives and 1,000 urban credit cooperatives had 10.4 percent; and the remaining 1.5 percent was taken by other financial institutions.[44]

Foreign banks have been set up in China since 1981. Initially, their scope of operations and services allowed were very restricted. Over time, these restrictions have been phased out, and foreign banks, in principle, now receive equal national treatment in accordance with WTO regulations.[45] However, as indicated in the preceding data, foreign banks' operations are still very modest in China.

In addition to these banking institutions, there are non-banking financial institutions under the management of PBOC and CBRC such as finance companies, leasing companies, trust and investment corporations, financial future companies, credit sponsoring companies, and debt resolution companies.

The Chinese banking system is quite large when compared to the Chinese economy. In 2005, total domestic credit was USD3 trillion (RMB24.8 trillion),[46] 150% of GDP. The Chinese banking system is big compared not only to the domestic economy, but also the world: it is the fifth largest, after the United States, Japan, Germany, and the United Kingdom. However, as detailed below, there is now considerable concern over the Chinese banking system's soundness.

Since the banking system is still dominated by SOCBs, and hence, the competition is quite low, Chinese banks have a relatively high interest margin of 1.79 percent, compared to 1.38 percent in Western European countries.[47] Lack of competition also breeds inefficiency in operations.

Loans account for 61 percent of total bank assets, with 85 percent of these loans going to firms. Within the business loan portfolio, although private firms are now generating more than a half of China's GDP, they receive only 27 percent of total credit - the remaining 73 percent is loaned to SOEs. Modern forms of lending such as mortgage loans and consumer finance comprise a very modest share of total lending, and other forms of bank investments are also a very small share of bank assets. In terms of liabilities, deposits and short-term raised capital constitute to 89.1 percent of total assets, while this figure is only 78.1 percent in Western European countries, reflecting a paucity of banking services now available for bank customers in China.

Since conventional market standards have not been widely applied, loans are of very bad quality, and the bad debt ratio is quite high. China seems to agree on the 2004 bad debt

[44] García-Herrero and Santabárbara, op.cit., Table 1, p. 342; Nicolas Hope and Fred Hu, *Reforming China's Banking System: How Much Can Foreign Strategic Investment Help?*, Stanford Center for International Development, 2006, p. 44; see: *http://scid.stanford.edu/pdf/SCID276.pdf*.
[45] Li Ruogu, *Revisit to China's Financial Reform*, 2001, p. 15 at http://www.emeap.org/review/0111/speach.pdf.
[46] See: http://www.pbc.gov.cn/english/diaochatongji/tongjishuju/gofile.asp?file=2005S4.htm, 22/08/2006.
[47] According to Ligang Songbieen, interest rates had been increasing significantly in the late 1990s. For a one-year loan, the interest margin was as much as 3.6 percent in June 1999 (Huang, 2006, p. 122).

figure of USD480 billion, or 36 percent of GDP.[48] However, Ernst & Young estimates the bad debt of the Chinese banking system to be as much as USD900 billion, or 40 percent of total loan balance and 55 percent of GDP, despite a withdrawal of its report in 2006.[49] According to the official figure announced by CBRC, the total bad debt of the Chinese banking system (excluding what has been transferred to AMCs) was USD170 billion as of the third quarter of 2006, of which SOCBs accounted for USD132 billion.[50] Whatever the actual number is, bad debts are certainly a very serious problem in the Chinese banking system.

Bank operations and profitability rely primarily on lending activities, which account for 80.8 percent of operating profit. Income from non-lending activities constitutes a very modest share of total bank income. In contrast, the proportion of net interest income and net non-interest income is 57-43 in Western European countries. Operational efficiency is also very low. In 2003, the return on assets (ROA) and return on equity (ROE) were 0.14 and 3.05 percent respectively, while these figures were 1.43 and 13.57 percent for Western European banks.

Despite the government's huge support and several rounds of recapitalization, the capital adequacy ratio (CAR) is very low due to inefficiencies and a high bad debt ratio. At the end of 2003, the CAR was 6.73 percent, compared to 8 percent international standard and 12.35 percent Western European average.[51] CARs of equitized banks, however, have been significantly improved.

Table 4 below summarizes the size, composition, and performance of Chinese banks from 1997 to 2003.

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[48] Huỳnh Thế Du, *Triangle Relationship among State-Business - Banks*, 2005, p. 2 at http://www.fetp.edu.vn/index.cfm?rframe=/research_casestudy/facresearchlist.htm.
[49] *The Financial Times*, May 4, 2006 at http://www.chinadaily.com.cn/china/2006-05/15/content_590282.htm, 09/02/2007; and Ernst & Young, Global Nonperforming Loan Report 2006 at http://www.chinalawblog.com/chinalawblog/files/ey_rehc_nonperformingloans_may20061.pdf.
[50] See: http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=2887, 08/02/2007.
[51] García-Herrero and Santabárbara, op.cit., p. 309-311.

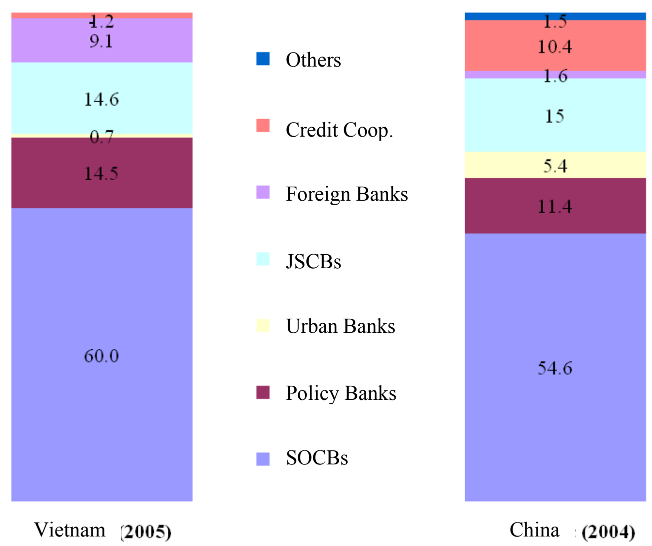
Table 4: A Snapshot of Chinese Banks from 1997 to 2003

Items	1997	1998	1999	2000	2001	2002	2003
ROA (%)	**0.43**	**0.22**	**0.2**	**0.26**	**0.23**	**0.22**	**0.14**
SOCBs	0.19	0.09	0.13	0.22	0.16	0.18	0.08
Other commercial banks	1.05	0.75	0.49	0.41	0.41	0.37	0.32
JS commercial banks	0.78	0.58	0.45	0.4	0.39	0.34	0.29
Other	1.5	1.03	0.57	0.43	0.46	0.51	0.47
Policy banks	0.12	0.07	0.06	0.14	0.26	0.01	0.03
ROE (%)	**9.39**	**4.19**	**3.48**	**4.59**	**4.21**	**4.48**	**3.05**
SOCBs	5.94	2.08	2.35	4.07	3.16	3.78	1.73
Other commercial banks	14.61	10.55	7.22	6.49	8.1	9.33	8.56
JS commercial banks	13.76	10.47	8.69	8.42	9.5	9.17	8.07
Other	15.42	10.62	5.86	4.54	5.86	9.81	10
Policy banks	2.68	1.4	1.21	2.97	4.99	0.23	1
NIM (%)	**2.03**	**2.07**	**1.9**	**2.22**	**1.93**	**1.95**	**2.03**
SOCBs	2.4	2.47	2.07	2.35	1.98	2.02	2.11
Other commercial banks	2.49	2.5	2.25	2.24	2.1	2.18	2.19
JS commercial banks	2.38	2.57	2.2	2.3	2.32	2.21	2.27
Other	2.68	2.4	2.32	2.14	1.43	2.04	1.89
Policy banks	0.06	0.02	0.81	1.63	1.47	1.01	1.21
Expenses/Income (%)	**54.51**	**65.4**	**62.22**	**56.61**	**54.51**	**55.52**	**51.68**
SOCBs	49.31	66.33	59.16	56.18	55.52	51.76	47.87
Other commercial banks	49.56	59.96	64.07	59.8	51.17	50.92	45.67
JS commercial banks	56.05	63.13	55.33	52.24	50.48	50.64	44.71
Other	38.61	54.47	77.17	75.2	54.47	52.04	49.52
Policy banks	65.94	34.25	48.49	23.47	6.23	64.93	67.22
Equity/Total Assets(%)	**4.54**	**6.03**	**5.72**	**5.56**	**5.16**	**4.54**	**4.34**
SOCBs	3.15	5.61	5.28	5.32	5.04	4.59	4.38
Other commercial banks	7.2	7.01	6.6	5.99	4.22	3.81	3.76
JS commercial banks	5.68	5.36	4.95	4.53	3.86	3.56	3.55
Other	9.72	9.63	9.7	9.07	5.91	4.78	4.57
Policy banks	4.6	4.73	4.59	4.72	5.98	2.81	2.95
Equity/Debt (%)	**4.76**	**6.41**	**6.07**	**5.89**	**5.44**	**4.76**	**4.55**
SOCBs	3.26	5.94	5.57	5.62	5.31	4.81	4.58
Other commercial banks	7.76	7.54	7.07	6.37	4.41	3.96	3.97
JS commercial banks	6.02	5.66	5.2	4.75	4.01	3.69	3.77
Other	10.76	10.66	10.75	9.97	6.28	5.02	4.79
Policy banks	4.82	4.97	4.81	4.96	6.36	2.9	3.04
Risk Provision/Loan(%)	**1.03**	**1.26**	**1.55**	**1.46**	**1.81**	**1.81**	**3.3**
SOCBs	1	1.12	1.52	1.24	1.66	1.82	3.91
Other commercial banks	1.83	2.43	2.99	3.82	2.93	2.32	2.08
JS commercial banks	1.05	1.63	2.23	3.94	3.35	2.6	2.24
Other	3.06	3.84	4.69	3.52	0.8	1.01	1.32
Policy banks	0.73	1.06	0.79	0.73	1.64	1.02	1.01
Risk Provision (millions of USD)	**2,197**	**2,957**	**3,662**	**6,971**	**10,277**	**10,379**	**14,061**
SOCBs	2,109	2,409	3,203	5,565	7,989	8,798	11,025
Other commercial banks	74	113	371	756	1,008	1,582	3,036
JS commercial banks	74	113	355	715	906	1,229	2,603
Other	0	0	15	41	102	353	433
Policy banks	0	436	89	650	1,281	0	0

Source: García-Herrero and Santabárbara.

The distribution of Vietnamese and Chinese banking system assets is shown in Figure 4 below. The organizational structure of financial intermediaries under SBV and CBRC are very similar: the market share of all types of state-owned financial institutions is 75.2 percent in Vietnam and 71.4 percent in China; if credit cooperatives, which are also dominated by the government, are taken into account, the market share rises to 76.4 percent in Vietnam and 81.8 percent in China. These figures reflect the significant participation of the State in the Vietnamese and Chinese banking systems.

Figure 4: Distribution of Vietnamese and Chinese Banking System Assets[52]

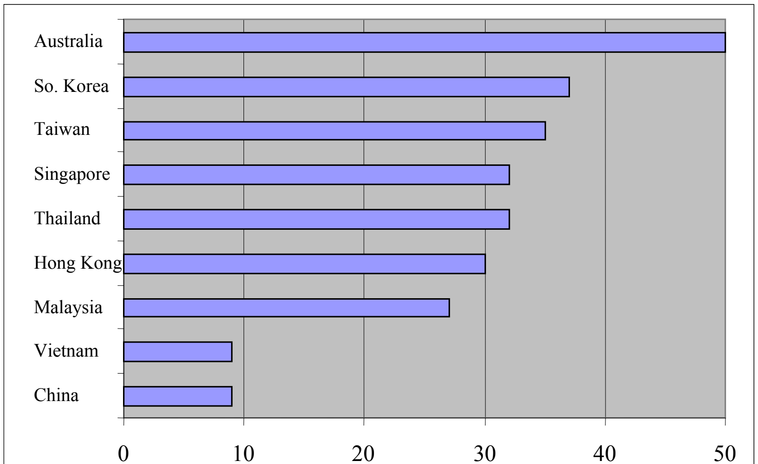


Sources: SBV, García-Herrero and Santabárbara, IMF, and the authors' estimates.

Figure 5 below shows service income as a share of operating income for banks in selected countries, and Figure 6 below comparative ROA and CAR figures for selected banking systems in 2004; Vietnam and China are ranked last in both Figure 5 and Figure 6.

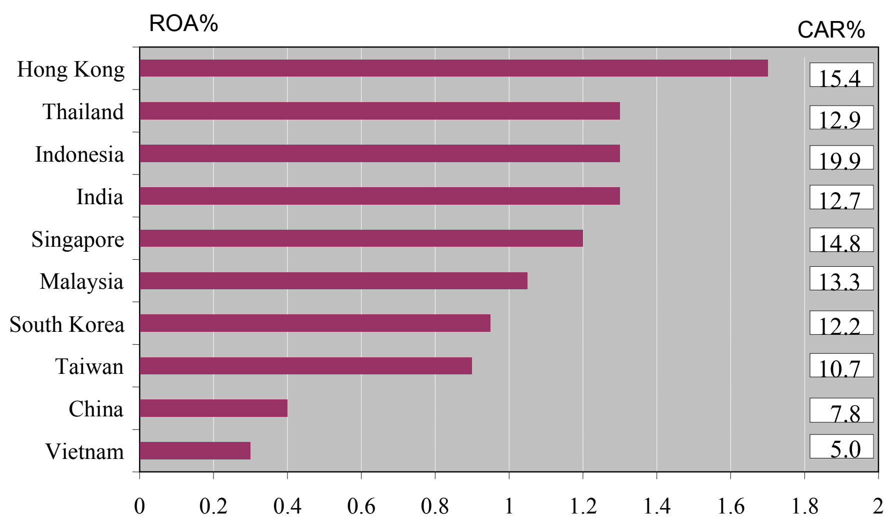
[52] Policy banks in Vietnam include VBSP, VDB, and VPSC; the local development investment funds are classified as urban banks.

Figure 5:
Service Income as a Share of Operating Income for Banks in Selected Countries (%)



Source: Goldman Sachs and authors calculations

Figure 6: ROA and CAR for Selected Banking Systems in 2004



Source: The authors' calculations.

d. Non-Bank Financial Institutions and Markets[53]

Stock Markets

Although the Vietnam stock market was officially launched in 2000 in Ho Chi Minh City and 2005 in Hanoi with establishment of HOSTC (Ho Chi Minh City Securities Trading Center)[54] and HASTC (Hanoi Securities Trading Center), respectively, this was the culmination of a decade of planning. Discussions on creating a stock market began in the early 1990s, and in 1993, SBV formalized the process by establishing an internal unit called the Board for the Study and Development of Capital Markets. This was followed by creation of the SSC (State Securities Commission) in 1995 to promote capital markets development.[55] In addition, plans were made to launch Vietnam's first stock exchange in 1998, but the launch was postponed two years because of the East Asian financial crisis.

On July 28, 2000, HOSTC began operations with two listed companies. The stocks index, known at the VN-Index, has frequently fluctuated since then to reflect changing and sometime volatile market conditions. After almost eight years (June 22, 2008), the VN-Index was at 368, reflecting an annual growth rate of 17.8 percent. Although this is quite high compared to other exchanges with similar conditions, it is less than half of its March 2007 peak of 1,171.

By end of April 2008, there were about 300 listed companies on Vietnam's two bourses with a total capitalization USD20 billion, equivalent to 28 percent of Vietnam's GDP. Like China, the role of stock market in Vietnam is becoming bigger, but it is still quite modest compared to the dominant role of the banking sector. Although difficult to document, total OTC capitalization is estimated to be three to four times greater than the formal stock exchanges.[56] Vietnam's stock market is also relatively illiquid, although the volume of transactions was growing rapidly until October 2007: the average daily turnover in August 2007 was USD51.5 million, six times greater than the 2006 figure of USD8.3 million. However, in the first half of 2008, during which time the trading band was narrowed by the government, the daily turnover has fallen to less than USD 10 million.

Table 5 provides some key indicators of Vietnam's stock market since 2001, including market capitalization, index values, and investor characteristics. Figure 7 shows trailing P/E (price/earnings) ratios for HOSTC firms, although these numbers are perhaps less revealing than they might first appear – not only are they easily manipulated, but forward P/E ratios might be more indicative of value when firms and earnings are growing quickly.

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[53] For a more complete description of the evolution and characteristics of Vietnam's capital markets, see: Vo Tri Thanh and Pham Chi Quang, *Managing Capital Flows: The Case of Viet Nam*, ADB Institute Discussion Paper No. 105, May 2008, pp. 12-19. For a more complete description of the evolution and characteristics of China's capital markets, see: Franklin Allen, Jun Qian, and Meijun Qian, *China's Financial System: Past, Present, and Future*, revised manuscript, July 21, 2005, pp. 25-30.

[54] HOSTC became the Ho Chi Minh City Stock Exchange in 2007.

[55] The SSC was brought under the direct control of the Ministry of Finance in 2004, foregoing its previous legal status as a separate ministry agency.

[56] Thanh and Quang, op.cit., p. 13.

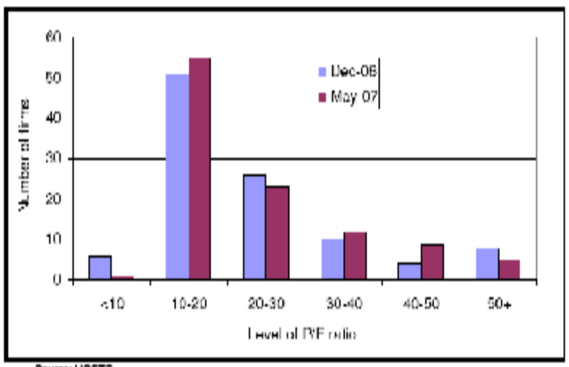
Table 5: Key Indicators of Vietnam's Stock Market

	2001	2004	2005	2006	2007
Market capitalization (%GDP)	0.3	0.5	1.1	22.8	43.0
VN index	235 (peak=571)	241	307	752	≈ 927 (peak=1,170 in March)
HASTC-Index	..	..	91.3	243	≈ 324 (peak=460 in March)
Number of listed firms	10	26	41	193	253
HOSTC/HOSE	10	26	32	106	138
HASTC		...	9	87	115
Investment funds	0	1	1	3	4
Securities companies	8	13	14	55	78
Investment management funds	0	?	6	18	25
No. of investors' accounts	8,774	21,616	29,026	≈130,000	≈330,000
Institutional	71	193	257	≈ 400	≈ 500
Foreign	0	207	427	1,650	8,140

Source: The SSC and other sources (end of year).

Source: Thanh and Quang, p. 14.

Figure 7: Trailing P/E Ratios for HOSTC Firms



Source: HOSTC.

Source: Thanh and Quang, p. 17.

The stock markets in China were created in early 1990 with establishment of two stock exchanges: the Shanghai Stock Exchange in 1990 and the Shenzhen Stock Exchange in 1991. There are two kinds of shares traded on these exchanges: A-shares in domestic currency that are bought by domestic investors and foreign investors who meet China's requirements as specified in the Qualified Foreign Instutional Investors (QFIIs) regulation; and B-shares in foreign currency (US dollars in Shanghai and Hong Kong dollars in Shenzhen), only for foreign investors until 2001, but now open to domestic investors with legitimate foreign accounts.

As of June 1, 2007, market capitalization was 17.21 trillion yuan (USD2.25 trillion)[57], 89.3% of China's GDP in 2006. The CSRC (China Securities Regulatory Commission), a ministry level agency, is the regulator of China's securities markets. Like Vietnam, although the role of the securities market in China's economy is growing, it is still quite modest compared to the role of banking sector.

Figure 8 compares VN-Index and Shanghai Composite Index trends since 1990. While the VN-Index has been a bit more volatile than the Shanghai Composite, both have moved in roughly the same direction, including a classic bubble expansion beginning in 2005 followed by an equally classic burst bubble in 2007. After seven years, the VN-Index, the main index of Vietnam's stock market, reached its peak in March 2007, achieving an annual growth rate of more than 42 percent. Likewise, after seventeen years, the Shanghai Composite Index, the main index of China's stock market, reached its peak in October 2007, after growing 27 percent annually. However, since reaching these peaks, both indices have gone down sharply. On June 22, 2008, the VN-Index stood at 368, a decrease of 69 percent, and the Shanghai Composite stood at 2,760, a drop of 55 percent.

A key characteristic of stock market transactions and trends in both Vietnam and China is that share prices and investor behavior are driven more by speculation than by the fundamental values of listed firms. Three indicators of this phenomenon are: extremely high turnover velocity coupled with relatively low concentration;[58] synchronous stock prices;[59] and a high correlation between buy and sell trades.[60] This is commonly attributed to weak protection of minority shareholders and poor market regulation and supervision, resulting in insider manipulation and trading.[61]

Tables 6 and 7 take a broader comparative look over a longer period of time at the performance of key stock indices around the world in terms of both market growth and market liquidity. None of the other stock indices have reached either the 83 percent growth rate of the VN-Index or the 60 percent growth rate of the Shanghai Composite from 2005 to 2007, although the 83 percent drop of the Nikkei from 1990 to 1992 surpasses both the 55 percent drop of the Shanghai Composite and the 69 percent drop of the VN-Index from 2007 through June 2008. As noted earlier, the market capitalization and daily turnover of both the Shanghai and Shenzhen stock indices greatly exceed those of HOSTC.

[57] Xinhua News Agency, June 3, 2007

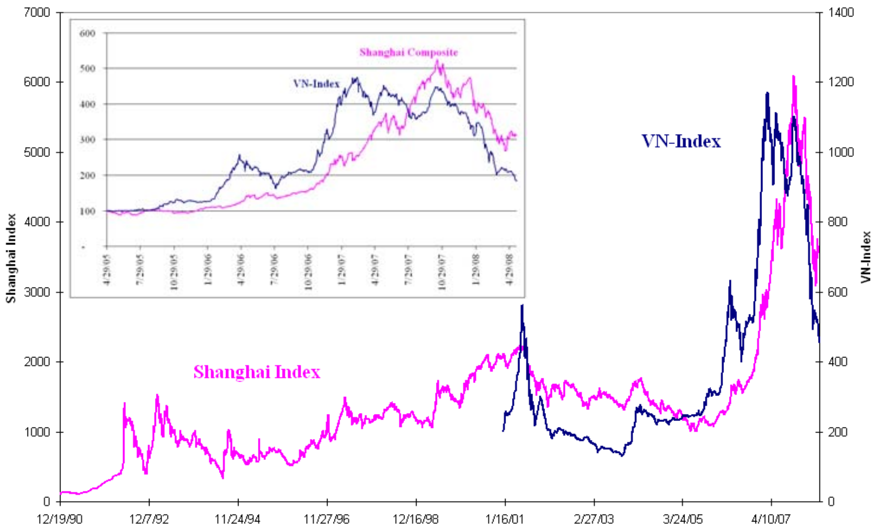
[58] "Turnover Velocity" is the total turnover for the year as a percentage of total market capitalization; "Concentration" is the fraction of total market capitalization of an exchange measured by the combined capitalization of the largest firms ranked in the top 5 percent (by capitalization).

[59] "Synchronous" means that sock prices move up and down together, like herd behavior.

[60] "High Correlation" means that buy and sell trades occur in the same time period, such as the same day.

[61] For examples from China of the three indicators summarized in this paragraph, as well as of the numerous lawsuits against insider manipulation and trading, see: Allen, Qian, and Qian, op.cit., pp. 25-28.

Figure 8: VN-Index and Shanghai Composite Index Trends Since 1990



Source: Global Financial Data

Table 6: Performance of Key Stock Indices Around the World

Indices	Annual growth	Indices	Annual growth
Nikkei		**SET-Thailand**	
1960-1980	10.6%	1986-1993	45.5%
1980-1990	19.0%	1994-1998	-41.4%
1985-1989	37.7%	1998-2007	13.6%
1990-1992	-82.6%	1975-2007	6.7%
1990-2003	-12.4%	**Shanghai Composite**	
2003-2007	14.4%	1991-2007	27.7%
1960-2007	6.25%	2005-2007	59.5%
1914-2007	7.21%	2007-2008 (9 months)	-54.8%
		VN-Index	
S&P 500		2000-2007	36.5%
1908-2007	5.2%	2005-2007	82.6%
		2007-2008 (15 months)	-68.6%

Source: Authors' calculations based on Global Financial Data.

Table 7: Global Indices of Stock Market Growth and Liquidity

	2006 % yoy	CAGR 03-05	2006 Average daily turnover (in USD millions)	2006 Annual turnover: Market cap (x)	2005 Annual turnover: Market cap (x)
HOSTC	**144.5**	**21.3**	**8.3**	**0.3**	**0.3**
Shanghai SE	130.4	(8.2)	3,078.6	0.8	0.8
Shenzhen SE	97.5	(13.2)	1,765.4	1.9	1.3
Jakarta SE	55.3	44.1	203.5	0.4	0.5
Mumbai SE	46.7	42.5	895.9	0.3	0.3
National SE India	34.0	33.1	1,767.7	0.5	0.6
Hong Kong SE	43.2	18.7	3,468.3	0.5	0.4
Philippines SE	42.3	25.6	46.9	0.2	0.2
Colombo SE	41.6	34.3	4.2	0.1	0.2
Kuala Lumpur SE	21.8	10.6	314.5	0.3	0.3
Karachi SE	5.0	36.3	573.1	2.8	2.9
Thailand SE	(4.7)	24.5	419.4	0.7	0.8

Source: World Federal of Exchange, KSE, HCSTC, Reuters.

Source: Thanh and Quang, p. 17.

Bond Markets

In both Vietnam and China, the bond market is quite small compared to bank loans, especially in Vietnam, and in both countries, most bonds have been issued by the government.

In Vietnam, at the end of 2007, outstanding bonds totaled USD9.79 billion, equivalent to 13.7 percent of GDP, of which government bonds accounted for USD8.28 billion, or 84.6 percent of all outstanding bonds.[62] The remaining debt securities consisted of Ho Chi Minh City and Hanoi municipal bonds,[63] DAF/VDB bonds,[64] education and infrastructure bonds,[65] SOCB recapitalization bonds,[66] BIDV bonds, Vietcombank convertible bonds, and other corporate bonds.

In China, also at the end of 2007, outstanding bonds totaled USD1.69 trillion, equivalent to about 50 percent of GDP, of which government bonds accounted for USD1.53 trillion, or 90.7 percent of all outstanding bonds.

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[62] Authors' calculations from a variety of official and unofficial sources – these figures are significantly larger than those presented in Thanh and Quang (p. 17).

[63] Ho Chi Minh City and Hanoi are authorized to issue municipal bonds up to 100 percent of their annual investment budget; the limit for other cities is 30 percent of their annual investment budget.

[64] According to Thanh and Quang, op.cit., p. 17, VDB has outstanding loans equivalent to roughly 20 percent of GDP, half of which are financed by ODA; presumably the other half are financed by the issuance of bonds and VPSC channeling of postal savings via loans.

[65] According to Thanh and Quang, op.cit., p. 17, the National Assembly authorized the issuance of VND110 trillion (approximately USD7 billion) of education and infrastructure bonds for the period 2005 to 2040.

[66] According to Thanh and Quang, op.cit., p. 17, in 2001 the government re-financed VND10.9 trillion in NPLs (2.5 percent of the 2000 GDP) with VND9.7 trillion in recapitalization bonds and the remainder in cash as part of its SOCB restructuring program.

The liquidity of bond markets in both countries is very low, as most investors hold bonds until maturity given the lack of comparable alternative investment opportunities. In Vietnam, most long-term bonds (10 to 15 years), comprising roughly 40 percent of the total, are purchased by insurance companies; short-term bonds (mostly 5-year bonds) are purchased by SOCBs.[67]

Insurance Markets

China started to open its insurance market in the 1980s, and Vietnam did the same in the 1990s. Since joining WTO (China in 2001 and Vietnam in 2007), both countries have committed to opening their domestic insurance markets more to foreign participation. The insurance markets in Vietnam and China are quite small when compared with their potential, based on internal demographic and economic trends, as well as the size of insurance markets in other countries. So far, the total revenue in both life and non-life insurance is less than 2 percent of GDP in Vietnam and less than 3 percent of GDP in China. Insurance revenue per capita in Vietnam in 2007 was about USD13, one-third of China in 2006 and one-eight of Thailand and 1/131 of South Korea in 2005.

Microfinance

Microfinance in Vietnam is a mixture of formal, semi-formal, and informal activity.

The government views microfinance as poverty alleviation rather than financial intermediation: it believes it can best help the poor by income transfers via subsidized credit and savings programs, rather than by promoting sustainable financial services for low-income households and family businesses. Thus, the government tries to help poor people through special programs implemented by state-owned financial institutions such as VBARD, VBSP, and VPSC. This approach, while well intentioned, fails to distinguish between the "poorest of the poor" who need both financial and non-financial assistance due to either chronic poverty or an economic shock, and the "working poor" who need the same financial services as everyone else, albeit with different products, pricing, and delivery systems than those offered by mainstream commercial banking.

NGOs also play a significant role: according to the ILO (International Labor Organisation), there are 57 international NGOs now supplying microfinance services, mostly credit, in Vietnam.[68] These are financed primary by ODA and government matching funds. Although NGO- implemented microfinance is a fertile ground for experimentation and innovation, these initiatives are often not sustainable because of their high cost and dependence on ODA and government funds, and they are difficult to scale-up for greater geographic coverage because of their legal status and institutional forms.

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[67] Thanh and Quang, op.cit., p. 17.

[68] Le Lan and Nhu-An Tran, *Towards a Viable Microfinance Sector in Viet Nam: Issues and Challenges*, ILO Viet Nam Working Paper Series No. 5 (Hanoi: ILO Office in Viet Nam, 2005), p. 1.

A large part of microfinance consists of informal activity called *hụi* or *họ*; these are Vietnamese ROSCAs - rotating savings and credit associations for relatives, friends, and neighbors to pool and distribute their savings. ROSCAs were once illegal in Vietnam, they are now permitted. Although *hụi* or *họ* do help to mobilize savings, their function is as much social as financial, and similar ROSCAs in other countries complement rather than substitute for formal financial services.

Vietnam has a national network of financial institutions that, if radically transformed, might provide the foundation for the large-scale, sustainable provision of microfinance, namely people's credit funds (called credit cooperatives before 1990). At the end of 2007, total loans outstanding of these institutions were about VND 10 trillion. Although the loans are less than 1 percent of total lending of the whole banking system, they play a significant role in financing for the poor.

In sum, Vietnam does not yet have a commercially-based model for the delivery of essential savings, credit, and payment services for most of its population, known elsewhere as the "unbanked majority." Thus, there remains considerable potential in Vietnam to develop a much more inclusionary financial sector.[69]

The situation in China is similar to Vietnam, being a mixture of formal, semi-formal, and informal activity. Most spending is done by the government as part of its Stage 3 poverty alleviation efforts, primarily channeled through state institutions: Stage 1 of poverty alleviation (until 1985) was focused on relief through the provision of direct fiscal subsidies; Stage 2 (1986-1993) stressed regional development; and Stage 3 (1994-present) targets villages and households.
Like in Vietnam, NGOs, working with the government and foreign donors, have implemented many microfinance pilot projects through initiatives such as: Funding the Poor Cooperative, initiated by the Rural Development Institute of the Chinese Academy of Social Sciences in 1993 with support from the Ford Foundation and the Grameen Trust; the UNDP-CICETE (United Nations Development Program - China International Center of Economic and Technology Exchange) sixteen microfinance projects; and the AusAID Qinghai Community Development Program in remote western China. However, these pilots face the same problem as they do in Vietnam: how to sustain and replicate these models when donor and government funding runs out?

China has ROSCAs (Rotating Savings and Credit Association) as well, also called *hui*, which function much like they do in other countries. However, in China, *hui* have periodically been transformed from a grassroots mechanism to provide low-income households with a community-based source of savings and credit to pyramid investment schemes. Two of the more infamous cases are the massive collapses in Wenzhou in the

[69] For a nice analysis of the potential and challenges for developing microfinance in Vietnam, see: *Conference Summary Report: Making the Transition to a Regulated and Financially Sustainable Vietnamese Microfinance Industry*, CEP Vietnamese Microfinance Conference, 14-16 May 2007, Ho Chi Minh City.

mid-1980s and Quanzhou in the early 1990s, which both led to local government efforts to eradicate the *hui*.[70]

Similar to Vietnam, China has a national network of rural financial institutions that can provide the foundation for the large-scale, sustainable provision of microfinance: the RCCs (Rural Credit Cooperatives). As mentioned in Section 1, reform of the RCCs is a high government priority, as indicated the recent USD20 billion injection of recapitalization funds, together with efforts to consolidate RCCs at the county level and strengthen their ownership and governance structures.

Although RCC micro-credit delivery has had the same problem at the local level as SOCBs have had at the national level, namely policy or political based lending to town and village enterprises, the RCCs have been very successful at savings mobilization: at the end of 2001, the RCCs had USD210 billion in savings, 12 percent of all financial institution deposits in China, and 80 percent of these savings came from rural households.[71]

e. Bank versus Non-Bank Financial Institutions and Markets

In Vietnam, the securities market did not really take off until 2006,[72] and even then the USD14 billion total value of all listed companies plus an additional USD5 billion in government and corporate bonds accounted for only 20 percent of total financial assets and 30 percent of GDP.

In China, the securities market was set up in the early 1990s, but even by the end of 2005, the market value of all listed companies and outstanding bonds was only 20 percent of total financial assets and 40 percent of GDP. Moreover, the State held as much as two-thirds of total shares of listed companies, and these shares were almost never traded.[73]

Banks continue to dominate the provision of financial services in both Vietnam and China, as indicated by Figure 9 below. Although Figure 10 below shows that the size of the financial sector relative to GDP for banks and non-banks is among the largest in the world for China, but among the smallest in the world for Vietnam.

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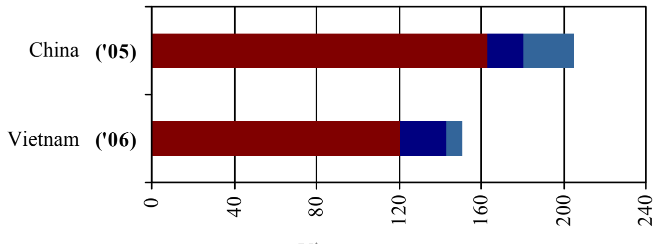
[70] For fascinating descriptions of these cases, see: Kellee S. Tsai, *Back-Alley Banking: Private Entrepreneurs in China* (Ithaca, N.Y.: Cornell University Press, 2002), pp. 134-140 and 87-89.

[71] For more micro-savings data, as well as a nice summary of microfinance in China, see: Roumei Sun, *The Development of Microfinance in China*, Kennedy School of Government Financial Sector Program Working Paper No. 1, August 2003.

[72] There were only 32 companies listed on the HCMC Securities Trading Center and 8 companies listed on the Hanoi Securities Trading Center, with a total market value of USD500 million in late 2005. There were almost 200 listed companies whose market value was around USD14 billion in late 2006.

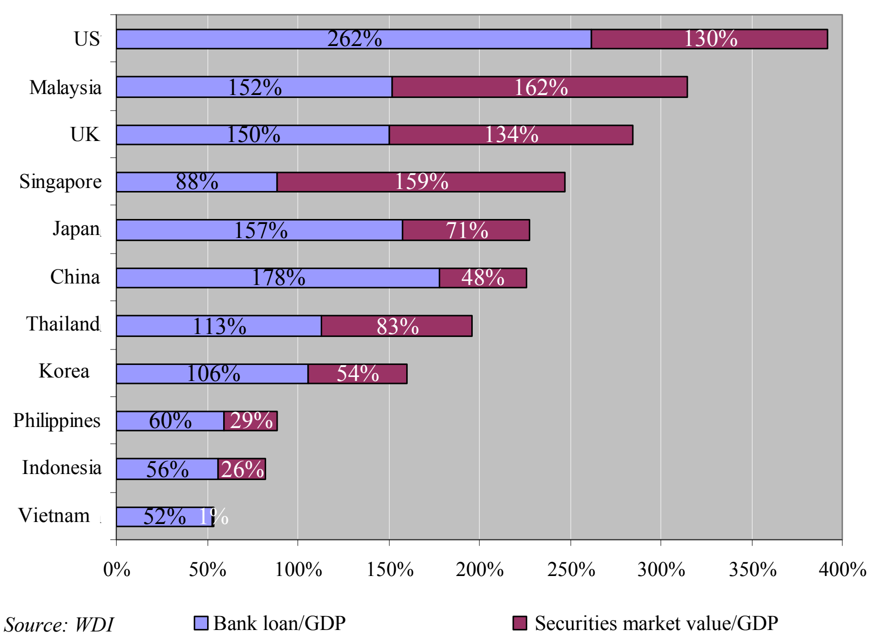
[73] Goodfriend and Prasad, op.cit., p. 29.

Figure 9: The Structure of Financial Assets in China and Vietnam (% GDP)



Sou

Figure 10: The Size of Financial Markets in Selected Countries (2004)



Source: WDI

CHAPTER FOUR:

FINANCIAL SECTOR REFORM IN VIETNAM AND CHINA

This chapter is devoted to an assessment of progress in Vietnam and China implementing the three pillars of financial sector reform: financial sector liberalization, deregulation, and stabilization.

I. Financial Sector Liberalization

As noted in Chapter Two's conceptual framework for assessing financial sector reform in Vietnam and China, financial sector liberalization refers to the transition from administration-based to market-based financial systems.

When applied to banking systems, this entails: the use of market prices rather than mandated interest rates to determine the value of funds; allocation of funds based on return to capital rather than policy and politically driven preferential credit lines and directed credit; and the use of reserve requirements to ensure the soundness of depository institutions rather than as a fiscal or monetary tool.

When applied more broadly to financial systems, financial sector liberalization refers to market-determined foreign exchange rates and open capital accounts instead of administratively determined exchange rates and capital flow restrictions.

a. Interest Rate Controls

Interest rate liberalization is an important step in the effort to strengthen utilization of market forces in capital allocation in Vietnam and China as both countries continue the transition from a planned economy. This is also prerequisite for increasing the competitiveness of financial institutions, applying market-based monetary tools, and improving the money circulation mechanism.

Vietnam

Vietnam's banking system liberalization in the late 1980s, summarized in the previous chapter, was quite extensive, as most "economic organizations" were allowed to raise capital from the public and lend these funds at self-determined loan terms and conditions, including interest rates.

In many ways this dramatic break with the past was too successful, and highlights the dangers of financial liberalization with inadequate regulation and supervision. During 1988-1989, credit cooperatives proliferated.[74] They operated as "Ponzi" schemes, paying early depositors with the funds from subsequent depositors. At the peak of credit cooperative expansion, nominal interest rates went as high as 24 percent per month.

[74] The number of credit cooperatives grew from one in 1983 to 7,180 in the late 1980s (Thành, op.cit., p. 3).

Consequently, the credit cooperative system collapsed, with Thanh Huong Perfume and Dai Thanh Credit just two examples of the many infamous cases this crisis created.[75]

After a series of destabilizing disruptions, credit activities were severely tightened, and both loan and deposit rates were curbed. Beginning in 1990, SBV imposed ceiling interest rates on both domestic and foreign currency loans, discriminating between various sectors to promote those it found to be the most strategic for national development. That is, different ceiling rates were applied for loans to agriculture, manufacturing, and services. Different deposit rates were also applied to households and firms.

Since 1992, SBV has tried to tie nominal interest rates to the consumer price index in an attempt to secure positive real interest rates, as negative real interest rates has a significant adverse impact on efforts to mobilize capital. Loan rate differentiation among various sectors was eliminated in 1993, but there was still interest rate discrimination between loans for working capital and fixed assets.

Beginning in 1995, SBV allowed commercial banks to set deposit rates freely, at least notionally, to increase competition in raising capital. However, the maximum loan-deposit rate spread was restricted to 0.35 percent per month. Thus, indirectly, banks were still subject to both loan and deposit rate ceilings. When interest rate competition started increasing between banks, the restriction of 0.35 percent per month spread gradually became ineffective, and was finally formally removed.

As banks became more commercialized in their operations, especially BIDV, they began to focus more on meeting market demand rather than channeling directed credit. This created severe competition between banks and difficulties in finding bankable projects, putting a downward pressure on deposit and loan rates.

A new interest rate mechanism was adopted in August 2000: domestic currency loan rates were adjusted based on the prime rate announced by the SBV. Banks were not allowed to set loan rates higher than the prime rate plus 0.3 percent per month for short-term loans and 0.5 percent per month for medium- and long-term loans. Banking operations during this period were virtually unaffected by this new regulation on prime rate-based lending due to rigorous competition and the relatively large interest rate band.

The ceilings on foreign currency loan rates were eliminated in November 2001, and the last restrictions on interest rates were removed in June 2002. Since then, at least according to the banking law and accompanying implementation regulations, banks have been fully free in deciding all loan and deposit rates. However, according the civil code, this is not correct, and interest rate ceilings are still in effect. The situation is made even more opaque because of the difference between "base rate" as defined in Vietnam banking laws and the conventional use of this term.

According to Article 476 of the 2005 Civil Code, lending rates are negotiated between lender and borrower, but can be no higher than 150 percent of SBV's base rate.[76] The

[75] Pierre Fallavier, *Developing Micro-finance Institutions in Vietnam*, University of British Columbia, Vancouver, unpublished Master of Arts thesis, 1998, p. 62.

reason for this indirect interest rate ceiling is to address the concerns of policy makers that if interest rate controls are completely eliminated, it could lead to unhealthy competition, adverse selection, increased operating risks, and hence, possible systemic collapse.

According to the SBV law, the base rate is the rate promulgated by SBV, which credit institutions are then supposed to use as the benchmark to set their business interest rates. This is an administrative regulatory tool that can be easily evaded by using non-interest charges such as "loan origination fees" or "loan management fees" to increase the effective lending rate when SBV's base rate does not reflect market realities. This is quite different from the common definition of base rate, namely the interest rate that banks charge their best customers, also called their "prime rate," which is benchmarked to a central bank's open market operations.

For example, the United States Federal Reserve (Fed) has two benchmark rates for commercial bank interest rates: the "federal funds rate" and the "discount rate." Both of these are part of the Fed's open market operations to implement monetary policy by controlling the supply of available funds through price adjustments in the cost of capital.

The federal funds rate is "the interest rate at which depository institutions lend balances at the Fed to other depository institutions overnight."[77] The discount rate is the interest rate charged by the Fed to member banks for loans when their reserves fall below the Fed requirements – this is the Fed fulfilling its role as the "lender of last resort," as banks would rather borrow from each other at the lower federal funds rate. From June 2006 to June 2008, the Fed has lowered the federal funds rate from 5.25 to 2.00 in an attempt to stimulate the economy; the federal discount rate is now 2.25 percent, and the Wall Street Journal prime rate is now 5.00 percent, both benchmarked to the federal funds rate.[78]

In short, despite significant improvements in interest rate policy management over the past two decades, implementation of interest rate liberalization decisions has often fallen well short of the stated objectives of these policy reforms because of the considerable confusion surrounding interest rates and interest rate liberalization in Vietnam. SBV undercuts its own interest rate liberalization policy through a combination of promulgation of its base rate, utilization of the above-cited civil code provisions, and an interest rate agreement with the Vietnam Bankers Association, an industry cartel in which the SOCBs still play a dominant role. This has been especially evident during the surge of inflation that hit Viet Nam in the early part of 2008.

The next steps in interest liberalization in Vietnam are to: first, gradually raise SBV's base rate to at least the inflation rate so that banks can offer a positive real interest rate to

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[76] Earlier, Article 473 of the 1995 Civil Code stated that lending rates should be negotiated between lender and borrower, but could be no higher than 50 percent of SBV's base rate.
[77] The United States Federal Reserve Board; see www.federalreserve.gov/fomc/fundsrate.htm. The federal funds rate is the interest rate charged on loans by banks that have excess reserves (funds above the Fed requirement) to banks with insufficient reserves.
[78] "The Wall Street Journal (WSJ) Prime Rate" is the consensus prime rate based on a survey of the 30 largest banks, and when three-quarters of them (23) change their rate, the WSJ changes its rate. This is the most widely quoted measure of the prime rate.

depositors and thus, offer a strong incentive to bring funds into the formal financial sector; and second, after bank oversight capacity has been enhanced enough to prevent destructive competition in funds mobilization, amend the civil code to remove the 150 percent of base rate ceiling on lending rates.

China

China has gradually but steadily liberalized interest rates over the past twelve years, but, like Vietnam, the process is not yet complete. Interest rates were first liberalized in the money and bond markets; this was followed by liberalization of lending rates; and finally, deposit rates were liberalized, as follows:

- The first step of interest rate liberalization was taken in 1996 with inter-bank interest rates on lending transactions between financial institutions.

- Repo interest rates[79] were then liberalized in 1997, followed by liberalization of interest rates on government bonds in 1998.

- Interest rate controls on foreign currency loans and large deposits were removed in 2000.

- An interest rate range was set up in 1996 to facilitate loans in RMB. This range was gradually widened, and finally removed in October 2004, except for credit cooperative loans.

- Interest rate floors on RMB deposits were removed in 2004, but interest rate ceilings have remained. In addition, PBOC has also reduced the ceiling limits on credit cooperative loans and removed the loan rate floors.

Liberalization of loan rate ceilings and deposit rate floors had been implemented step by step, and the spread had been widening: it had increased 27 basis points from 3.30 to 3.57 percent as of April 2006. Within this band, financial institutions are free to decide loan rates based on valuation of customer risk for individual customers.[80] This has helped banks to operate in a safer manner for conventional borrowers because of larger net interest margins.

However, deposit rates are still negative in real terms, offering a disincentive to deposit money in the banking system, and the spread for lending rates is still too small to cover the transaction costs of commercially sustainable microfinance. PBOB plans to remove the interest rate ceilings on RMB deposits and liberalize interest rates on all other types of deposits (small deposits of less than one year maturity) in the future. In this context, PBOC has also introduced market-based monetary policy tools.[81]

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[79] A "repo rate" is the discount rate at which a central bank repurchases government securities from commercial banks; the repo rate is usually adjusted to accommodate the central bank's target level of money supply it would like to achieve in a country's monetary system.
[80] Goodfriend and Prasad, op.cit., p. 30.
[81] García-Herrero and Santabárbara, op.cit., p. 318; Christian Roland, "*Banking Sector Reform in India and China – A Comparative Perspective,"* 2006, p. 14 at

b. Credit Lines and Directed Credit

Vietnam

Vietnam made extensive use of credit lines to manage monetary policy beginning in 1994, but the government notionally eliminated this practice in 1998. Nonetheless, SBV continues to set target credit growth rates for the banking system, of which the SOCBs comprise the largest share.

The government's interventions in commercial bank lending decisions have been decreasing since the 1990s as a result of the promulgation of the Law on the State Bank and the Law on Credit Institutions in 1997, effective one year later. According to these laws, government agencies are prohibited from intervening in bank credit decisions.

In fact, directed credit and credit to SOEs have indeed been significantly reduced, falling from 90 percent[82] of total credit in the early 1990s to 31.4 percent by March 2007.[83] This suggests that commercial banks, including SOCBs, are now facing declining pressure to grant credit to the public sector.

However, the story is dramatically different if the loan balances of the policy banks, especially VDB, as well as the local investment funds, are taken into account.[84] For example, as noted in Chapter 3, the assets of Vietnam's policy banks at the end of 2005 were about 15 percent of total bank assets, equal to roughly 18 percent of GDP (Table 2); at present, VDB's loan portfolio alone is estimated to be more than 10 percent of GDP.

"Quarantining" directed credit outside of the mainstream banks helps to improve the market orientation and commercial performance of Vietnam's banking sector, thus reducing its vulnerability to systemic credit risk, but it also poses considerable opportunities for misallocation of capital and institutional corruption: these institutions are off-budget mechanisms to channel resources to public enterprises, with little transparency and minimum disclosure requirements; they are essentially political institutions masquerading as banks, beyond the purvue of SBV.

China

SOCBs have had more autonomy and accountability in their lending decisions since the early 1990s. Credit quotas haves been removed, and the government's intervention in credit allocation has been prohibited, at least formally.[85] However, the fact that most of bank loan balances, especially for SOCBs, are on the balance sheets of SOEs suggests

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http://unpan1.un.org/intradoc/groups/public/documents/APCITY/UNPAN024226.pdf, 26/12/2006; and Richard Podpiera, *"Progress in China's Banking Sector Reform: Has Bank Behavior Changed?*" IMF Working Paper WP/06/71, 2006, p. 12 at http://www.lesechos.fr/info/medias/200075345.pdf.

[82] Jens Kousted, John Rand, Finn Tarp, Le Viet Thai, Vuong Nhat Huong, and Nguyen Minh Thao. *"Financial Sector Reforms in Vietnam - Selected Issues and Problems,*" CIEM/NIAS report, NIASPess, 2003, p. 19.

[83] IMF. "*Vietnam: Statistical Appendix,"* 2007, p. 23, at http://www.imf.org/external/pubs/ft/scr/2007/cr06423.pdf.

[84] Thành, op.cit., p. 142.

[85] García-Herrero and Santabárbara, op.cit., p. 327.

that directed credit seems to be pervasive in Chinese SOCBs *de facto*, in addition to special-purpose financial institutions (Development Bank, Agriculture Development Bank, and Export-Import Bank) conducting directed lending *de jure*.[86] This remains is a big problem in reforming the banking system, especially the SOCBs in China, and can only be fully resolved as the SOEs themselves are commercialized, equitized, or liquidated. At present, it appears that directed credit and credit to SOEs is more pervasive in China than in Vietnam.

II. Reserve Requirements

Vietnam

Required reserves[87] have not ever been a source of budget revenue in Vietnam, because although the required reserve ratio may be as high as 35 percent,[88] it has never been above 15 percent.

Instead, required reserves have been used solely as a tool to execute monetary policy. This is consistent with the common central bank practice of using reserve requirements as lending controls, for example, raising the reserve requirement ratio to reduce lending when tightening monetary policy, as SBV did in 2004 to help curb inflation.[89]

SBV has utilized the USD required reserve ratio in a similar manner, for example when it increased this ratio to 12 percent in 2000 due to dollarization pressures and adverse fluctuations in the foreign exchange market.

China

China's treatment of required reserves is similar to Vietnam's, namely as a tool to execute monetary policy rather than as a way to finance budget deficits. As part of a general decline in government intervention in the banking system that began in the early 1990s, the government reduced the required reserve ratio from 20 to 8 percent in 1998, and then to 6 percent in 1999. In addition, interest rates on excess reserves were reduced to discourage banks from holding liquid assets and to encourage them to improve their asset management. The last reduction in interest rates on excess reserves was in 1999, from 1.60 to 0.99 percent.[90]

III. Foreign Exchange Policy and Exchange Rate Management

[86] In late 1999, the loan balance to the private sector was only USD7 billion, accounting for 0.62% of total bank loan balances, and less than 0.5% of loan balances of SOCBs (Huang, op.cit., p. 117).
[87] The reserve requirement ratio is the percentage of customer deposits that banks must set aside as reserves.
[88] Regulation on Reserve Requirement promulgated in association with Decision 108/QĐ-NH dated 09/06/1992 of the SBV.
[89] Although the reserve requirement is different for financial institutions operating in the rural and urban areas, some institutions like VBARD (Vietnam Bank for Agriculture and Rural Development), despite the name, are operating almost entirely in urban areas.
[90] García-Herrero and Santabárbara, op.cit., p. 317

Vietnam

In Vietnam, both foreign exchange and the exchange rate are tightly controlled.

The exchange rate reform process can be divided into four stages:

- During 1986-1989 (or more exactly, 1955-1989), only the government engaged in foreign trade and foreign exchange transactions; exchange rates were therefore set administratively.
- During 1989-1991, the multi-rate system was replaced by the single-rate system, with market forces having increasing impact; some consider this period one of a flexible exchange rate regime.
- During 1992-1999, exchange rates were first officially set in the foreign exchange trading center on an auction basis (until 1994), and then in the inter-bank foreign exchange market based on average transaction rates. During this period, the exchange rates also reflected supply and demand.
- From 1999 until now, SBV has only "announced" the average transaction rates in the inter-bank market, instead of setting and announcing the official exchange rates. The fixed exchange rate regime has been replaced by the pegged float exchange rate regime.[91]

There have always been two or three types of exchange rates during the reform process: the official rate announced by SBV, the rate at which commercial banks make transactions (nominal and effective), and the rate in the free market (black market). During the early years of reform the official and free market rate spread was very large, but the gap had closed significantly by the end of 2006 (see Table 8 below). However, the spread has begun to widen again during the current financial crisis, as has the difference between the nominal and effective exchange rates of commercial banks due to their imposition of extra charges such as a "money counting fee" when SBV's official trading band does not reflect market prices.

Table 8: The Spread Between Official and Free Market Exchange Rates

Year	**'85**	**'86**	**'87**	**'88**	**'89**	**'90**	**'91**	**'92**	**'06**	**'07**	**'08**	
											03/20	**06/19**
Official	15	80	368	3,000	3,900	5,133	9,274	11,179	16,091	16,114	15,861	16,619
Free	115	425	1,270	5,000	4,750	5,610	9,546	11,334	16,120	16,150	15,355	19,500
Free/Official	7.67	5.31	3.45	1.67	1.22	1.09	1.03	1.014	1.002	1.002	0.968	1.222

Source: SBV; *Tiến*, op. cit.

Foreign exchange management was probably most stressful in the late 1990s, when dollarization was serious and the growth rate had come to a halt. At that time, firms were

[91] Nguyễn Văn Tiến, "Modern International Finance: Assessing Vietnam's exchange rate policy after 20 year of reforming*,"* Statistical Publisher, 2005, p. 795; and Phí Đăng Minh, *"Current situation and Conditions to liberalize capital account in Vietnam,"* SBV, 2007, p. 23.

sometimes required to sell 100 percent, and then later 80 percent of their foreign exchange to those banks that were allowed to trade foreign exchange.[92]

According to current laws, "the exchange rate of the Vietnamese currency is created by the demand for and the supply of foreign currencies in the market under the government's regulation."[93] In practice, SBV announces the so-called inter-bank exchange rate of the VND against the USD every day. Based on this rate, banks decide their trading rates within a band of less than 0.5% of the announced rate.[94] For other foreign currencies, banks are fully free to decide the exchange rates. If necessary, the government can "apply the regulations on the obligation to sell foreign currencies for institutional residents," as well as some other administrative measures.[95] At present, the IMF considers that Vietnam has implemented Article 8 of IMF regulations on the capital account and exchange rate controls.[96]

China

The RMB was first issued just before the collapse of the Kuomintang regime in 1949 amidst a macroeconomic meltdown that accompanied the bloody political transition. Thus, one of the new Communist government's most urgent challenges was to tame a raging hyperinflation.

For the next three decades, during the era of China's command economy, the RMB was set to unrealistically high exchange values vis-à-vis foreign currencies, and thus, severe currency exchange regulations were promulgated to try to enforce adherence to a very overvalued RMB.

When China began its transformation in 1978 to a more market oriented economy, it introduced a dual track currency system under which only the RMB could be used domestically and foreigners had to use foreign exchange certificates. This system, which continued to peg the RMB exchange rates at terribly overvalued levels, created ripe conditions for a thriving black market in currency transactions.

From the late 1980s to the mid 1990s, China made the RMB more convertible, abolished the dual track currency system, and brought the RMB down closer to market values through the use of swap centers. Through a series of "managed devaluations" the RMB-USD exchange rate gradually fell from 3.7 to 8.6 over a period of about five years.

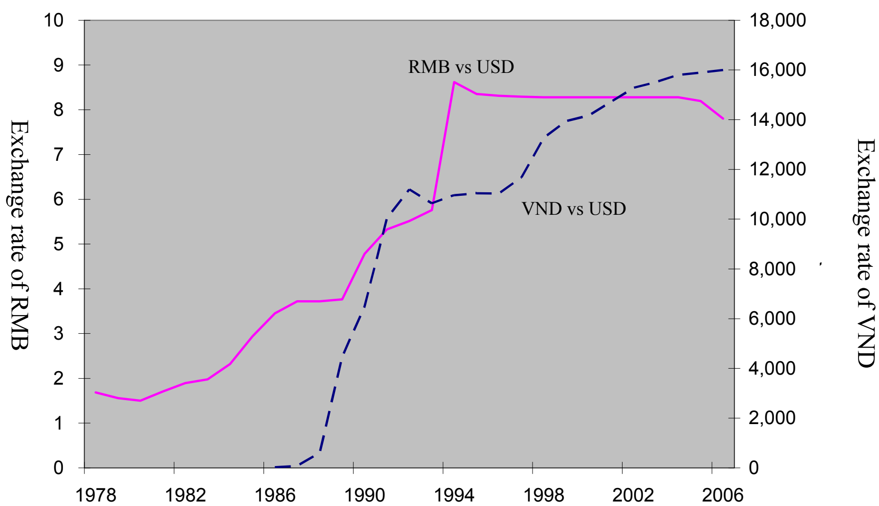
From 1994 to July 2005, the RMB has been pegged to the USD. While China was commended for this policy, which helped to prevent a round of competitive devaluations during the 1997-1998 East Asian financial crisis, it has been subject to growing pressures since 2003, when its USD peg caused it to fall in tandem with the USD, to appreciate what many perceive to be an undervalued currency.

[92] QĐ173/1998/QĐ-TTg, dated 12/09/1998; SBV data; and Minh, op. cit., p. 26.
[93] Ordinance on Foreign Exchange in 2005, Provision 1, Article 30.
[94] Decision 2554/2006/QĐ-SBV dated 31/12/2006, Article 1.
[95] Ordinance on Foreign Exchange in 2005, Article 41.
[96] See: http://www.imf.org/external/np/sec/pr/2006/pr0602.htm, 31/12/2006.

This is a highly complex and contentious issue, with strong arguments both for and against revaluation of the RMB.[97] While appreciation would help ease inflationary pressure and the increased difficulty of effective inflow sterilization, as well as reduce external political criticism, it would also make Chinese exports less competitive and could dampen economic growth, in addition to reducing the value of China's more than USD1 trillion in reserves[98] and exposing domestic banks to currency risks they might not be able to mitigate effectively. However, there is a consensus among most stakeholders that whatever strategy China adopts, incremental policy change is preferable to a major monetary dislocation.

The RMB remained almost fixed at 8.27 per USD until July 2005.[99] The RMB is now undergoing "managed appreciation"; it had risen 6 percent against the USD by the end of 2006, and the trend has continued through the first half of 2008 – as of June 12, the RMB had appreciated to 6.9 per USD. VND and RMB exchange rate trends with the USD are depicted in Figure 11 below.

Figure 11: VND – USD and RMB – USD Exchange Rate Trends



Sources: WDI, SBV, PBOC

[97] For a good summary of this debate, see: Jeffrey Frankel, *On the Renminbi: The Choice Between Adjustment Under a Fixed Exchange Rate and Adjustment Under a Flexible Rate*, National Bureau of Economic Research Working Paper 11274 (Cambridge, MA: NBER, April 2005).

[98] China has spent an amount of RMB equal to 40 percent of money supply to buy approximately USD1 trillion for the last ten years, but the average inflation rate is still less than 1 percent, the growth rate of money supply is 16 percent, and the growth rate of foreign exchange reserves is more than 24 percent. One common explanation for this is that the RMB is strong, so one wants to hold RMB (in cash) or transfer funds abroad, wait until the RMB appreciates, and then sell it for a handsome profit.

[99] Min Zhao, *"External Liberalization and the Evolution of China's Exchange System: An Empirical Approach,"* World Bank Research Paper No.4 (Washington, D.C.: World Bank, 2005), pp. 12, 15, 16 and Appendix 2, p. 31, at http://siteresources.worldbank.org/INTCHIINDGLOECO/Resources/external_liberalization_and_exchange_control.pdf.

IV. Capital Flows Policy and Capital Account Management

As the last step of financial liberalization, and in the aftermath of the 1997-98 East Asian financial crisis, which was exacerbated at least in Thailand by opening the capital account too quickly, capital account liberalization has been the slowest component of financial sector reform in both Vietnam and China. Given the risks of mismanaged capital account liberalization, this is not necessarily a bad thing.

Vietnam

Vietnam has been very conservative with capital flow movements, especially capital outflows. Policies are different for various capital flows, as follows:

- *Foreign direct investment (FDI):* When Vietnam started opening in the late 1990s, FDI flows were very restricted. These restrictions have been phased out gradually; today there are almost no restrictions on FDI capital flows.

- *Foreign portfolio investment (FPI):* Compared to FDI, the growth of FPI flow to Vietnam has been slower, because foreign investors were not allowed to buy shares in domestic firms until the late 1990s. For many years, foreign investors were entitled to own a maximum of 30 percent of shares in listed domestic companies. This limit was increased to 49 percent in October 2005, and immediately caused a positive effect on the development of the Vietnamese securities market. The government is planning to loosen the regulation on foreign ownership for selected industries, and foreign investors are expected to be allowed to own up to 100 percent of shares in a domestic firm for some industries. Unlike China, Vietnam does not issue a quota for foreign investors to enter the securities market. According to Mr. Le Xuan Nghia, the only tool to regulate FPI flows is the regulation on the foreign ownership of a domestic firm.

- *Debt flow:* The debt flow is tightly controlled in Vietnam. In late 2006, Vietnam's total foreign debt was only 30.2 percent of GDP; most of it was long-term public debt. Total private debt accounted for only 6 percent of GDP, and short-term debt took only 1 percent.[100] In general, external private debt was not encouraged. For a long time, almost all outgoing remittances had to be approved by SBV (excluding the limit on the amount of foreign exchange individuals are allowed to take abroad). The private sector's borrowing had not been loosened until 2005.[101]

China

Capital account liberalization in China has consistently followed the following three principles:

- Attraction of foreign direct investment is the highest priority.

[100] IMF 2007, op. cit., p. 3.
[101] Minh, op. cit., p. 29 and Decree 134/2005/NĐ-CP.

- Strategic liberalization is pursued to secure the smoothness of capital flows.
- External liberalization is gradual and careful, and coupled with enhancement in capacity to monitor risks.

In addition to restrictions on the foreign ownership in domestic firms, like Vietnam, China has controlled capital flows by issuing quotas for foreign investors who wish to participate in the capital markets.[102] With this policy, China can capture the capital inflow in the securities market while reducing the risk of these fund flows. In general, China only opens the market for FDI; the other components of the capital account are still under tight controls. In addition, again similar to Vietnam, foreign borrowing is not encouraged; as of late 2005, foreign debt accounted for only 25 percent of GDP.

In general, capital flow management policies in China follow the principle of "easy inflow, hard outflow." All capital outflows (even to pay debt) must be approved by the Chinese Foreign Exchange Management Agency.[103] Nonetheless, China's capital account has been opening slowly.[104]

V. Financial Sector Deregulation

As noted in Chapter Two's conceptual framework for assessing financial sector reform in Vietnam and China, financial sector deregulation refers to the transition from a closed to a competitive financial system.

When applied to banking systems, this entails the use of market performance rather than preferential treatment to determine market share and bank profitability by: reducing administrative and legal barriers to entry, expansion, and diversification; opening the banking sector to private ownership and competition, from both domestic and foreign investors; and equal treatment of domestic and foreign banks.

When applied more broadly to financial systems, financial sector deregulation refers to application of these principles to non-bank financial institutions as well as to capital markets.

a. Barriers to Entry, Expansion, and Diversification

Vietnam

Shortly after the Vietnamese banking system began to operate formally as a two-tier banking system in 1990, the government began to gradually reduce administrative and legal barriers to entry, expansion, and diversification of its newly structured banking system. The market was slowly opened to both JSCBs (Joint Stock Commercial Banks) and foreign banks, the latter which were permitted to either open branches or establish joint ventures with domestic banks.

[102] Barth, op. cit., p. 6.
[103] García-Herrero and Santabárbara, op.cit., p. 322.
[104] Goodfriend, op.cit., p. 28.

Opening up the Vietnamese banking system was a mixed success. Competition did increase dramatically, as the number of JSCBs grew from only 4 in 1991 to 51 in 1997.[105] However, this rapid growth also created a bifurcated and imbalanced market in which most of the assets were concentrated among the SOCBs and the rest of the market was extremely fragmented and characterized by destructive competition among the JSCBs. This led to a market consolidation via bank restructuring and mergers, particularly during 1999-2001, so that by 2006 the number of JSCBs had fallen to 34.

Another more recent problem with expansion of Vietnam's banking system is the issuance of bank licenses to SOE conglomerates, as well as the acquisition of JSCBs by SOEs, which poses the same systemic risks that affiliated lending created in Japan, Korea, and Indonesia prior to their respective banking crises. This risk is heightened by SOE and SOCB ownership of non-bank financial institutions such as finance companies and leasing companies, and what is believed to be extensive but non-transparent cross-institutional shareholdings among SOEs, SOCBs, and affiliated financial entities. The risk of SOE diversification into the financial sector has been compounded by the desire of many of the banks themselves to diversify their operations by becoming universal banks.
So now Vietnam is both well banked and poorly banked. In terms of number of institutions and their retail distribution networks, the growth has been encouraging: there are now 80 banks and 924 credit cooperatives in Vietnam (see Figure 1), and the SOCBs alone have over 3,000 offices around the country. In terms of market composition, though, the figures indicate there are still significant structural weaknesses in the competitive position of JSCBs vis-à-vis SOCBs: in 2006, the market share of SOCBs was still nearly 70 percent of total deposits and 65 percent of outstanding credit, and the top 15 banks together had 92.4 percent of market share by assets, excluding foreign bank branches (see Chapter 3 for a more detailed description of Vietnam's current banking system).[106] Furthermore, majority of the Vietnamese businesses and households still do not have access to formal financial services, as most of the banks in Vietnam are chasing the same small subset of formal businesses and relatively high-income urban consumers.

China

The saga of falling barriers to entry, expansion, and diversification in China is similar to Vietnam's story, but beginning about a decade earlier. For most of the 1980s, the most significant development of China's financial system was the growth of non-SOCB financial intermediaries: regional banks, partially owned by local governments, were formed in the coastal Special Economic Zones (SEZs); RCCs were established in rural areas and UCCs in urban areas; other non-bank institutions were established, such as Trust and Investment Corporations; and foreign banks set up branch offices in SEZs for currency exchange operations.[107]

All of these new financial intermediaries began to take deposits and make loans, which was healthy for enhancing market competition and was extremely successful in

[105] Vu Viet Ngoan, *Financial Reform in Vietnam: Toward International Integration,* ABA 20th Annual Meeting and Seminars, 2003.
[106] Thanh and Quang, op. cit., pp. 7-8.
[107] Allen, Qian, and Qian, op. cit., p. 7.

mobilizing savings. However, this also contributed to higher levels of inflation, and most of the credit was directed at either SOEs or town and village enterprises (TVEs), simply replacing financing via budget allocations with financing via the channeling of funds through the banking system.[108] This off-budget financing mechanism, while attractive politically, not only undermined the soundness of China's financial intermediaries, but was also illusionary: when many of these loans were not repaid and the lenders became insolvent, the burden reverted to the budget in the form of allocations to recapitalize these financial intermediaries.

The inflationary pressures created by this rapid expansion led to a slowdown of financial reforms from 1988 to 1991, during which time the government also consolidated many of the new institutions, but financial sector deregulation resumed with the beginning of another economic boom in 1992. The results are similar to those of Vietnam: a relatively large number of financial institutions, some with extensive retail distribution networks, but a banking system still dominated by SOCBs and lending to SOEs (see Figure 2 and Table 3).

b. Privatization/Equitization

Vietnam

Vietnam is just beginning its SOCB privatization program: the first and only IPO to date, for VCB, was undertaken in December 2007, after many delays. Although the other four SOCBs (BIDV, ICB, VBARD, and MHB) still plan to go public, their IPOs have been postponed until 2009 at the earliest. Furthermore, VCB's IPO was disappointing for two reasons: the IPO was not preceded by collaboration with a strategic investor (see discussion below); and public confidence has dropped sharply since the IPO, reflected in a more than 70 percent drop in VCB's share price.

The concept underlying privatization (referred to as equitization in Vietnam and China) is that private ownership, whether partial or full, can bring with it not only investment capital, but other resources as well that should improve bank performance, such as proprietary innovative technology, effective management, and sound governance structures. If properly applied, these resources should both increase bank profitability and improve consumer financial services.

Thus, Vietnam and China have plans to equitize their SOCBs, in two stages: first, find a strategic investor (usually a foreign bank) to add value to the SOCB by commercializing and corporatizing it; and second, sell shares to the public at a higher price than the government would have received without a strategic investor.

Privatization is generally an extremely sensitive subject, as it entails selling state assets, often considered sovereign wealth, to domestic and/or foreign investors. While the concept might be sound in theory, if not implemented with adequate preparation and in a

[108] For example, "the main investment channel for firms (from the government to SOEs) shifted from budget appropriation (70% in 1978) to loans from state-owned banks (80% in 1982)." (Allen, Qian, and Qian, p.7.)

competent and transparent manner, it could make things worse, especially for quasi-public goods like financial services. It could simply transfer public assets, rights, and prerogatives to the private sector without internal checks and balances or external disclosure requirements, enriching well-connected insiders at the public's expense in the process, as was done during Russian privatization.

China

Three of China's "big four" SOCBs are already listed on the Hong Kong and Shanghai Securities Exchanges (BOC, CCB, and ICBC) as a result of IPOs in 2005 and 2006, and China is planning an IPO for ABC in 2008 or 2009, after it is recapitalized with a $100 billion injection of state money (see Chapter 3). The primary difference between China's three IPOs and Vietnam's IPO for VCB is that to date, China has adhered to the concept of two-stage equitization. As indicated in Table 9 below, China's SOCBs not only raised substantial sums of capital from their strategic investors, but these strategic investors also participated in SOCB governance and management, and provided many forms of technical assistance.[109]

Table 9: Foreign Investors in China's Five Largest Banks

Bank (estimated assets, end-2005)	**Foreign Investor**	**Board Representation and Management Responsibility**	**Technical Assistance**	**Investment Safeguards, Specific Cooperation**	**Listing Status**
Industrial and Commercial Bank of China ($827 billion).	**Goldman Sachs**, **Allianz**, and **American Express**, 8.5 percent (combined) for $3.8 billion (of which Goldman Sachs $2.58 billion).	Goldman Sachs to nominate one Board member, no management responsibility.	Risk management, corporate and investment banking, credit cards (Amex), and insurance (Allianz).	Compensation only if book value declines below end-2005 level prior to the IPO.	IPO in Hong Kong and Shanghai in October 2006, raised almost $22 billion.
Agricultural Bank of China ($608 billion).	None	--	--	--	--
Bank of China ($587 billion).	Consortium led by the **Royal Bank of Scotland**, 9.6 percent for $3.0 billion (all data pre-IPO). **UBS**, 1.6 percent for $492 million. **Temasek**, 4.8 percent for $1.5 billion	RBS to nominate one Board member, no management responsibility. None None	Corporate governance, risk management, and IT. Cooperation with RBS in wealth management, credit cards, and corporate banking; partnership with UBS in investment banking and securities.	Compensation if book value through end-2007 declines below book value at end-2004. Credit cards: 50:50 management of a business unit with RBS, when a separate joint venture is established, RBS will have 49 percent ownership.	Raised $11.2 billion in Hong Kong and started trading on June 1, 2006.
China Construction Bank ($568 billion).	**Bank of America**, 8.5 percent for $3 billion. **Temasek** 6.0 percent for $2.5 billion.	One Board member and no management responsibility. Could nominate one Board member, but no plans to do so now; no management responsibility.	Approximately 50 personnel to assist in risk management, governance, consumer banking, and other areas. 1000 person/day training in treasury business and other areas.	An adjustment of the purchase price if December 2004 financial statements are restated; credit card venture under negotiation. No known adjustment.	IPO in Hong Kong, started trading on October 27, 2005. Total funds raised $9.2 billion.
Bank of Communications ($176 billion).	**HSBC**, 19.9 percent for $1.75 billion.	Two Board members, one on audit committee, the other on personnel and compensation committee. One senior manager (vice president) and management of the credit card business.	At least 150 hours of technical assistance each year, eight HSBC experts are working in BoComm now, three more to arrive in 2006.	Credit card business unit set up, with 50:50 representation of BoComm and HSBC managers, to be converted to a Sino-foreign joint venture with 50:50 shares.	IPO in Hong Kong in June 2005, raising $2.16 billion.

Source: Lamin Leigh and Richard Podpiera, The Rise of Foreign Investment in China's Banks – Taking Stock, IMF Working Paper WP/06/292 (Washington, D.C.: IMF, December 2006), p. 12.

[109] China's equitization strategy is described in detail by the PBOC on its web page at: http://www.pbc.gov.cn/english//detail.asp?col=6400&ID=966

Table 10 below indicates that both Vietnam and China are well behind the transitional economies of Eastern Europe in terms of banking sector privatization.

Table 10: Bank Ownership in Selected Transitional Economies[110]

Country	1993		2003	
	State-owned	Private	State-owned	Private
Poland	86.2%	13.80%	25.2%	74.8%
Hungary	74.9	25.1	7.0	93.0
Czech	11.9	88.1	3.0	97.0
Slovakia	70.7	29.3	19.0	81.0
China	**83.8**	**16.2**	**67.6**	**32.4**
Vietnam	**>90.0**	**<10.0**	**71.0**	**29.0**

Source: SBV, Guiraud, García-Herrero, and the author's calculations

c. Participation of Foreign Financial Institutions

Vietnam

Vietnam has been gradually opening its financial sector to foreign institutions in accordance with the bilateral trade agreement (BTA) it signed with the United States in 2000 (effective in 2001), and the terms of its WTO ascension in 2007 as summarized in Figure 12 below. For example, restrictions on the operations of foreign banks have been reduced or phased out, and the limit on domestic currency mobilization has risen from 100 to 500 percent of equity. The ownership in a domestic bank still may not exceed 15 percent for a single foreign investor, and may not exceed 30 percent for all foreign investors.

Recently there has been a heated debate on whether to increase the ceiling on foreign ownership in a domestic bank to 49 percent, but this issue has not yet been resolved. Given the relatively small size of Vietnamese banks and the Vietnamese economy compared to China, there is greater fear of the impact of foreign ownership on national sovereignty in Vietnam than in China.

[110] Data for banks only, not including non-banking financial institutions.

Figure 12: Vietnam's WTO Commitments in the Financial Sector

Box 1: Viet Nam's WTO Commitments

Under Viet Nam's commitments to the WTO, foreign credit institutions are permitted to establish a commercial presence in Viet Nam in a number of forms including representative offices, branches of foreign commercial banks, commercial joint venture banks with foreign capital contribution not exceeding 50% of charter capital, and banks with 100% foreign-owned capital. The banking market is set to open up to full foreign competition.

During the 5 years from the date of Viet Nam's WTO accession, Viet Nam may limit the right of a foreign bank branch to accept deposits in Vietnamese Dong from Vietnamese citizens with which the bank does not have a credit relationship to a ratio of the branch's allocated capital according to the schedule below:

- 1 January 2007: 650% of allocated capital;
- 1 January 2008: 800% of allocated capital;
- 1 January 2009: 900% of allocated capital;
- 1 January 2010: 1,000% of allocated capital;
- 1 January 2011: Full national treatment.

Viet Nam may limit equity participation by foreign credit institutions in equitized Vietnamese State-owned banks to the same level as equity participation by Vietnamese banks. For capital contribution in the form of buying shares, total equity held by foreign institutions and individuals in each of Viet Nam's joint stock commercial bank may not exceed 30% of the bank's chartered capital, unless otherwise provided by Viet Nam's laws or authorized by a competent authority of Viet Nam. A branch of a foreign commercial bank is not allowed to open other transaction points outside its branch office. Upon accession, foreign credit institutions are allowed to issue credit cards on a national treatment basis.

Source: Thanh and Quang, op. cit., p. 7.

In response to Vietnam's opening up of its financial sector, there has been a stream of foreign investment in domestic JSCBs, as summarized in Table 11 below. Some of these have been very high-profile transactions, such as ANZ's purchase of 10 percent of Sacombank and Standard Chartered's purchase of 8.6 percent of Asia Commerce Bank – not only are these blue-chip investors, but they are buying stakes in two of Vietnam's largest and most profitable JSCBs.

Table 11:

Strategic Investments in Vietnamese JSBCs by Foreign Financial Institutions

Target Bank	Acquirer	Acquisition Announcement Date	Stake Acquired	Target Bank Asset Size*	
				VND trillion	US$ billion
Sacombank	ANZ Bank	24 Mar 2006	10.0%	24.9	1.5
Asia Commerce Bank	Standard Chartered	17 Jun 2005	8.6%	44.6	2.8
Techcombank	HSBC	28 Dec 2005	10.0%	17.5	1.1
VP Bank	OCBC	21 Mar 2006	10.0%	10.2	0.6
Orient Commercial Bank	BNP Parisbas	17 Nov 2006	10.0%	6.4	0.4
Southern Bank	UOB	25 Jan 2007	10.0%	9.2	0.6
Techcombank	HSBC	25 Jan 2007	10.0%	17.5	1.1
Habubank	Deutsch Bank	01 Feb 2007	20.0%	11.6	0.7
Eximbank	SMBC	30 Mar 2007	15.0%	24.9	1.5
PVFC	Morgan Stanley	13 Nov 2007	10.0%	34.5	2.15

Note: As of 31 December 2006.

Source: Company announcements, newswires.

Source: Thanh and Quang, op. cit., p. 12.

China

An important milestone of Chinese financial sector liberalization was WTO ascension in late 2001. According to its WTO commitments, China had a five-year timetable similar to the one Vietnam is now following. China has worked steadily to meet this objective, although progress has been slow given the complexity and sensitivity of foreign participation in China's domestic banking market.

The process has been incremental, and actually started more than two decades ago:

- In the mid-1980s, foreign banks were only allowed to conduct foreign currency transactions, and were confined to certain services and geographical areas, mainly SEZs.

- Subsequently, they were allowed to supply domestic currency services to foreign individuals and firms in certain areas (starting with the richest areas), with high minimum reserve requirements and safety standards.[111]

- In 2003, the wholesale market in domestic currency (for large Chinese firms, for instance) was opened to foreign banks in many provinces.[112]

- Finally, since 2007, foreign banks have been allowed to supply all financial banking services anywhere in China.

- In addition, China recently adopted a strategy to facilitate market entry for foreign financial institutions. For example, the ban on opening more than one branch per year has been removed, and the minimum capital requirement to set up a new branch has been reduced.

The number of foreign bank branches indeed increased from 157 in 2001 (WTO accession) to 192 in 2004. Most of these bank offices are from Asian economies (Taiwan, Hong Kong, and Korea). The number of representative offices also increased, from 184 to 223.[113]

Although not part of its WTO commitments, China has also increased the single foreign investor ownership ceiling in a domestic bank from 15 to 20 percent, and the total foreign investors' ownership ceiling 25 percent. This is consistent with a common perception that China's banking system is in need of capital, as well as banking governance and management expertise. By October 2005, 17 foreign banks have bought shares in domestic banks totaling USD20.88 billion.[114]

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[111] This regulation required that foreign banks should have more reserves on mobilized funds, and hence, less funds available for lending; so their competitiveness was reduced.

[112] In finance, "wholesale market" refers to the provision of services to large firms, while "retail market" refers to the provision of services to individuals and small firms.

[113] García-Herrero and Santabárbara, op.cit., pp. 319-320.

[114] Thomas Achhorner, Johnson Chang, Holger Michaelis, and Tjun Tang, *"Banking on China: Successful Strategies for Foreign Entrants."* The Boston Consulting Group, 2006, pp. 11-12, at http://www.bcg.com/publications/files/Banking_on_China_Successful_Strategies_May06.pdf.

VI. Financial Sector Stabilization

As noted in Chapter Two's conceptual framework for assessing financial sector reform in Vietnam and China, financial sector stabilization refers to ensuring the long-term soundness of a nation's financial system.

When applied to banking systems, this entails restoration of liquidity and solvency after a banking crisis, usually through a combination of bank restructuring, resolution of bad debt overhang, and if necessary, subsequent bank recapitalization. This is coupled with improvement of bank regulation and supervision capacity to maintain the future safety and health of banks once the system has been stabilized.

When applied more broadly to financial systems, it entails mitigation of market failures in the financial sector like asymmetries of information and incomplete markets through enactment of measures such as consumer protection laws and the credible enforcement of contracts. The purpose is to address potentially costly and destabilizing behavior such as adverse selection, moral hazard, and fraud.

a. Restructuring

Vietnam

Vietnam has focused most of its bank restructuring efforts on its SOCBs in preparation for their IPOs. Responding to the relatively low level of SOCB efficiency and profitability, the government's efforts have focused on trying to improve governance and management systems, capital structure and asset quality, and effective application of banking technology. As noted earlier, significant progress has been made in reducing formal preferential lines of credit and officially directed credit as part of financial sector liberalization, but there is still considerable informal government interference in SOCB operations.

There have also been some significant reforms of Vietnamese JSCBs, such as institutional consolidation and financial capacity enhancement during the late 1990s described earlier.[115] One tangible result of these efforts is that the Sacombank and ACB JSBCs are officially listed in the securities market, and have two of the highest values of all listed firms. However, the process still has a long way to go, as evidenced by growing financial sector distress.

China

China has also focused most of its attention on restructuring its SOCBs to prepare them for their IPOs (see previous section on financial sector deregulation).

Other significant reforms in China have been launched to address structural weaknesses in the financial sector, especially regarding the credit cooperative system. Those credit cooperatives that meet a series of conditions specified by the government are entitled to receive additional capital or tax incentives from PBOC or local governments. In addition,

[115] See: http://www.sbv.gov.vn/home/hethongTCTD.asp, 30/12/2006.

loss-making credit cooperatives might have to shut down. The objective is to reduce the 36,000 credit cooperatives in China in 2004 to only 10,000 credit cooperatives by 2007, mostly through consolidation at the county level. To date, the government has supported this consolidation effort by injecting USD40 billion into restructured credit cooperatives. These capital injections have been coupled with improved ownership and governance practices. In fact, 2007 has been deemed the "Year of Credit Cooperative Reforms."[116]

The real shortcoming of these reforms is lack of attention to the operational side of the credit cooperatives, particularly for credit services. Without substantial reform of credit products, pricing, and delivery systems, as well as the introduction of significant positive and negative staff incentives to make the credit cooperatives commercially viable, the reforms will probably fall well short of their objectives.

b. Bad Debt Resolution

Vietnam

Unlike China, which established independent AMCs (see next section), in Vietnam the four largest SOCBs established internal AMCs in 2000 as part of a national plan to restructure commercial banks. The charter capital of each AMC was VND30 billion, so the total charter capital of VND120 billion was about 0.5 percent of total commercial bank bad debt in late 2000. Because of the institutional affiliation of AMCs with their respective SOCBs, as well as the small amount of AMC charter capital, it is believed that the role of AMCs to date has not been significant, and that they have primarily served as debt workout departments within the SOCBs. However, no official data are available to corroborate this perception. In any case, to date, no bad debt has been transferred from banks to AMCs.

The internal status of AMCs in Vietnam also has significant accounting ramifications. In China, although AMCs are closely related to banks, they are formally independent, so banks write off debts transferred to AMCs. In Vietnam, however, bad debts transferred to AMCs still appear on the bank's consolidated balance sheet, negatively affecting many key performance indicators related to bank solvency and profitability.[117]

This, in turn, provides powerful incentives to under-report bad debts using techniques such as: rolling over non-performing loans with capitalization of unpaid interest (evergreening); restructuring non-viable loans with lower interest rates and longer repayment periods (rescheduling); and artificial inflation of loan disbursements that either never actually leave the bank, but instead are transferred to the borrowers current account, or that quickly "round-trip" to the bank after the close of the reporting period (window dressing).

In addition to the four SOCB AMCs, Vietnam also established DATC (Debt and Asset Trading Corporation) in 2003 with VND2 trillion in charter capital. DATC is a

[116] García-Herrero and Santabárbara, op.cit., p. 317.
[117] VCB plans to dissolve the AMC in its equitization package.

commercial enterprise with the long-term mandate to generate profits from the purchase and sale of bad SOE assets, unlike a conventional AMC.

Resolution of bad debts from the period that preceded establishment of the AMCs (prior to December 31, 2000) is conducted under Decision 149/2001/TTg of the Prime Minister, in which debts are classified into 3 groups: asset-secured debts[118] (Group 1), primarily the debt of private firms; unsecured debts with no debtors (Group 2), the relatively insignificant debt of bankrupt borrowers; and unsecured debts with debtors still in operation (Group 3), mainly SOE debt.

Debt resolution has been quite simple for Groups 1 and 2, and most of the resolved debts are in these groups. It has been harder to resolve debts in Group 3, as indicated by the following debt resolution results:

- According to SBV, the resolved bad debts of SOCBs were VND13.4 trillion billion at the end of 2003, or 63 percent of total bad debts specified in the Commercial Bank Bad Debt Resolution Plan as of the end of 2000, of which VND8.9 trillion (two-thirds) was resolved by the banks themselves, and VND4.5 trillion (one-third) was resolved by the government.

- 40 percent of commercial banks bad debt was resolved using their bad debt provisions; only 24 percent was resolved through selling and managing secured assets, and collecting in cash.[119]

- According to the IMF, as of March 2003, resolved debts totaled VND3.1 trillion, of which VND 2.8 trillion were debts (basically of private firms) resolved using secured assets.[120] Resolution of unsecured debts was only VND300 billion, just 10 percent of total resolved debts.

Hence, the truly resolved debts (funds actually received by banks) only account for a small proportion of total bad debts, while about VND5 trillion of banks' provisions has been used to write off bad debt. This figure is equivalent to the charter capital of all 5 SOCBs as of the end of 2000.

It appears that there has not been any official report on bad debt resolution results since the 2003 SBV report cited above. A review of SOCB annual reports suggests that quite a large amount of debt has been resolved using risk provisions. Actually, this is simply a way to clean up the balance sheets, and in essence, debts are still not fundamentally resolved.[121]

China

[118] Before Decree 178/1999/NĐ-CP, loans to private firms had to be secured with assets.
[119] See: http://www.laodong.com.vn/pls/bld/folder$.view_item_detail(96000).
[120] It is the authors' assessment that the sale of the assets of Minh Phụng Co., Ltd in the case of Minh Phụng - EPCO accounts for a very large part of resolved bad debts.
[121] See "Should not make difficulty for yourself" at http://www.saigontimes.com.vn/tbktsg/detail.asp?muc=205&Sobao=846&SoTT=27&sotrang=1, 27/03/2007.

The bad debts of Chinese banks have been resolved either by AMCs, or by the banks themselves, by liquidating collateral, converting debt into equity, and selling debt to investors, including foreign investors.

Total SOCB bad debt received by AMCs was around USD323 billion, of which USD170 billion was transferred in 1999, and the remaining amount was transferred later on. In addition to the USD20 billion in initial AMC charter capital, PBOC lent the AMCs another USD175 billion to balance the debt transferred in 1999. As of the end of March 2006, AMC had resolved USD111 billion in bad debt and collected USD23.1 billion; the recovery ratio was very small, only 24.2 percent. Data on resolution of USD153 in bad debt that was transferred recently are not yet available. The AMCs have been operating for almost ten years, which is their expected lifetime, but their performance has been very limited, and many have questioned the rationale and role of the Chinese AMCs. [122]

In addition to the bad debts transferred to AMCs, Chinese SOCBs still have very large bad debts to be resolved on their own. The total bad debt of the "big four" SOCBs fell from USD232 billion in 2003 to USD140 billion in 2006, and the SOCBs themselves had resolved USD157 billion by the end of 2005.[123] Detailed data are not available, but it is likely that debts have been resolved using the bad debt provision to write them off the SOCB balance sheets, which poses other problems for banks.[124] Trends in Chinese SOCB bad debt are shown in Figure 13 below, although it should be noted that NPLs in China are widely believed to be significantly underreported.[125]

By the end of August 2004, Chinese banks and AMCs had sold debt with a face value of about USD6 billion to foreign investors, of which Citigroup took the highest proportion at a purchase price of almost USD2.2 billion.[126] This figure is a small proportion of the total bad debt of Chinese domestic banks, but it is significant for a single foreign bank, perhaps part of a strategy to increase their market share in China.

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[122] Calculation of these figures is based on research papers of PriceWaterHouseCooper, *"China NPL Investor Survey 2006"* at *http://www.pwchk.com/webmedia/doc/633009151052592032_cn_npl_survey2006.pdf*; and Ernst &Young, *"Global Nonperforming Loan Report 2006"* at http://www.chinalawblog.com/chinalawblog/files/ey_rehc_nonperformingloans_may20061.pdf. and Guifen Pei and Sayuri Shirai (2004): " The Main Problems of China's Financial Industry and Asset Management Companies" at http://coe21-policy.sfc.keio.ac.jp/ja/event/file/s1-7.pdf

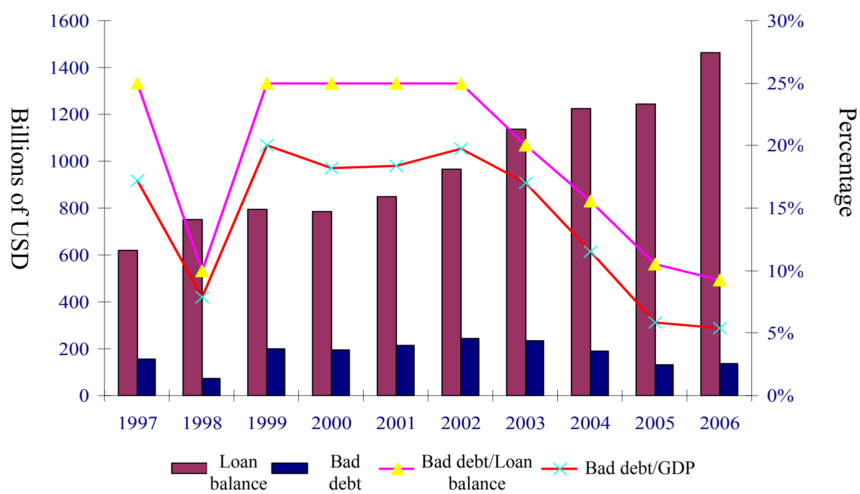
[123] See: http://www.cbrc.gov.cn/english/info/statistics/index.jsp and http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=20070212B7F451E045DD251AFFB4C2512EB89E00 .

[124] See "Should not make difficulty for yourself" at http://www.saigontimes.com.vn/tbktsg/detail.asp?muc=205&Sobao=846&SoTT=27&sotrang=1 .

[125] For a discussion of the reliability (or lack thereof) of NPL figures reported in China, see: Guifen Pei and Sayuri Shirai, *The Main Problems of China's Financial Industry and Asset Management Companies, unpublished manuscript*, February 2005.

[126] PriceWaterHouseCooper, *"China NPL Investor Survey 2004."*

Figure 13: The Bad Debt of Chinese SOCBs



Sources: CBRC, García-Herrero and Santabárbara, op.cit., and the authors' compilation.

c. Recapitalization

Vietnam

The Vietnamese SOCBs almost never received official capital from the government in the 1990s; even when the four SOCBs were established with charter capital of VND2.2 trillion for VBARD and VND1.1 trillion for each of the other banks, the government did not grant money to these banks. The government's main SOCB activities during this period was restructuring banking operations and separating directed credit from commercial activities via establishment of the Vietnam Bank for the Poor (later called the Vietnam Bank for Social Policy) and the Development Assistance Fund (later called the Vietnam Development Bank).

From 2001 to 2005, the government granted approximately VND15 trillion in charter capital to the SOCBs strengthen the financial structure of these banks.[127] Most of this additional charter capital was granted in the form of non-transferable government bonds

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[127] SBV; Phung Khac Ke, "*WTO Accession and Banking Reform in Vietnam,"* 2006, at http://www.epic.com.vn/resources/WTO_accession_banking_sector.pdf.

at an annual coupon rate of 3 percent. [128] If bad debt resolution is taken into account, the amount granted to SOCBs is about USD2 billion, or 4 percent of 2005 GDP, much smaller than in China (see next section).

China

The first wave of Chinese SOCB restructuring began in 1998 when the government poured USD33 billion into the four largest SOCBs in the form of non-transferable RMB-dominated bonds. One year later, USD170 billion in bad debt was transferred to four AMCs.[129]

The second wave started in 2003 as another USD45 billion was granted to BOC and CCB, the two SOCBs that had best resolved their bad debt. This amount was granted in the form of ownership transfer of US government bonds from the national foreign exchange reserves to these banks. Just like the above-mentioned non-transferable bonds, the banks were not allowed to convert these bonds into RMB for a specified time period. However, bank capitalization increased, since the bad debt provision was used to write off bad debt worth USD23.4 billion.

In June 2004, BOC received USD18.1 billion and CCB received USD15.6 billion from selling to AMCs bad debt whose face value was double the proceedings.[130] In addition, BOC and CCB increased tier-2 capital through issuing subordinate debt worth USD7.8 billion and USD4.8 billion, respectively. The last steps of this second wave were the IPOs of CCB and BOC, who were listed on the Hong Kong Securities Exchange in late 2005 and June 2006, respectively.[131]

The third wave started in April 2005, when the government granted USD15 billion to ICBC in the same form as funds it had granted earlier BOC and CCB. The process of restructuring ICBC went on until June 2005, when the bank was allowed to transfer USD85.5 billion in bad debt to an AMC, as well as issue USD12.1 billion in subordinate debt. In October 2006, ICBC officially held its IPO and achieved resounding success, like CCB and BOC previously.

The largest bank still in difficulty is ABC; the government will spend USD100 billion to strengthen the bank's financial condition before ABC's IPO in 2008.

Thus, China has spent more than USD200 billion, or 10 percent of 2005 GDP, over almost 10 years to clean up the SOCB balance sheets. If the amount transferred to AMCs

[128] This is a very special way to recapitalize banks in Vietnam and China. Instead of transferring money, the government grants government bonds to banks, and banks are not allowed to transfer the bonds for a specified time period. At maturity or after the time limit, banks can sell these bonds or redeem them with the government. When the bonds are granted to a bank, the bank's CAR increases, because a government bond is a zero risk-weighted asset; the bank's equity also increases.
[129] This issue is discussed in greater detail in the previous section on bad debt resolution.
[130] Selling the debt generates a difference of 50 percent of the debt value between the credit and debit sides of the balance sheet; this difference is offset by the capital granted by the government and bad debt provisions.
[131] García-Herrero and Santabárbara, op.cit., pp. 313-14.

is taken into account, the spending totals almost USD500 billion, or half of China's foreign exchange reserves as of late 2006.

VII. Regulation and Supervision

Vietnam

Although promulgation and enforcement of regulations based on international standards has been very difficult to achieve in Vietnam and much work still remains in bringing Vietnam's regulatory and supervisory system up to international banking norms, considerable progress has been made nonetheless in construction of an effective legal framework for banking operations.

The first major step in establishing this legal framework was taken in 1990 after the collapse of the credit cooperatives, with promulgation of the twin ordinances on SBV and credit institutions. Although in retrospect it is clear these ordinances had many flaws,[132] they were a significant achievement in banking reform at the time.

The next significant step in establishing an effective legal framework for Vietnam's banking system operations was promulgation of the Law on the SBV and the Law on Credit Institutions in 1997. In this revised legal framework, the central bank, although still a dependent ministerial agency, had its role more clearly defined.

The capital adequacy requirements of banks as specified in this improved legal framework also approached international standards. However, there were serious problems in actually meeting these requirements in 1999, a difficult time for banks, when banks were required to have a ratio of tier-1 capital to risk-adjusted assets as high as 8 percent.[133] Nevertheless, Vietnam continued to tighten its requirements, and the 2005 capital adequacy regulation is very close to Basel I norms,[134] although the gap between legal documents and field realities is still quite wide.

At present, while the legal framework for bank operations has been considerably strengthened, two key problems remain:

- weak SBV technical capacity to determine the true soundness of banks, in terms of both individual bank weaknesses and vulnerabilities, as well as the systemic risk of banks collectively; and

- lack of SBV independence to intervene in bank operations to mitigate shortcomings that it is able to detect.

To address these problems, Vietnam plans to transfer bank oversight responsibilities from SBV to a separate bank supervisory agency, similar to the model adopted by China (see next section), as the next step in improving both the legal and operational framework for Vietnam's banking system.

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[132] For example, see Ordinance on Banks and Credit Cooperatives 1990, Article 23.
[133] Decisions 297/1999/QĐ-NHNN5, dated 25/08/1999, and 488/2000/QĐ-NHNN5, dated 27/11/2000.
[134] Decisions 493/2005/QĐ-NHNN, dated 22/04/2005, and 457/2005/QĐ-NHNN, dated 19/04/2005.

China

The first step to reform the soft infrastructure of the Chinese banking system was taken in 1984, when the two-tier banking system was established.

In 1995, several more significant steps were taken: the central bank's position was elevated as it was granted greater authority; and regulations on capital adequacy, financial safety ratios (such as the loans to raised funds ratio), and the structure of liquid loans were applied to all commercial banks. Furthermore, in 2002, PBOC adopted the internationally-applied five-group loan classification system, codified by Chinese legislators in 2003. However, this regulation was not strictly enforced because PBOC had no viable sanctions to impose on violators of the law.

Fortunately, there have been many regulatory improvements since CBRC was established in 2003. These improvements are reflected in newly adopted asset quality, capital adequacy, and supervisory standards:

- In terms of *asset quality*, CBRC has strengthened its five-group loan classification system provisions and strictly enforced these for all banks since late 2005; CBRC expects to have bad debt provisions fully in place at the end of 2008. CBRC also adopted three tools to enhance bad debt tracking in 2005: peer group comparison, evaluation of precise loan classifications, and tracking of loans transferred between classifications. Beginning in 2006, CBRC has restricted lending concentrated in a firm or an industry when a bank has large loans concentrated in SOEs.

- CBRC has applied regulations on *capital adequacy* based on Basel standards; of particular note are the minimum capital requirements for tier-1 capital of 4 percent and tier-2 capital of 8 percent, as well as the provision that all banks must meet these requirements by the end of 2007. Furthermore, CBRC has adopted regulation utilizing a risk-based analysis framework, with specific guidelines on credit risk, market risk, and operating risk. CBRC has also applied the CAMEL risk evaluation model, which includes quantitative and qualitative criteria on **c**apital adequacy, **a**sset quality, **m**anagement, **e**arnings, and **l**iquidity. However, this model has only been applied to JSCBs.

- CBRC has enhanced *supervisory standards* by imposing sanctions on banks that have violated its prudential norms. The authority to punish banks has been supported by the adoption of legal protection for CBRC supervisors. In addition, CBRC is implementing substantial capacity enhancement programs to have sufficient means to supervise the banking system through off-site surveillance and on-site inspections.

CBRC has also tried to improve the corporate governance of banks through establishment of shareholders' councils with outsider members, but this is just an initial small step to address a very large problem.

Finally, CRBC is promoting bank transparency by: publishing data for all banks; and issuing a new regulation on information disclosure, that specifies, among other things, that a listed bank's financial statements must be audited, as well as fully and specifically disclosed.[135]

[135] García-Herrero and Santabárbara, op.cit., pp. 322-24; Hope and Hu, op. cit., p. 51; and Roland, op.cit., p.15.

CHAPTER FIVE:

CONCLUSIONS AND RECOMMENDATIONS

I. Synthesis of Similarities and Differences Between Vietnam and China

Three important conclusions can be drawn from the preceding comparison of the Vietnamese and Chinese banking systems.

First, the structure, development, and reform sequence of Vietnamese and Chinese banking system reform are basically quite similar, and both countries have made significant progress in their reform program, as follows:

<u>Financial Sector Liberalization</u>

- Partial interest rate liberalization to more closely reflect market prices.
- Transfer of the bulk of directed credit from commercial banks to special policy-based banks and increase in the lending discretion of SOCBs.
- Refusal to use reserve requirements as a budget financing tool.
- More flexible and market-influenced foreign exchange policies and the prudent incremental opening of capital accounts.

<u>Financial Sector Deregulation</u>

- Reduced barriers to entry, expansion, and diversification to promote competition and create a more level playing field.
- Greater participation of the private sector through the equitization of SOCBs and establishment of JSCBs.
- Greater participation of foreign financial institutions in domestic banking.
- Growth of financial sector institutions, products, and retail networks.

<u>Financial Sector Stabilization</u>

- Substantial bank restructuring, focused on the SOCBs in preparation for their IPOs and on JSCB consolidation in the aftermath of overexpansion.
- Modest resolution of bad debt.
- Stronger financial structures through periodic bank recapitalization.
- Enhancement of financial sector regulation and supervision capacity.

Second, the reform process is far from over. Much remains to be done in both Vietnam and China, as follows:

<u>Financial Sector Liberalization</u>

- Complete interest rate liberalization to accurately reflect market prices.
- Elimination of directed credit and preferential credit lines.
- Use of reserve requirements solely to strengthen the soundness of banks rather than to conduct monetary policy.
- Market-based foreign exchange policies and the further incremental opening of capital accounts.

<u>Financial Sector Deregulation</u>

- Further reduction of barriers to entry, expansion, and diversification to promote even more competition in the financial sector.
- Increased participation of the private sector through further equitization of SOCBs and equal regulatory treatment of JSCBs.
- Increased participation of foreign financial institutions in domestic banking through lifting of the foreign investment restrictions.
- Further growth of financial sector institutions, products, and retail networks, especially for low income households and family businesses, as well as in the provision of non-bank financial intermediation.

<u>Financial Sector Stabilization</u>

- More bank restructuring, still focused on the SOCBs as they are further equitized and on another round of JSCB consolidation.
- More effective resolution of bad debt.
- Additional bank recapitalization as necessary to meet Basel standards.
- Further enhancement of financial sector regulation and supervision capacity of financial and capital markets, especially regarding affiliations between SOEs and both bank and non-bank financial institutions, and protection of minority shareholders and small-scale investors.

Third, a closer look at financial sector reforms in Vietnam and China reveals key differences in the progress to date in each country.

Vietnam has performed relatively better than China in the following areas:

- Faster liberalization of interest rates.
- Less dependency on the use of bank reserve requirements to implement monetary policy.
- Smaller ratio of directed credit to total bank credit, and a smaller ratio of SOE assets to total bank assets.
- More flexible exchange rate management and a more open capital account.
- Greater market participation of both foreign banks and JSCBs.
- Less costly SOCB restructuring.

In contrast, China has performed relatively better than Vietnam in the following areas:

- Enhancement of regulatory and supervisory capacity, including central bank reform and creation of a separate banking supervisory agency.
- Equitization of SOCBs.
- Overall financial sector growth and diversification.

In many ways, Vietnam's quicker movement to more market-based policies while at the same time making little progress on improving the legal framework and implementation capacity for effective financial sector regulation and supervision is very risky, as it creates substantial monetary and financial system vulnerabilities. Policy makers in Vietnam need only to recall the credit cooperative crisis in the late 1990s to appreciate the risks of financial sector reform that is too hasty and not well sequenced. This crisis not only created serious macroeconomic disequilibrium, but it also eroded public confidence in the banking system.

Nonetheless, Vietnam can continue to reform its financial sector faster and at a relatively lower cost than China if it does so prudently, mainly because the size of Vietnam's financial sector in general, and the banking system in particular, is much smaller than China's in both absolute terms and in relative terms when compared with the size of the economy. The finding is important because although the authors have not encountered it in any previous publication on the subject, it suggests that Vietnam's relatively smaller size and greater homogeneity might be significant factors in allowing it to implement financial sector reform faster than China without compromising the safety and stability of Vietnam's financial system. The key is striking a proper balance between operational reform and enhancement of the government's capacity to oversee a financial sector in transition in a manner that effectly protects the public interest.

As Vietnam and China continue to pursue their respective financial sector reform programs, especially to fulfill their WTO commitments, regardless of the pace and sequencing of reform, they must both address a series of daunting challenges:

- *Inherent weakness of SOCB domination: A*lthough China and Vietnam have opened up their banking sectors to private sector and foreign participation, SOCBs still dominate with more than three-fourths of the market. This hinders general financial sector performance and growth because: SOCB governance mechanisms have not radically improved; greater efficiency, higher profitability, and asset value appreciation have not been high SOCB priorities; explicit and implicit preferential government treatment of SOCBs puts JSCBs and private sector customers at a competitive disadvantage; and it will take a long time to mitigate these weaknesses.

- *General banking system instability and fragility:* Bank liabilities are of shorter maturity than their assets - the maturity difference is as much as ten-fold, resulting in high liquidity and interest rate risks. In addition, as banking governance and risk management are still limited, and banks are growing too rapidly (for example, some banks are doubling their size each year and credit growth of the banking system in 2007 is too high at 53 percent), banks are extremely fragile, particularly in their lending exposure to real estate and stock markets.

- *Threat of being taken over by foreign financial institutions:* Openness for foreign participation, especially for foreign strategic investors, is good, as it helps increase the banking system's quality. However, the main objective of foreign banks and investors is to build global financial holdings with Vietnam and/or China as a part of their global market. They want to have a strong network under their own brand name, rather than an increase in the value of their capital contribution to domestic banks. Hence, Vietnamese and Chinese banks should be careful if they do not want to become merely agents of foreign banks.[136] This may be a topic of much greater concern for Vietnam, because Vietnamese banks are much smaller than multinational banks. For example, the total value of Vietnam's bank assets was roughly USD40 billion in 2004, equivalent to that of just Guangdong Development Bank for the same period, and less than one-tenth of ICBC's value.

II. Policy Recommendations for Further Financial Sector Reform in Vietnam

There is still considerable scope for reform if the Vietnamese financial sector is to become an efficient capital allocation channel and a principal contributor to stable economic growth and development. In the context of the preceding comparative analysis of financial sector reform, it is clear that reform must continue in all three domains of financial sector liberalization, deregulation, and stabilization.

[136] Becoming foreign bank agents is foreseeable. At present, the number of services supplied by Vietnamese banks is in the hundreds, while those supplied by an average bank in a developed country is in the thousands. For now, when a foreign bank "asks" a domestic bank to be its agent for some products, the domestic bank's image may be still sharp. However, what if the products served by the domestic bank as an agent are more than the products produced by the bank itself? In fact, Vietnam has learned this lesson; via joint ventures, some foreign firms have used this "trick" to transform the domestic firms' distribution networks into their own. When joint ventures come to an end, domestic firms imperceptibly have not only spent money to promote the foreign firms' products through their capital contribution, but also lost their market share.

However, to accelerate the speed of reform while at the same time redress current reform imbalances, the government's priorities should be in reverse order. Further financial sector liberalization without adequate capacity to regulate and supervise a market-based financial sector is a recipe for disaster similar to the problems faced by Thailand and Indonesia a decade ago during the East Asian financial crisis.

Priorities of further financial sector reform in Vietnam should be, in descending order of importance:

1) establishment of a strong banking supervisory agency with effective monitoring tools to secure the stability and sustainability of the banking system;

2) promotion of domestic bank restructuring, especially SOCBs, to create strong, competitive banks that can serve as true financial intermediaries;

3) development of institutions, products, and delivery systems to provide formal financial services to Vietnam's low-income households and family businesses; and

4) prudent liberalization, in keeping with capacity to identify and mitigate the risks of a market-based financial sector.

a. Financial Sector Stabilization (#1 and #2 above)

The most urgent need to enhance the prudential soundness and commercial competitiveness of Vietnam's financial sector is dramatic improvement of the government's capacity to protect the public interest through better regulation and supervision of the financial sector.

This entails reform of SBV, including consolidation from provincial to regional branches, and establishment of a new agency for banking oversight. However, the creation of a new agency is no guarantee that it will be any more effective than the current regime, unless this is accompanied by adoption of appropriate financial sector regulations and effective off-site and on-site monitoring tools.

In addition, SBV must continue to recapitalize insolvent banks during the current macroeconomic crisis to maintain confidence in the banking system. At the same time prepare a plan for restructuring the banking system, comprising commercialization of the SOCBs and consolidation of the JSCBs - Vietnamese domestic banks are very small,[137] so it is difficult to achieve the economies of scale and scope to enhance their competitiveness, especially vis-à-vis foreign banks.

The government should also bring its policy banks, especially VDB, as well as its many quasi-bank financial institutions now run by sectoral ministries and local governments,

[137] Total assets of VBARD, the largest SOCB in Vietnam, were less than USD20 billion at the end of 2007, and total assets of ACB, the largest JSCB, were less than USD6 billion. If other countries had the same regulation as Vietnam that a foreign bank should have minimum assets of USD20 billion to open an overseas branch and minimum assets of USD10 billion to open an overseas subsidiary, then only 4 Vietnamese banks would be eligible to open overseas subsidiaries and no banks would be qualified to open overseas branches.

under formal regulation and supervision like any other banking institution, whether by SBV or a new oversight agency. Having a "parallel" banking system not subject to prudential regulation and oversight undermines the legitimacy and integrity of the entire financial sector, and creates enormous difficulties in implementing consistent fiscal and monetary policies.

Finally, the government must increase its effort to resolve the substantial bad debt overhang now preventing the banking system from reaching a new equilibrium.

b. Financial Sector Deregulation (#3 above)

The government's highest priority to improve the quantity, quality, and accessibility of formal financial services in Vietnam should be promotion of nationwide, sustainable microfinance.

Most families and businesses in Vietnam still do not have access to basic financial services such as savings, credit, and payment facilities, despite Vietnam's rapid economic growth over the past two decades – this "unbanked majority" needs to be provided these financial services if its full potential is to be realized.

Most of the microfinance efforts to date are either government and donor-sponsored poverty alleviation initiatives, or NGO-based pilot projects that are difficult to replicate nationwide. Vietnam should look at successful microfinance elsewhere, such as Bank Rakyat Indonesia, for models that might be adapted.

III. Financial Sector Liberalization (#4 above)

The most important next step for financial sector liberalization in Vietnam is complete elimination of interest rate caps and directed credit, so that savings and lending rates accurately reflect the market price of capital, and thus, formal financial institutions can effectively mobilize funds from the public and then allocate this capital to the highest return investments.

However, the government should proceed with capital account liberalization, the last step of the financial liberalization process, with great caution. Free capital inflows and outflows create significant risks when market institutions have not been fully established. Capital flight, as occurred during the 1997-98 financial crisis, would have a severe negative impact on Vietnam's industrialization and modernization efforts. Therefore, financial liberalization should be done incrementally, with adequate preparation taken for each step in the process.

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