ASIAN FIANNACIAL CRISIS, RESTRUCTURING AND IMPLICATIONS FOR FINANCIAL SECTOR'S REFORM IN VIETNAM

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ABSTRACT

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Vietnam benefits from both the success's and failure's experiences of other countries in the region on the road to development especially in the transition process from a relatively closed economy with rudimentary, repressed financial system toward a market-based open financially economy. The thesis briefly traces the financial liberalization, crisis and restructuring in East Asian countries, namely Thailand, Indonesia and Korea and attempts to discuss some issues and lessons that seem beneficial to further the process of financial sector's reform in Vietnam. The thesis consists of four chapters. Chapter I begins with an introduction of purposes, scope, methods and content of the thesis. Chapter II, comparative countries analysis and descriptive inference with supports from relevant studies will be employed to underscore the weaknesses of the banking and financial sector, inadequate financial supervision and regulations, ill prepared financial liberalization and vulnerable exchange regime, which rendered the system vulnerable to a sudden withdrawal of investors' confidence. When it occurred, the crisis was the result. The ongoing restructuring in these countries is quite complex but provides a general framework to address these weaknesses and to build a robust domestic financial system. Chapter III, time series data analysis and overall financial soundness indicators of state-owned

enterprises and the banking sector will be used to assess the economic performance in the last decade and the ongoing reform of the financial sector in Vietnam. In light of the lessons and experiences abstracted from elsewhere in the region, the thesis highlights the weaknesses of the current system, which in many ways are similar to those in other countries. This thesis also discusses some measures to address these weaknesses. Chapter IV briefly analyzes the recent recovery and development of Vietnamese economy and its impacts on the financial system. To further the financial sector reform, the conclusion part discusses some suggestions regarding strengthening banking regulations and supervision, interest rate liberalization and once again, highlights the lessons from the region financial crisis with implications for mitigating the adverse consequences of such reform and liberalization of the financial sector in Vietnam.

Dedicated to my family

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CHAPTER I. INTRODUCTION

Vietnam is being in the transition process from a relatively closed economy with rudimentary, repressed financial system toward a market-based, open, financially economy. Despite remarkable economic performances in the last decade, the problems of inefficiency, high indebtedness of State-owned enterprises (SOEs) remain unsolved and a fragile banking sector is the result. However, the financial sector itself has many weaknesses, which have manifested in poor performance and management, fell short of performing the main functions of finance in a market-based economy. Entering the 21st century, Vietnam aims at an ambitious goal of repeating the superb performance of rapid growth in the 1990s, doubled real GDP in one decade. The most important issue for sustained economic growth is to get the financial system right to effectively and efficiently mobilize resources and ensure sound investment. This is also an urgent need as most of factors contributed to Asian financial crisis have been found in Vietnam's financial system. It is not saying that the financial crisis will happen in Vietnam but the Asian financial crisis once again has forcefully demonstrated the potential danger of distorted practices in finance on the road to development. Vietnam will benefit from both success and failure experiences of other countries in the region. This thesis, therefore, attempts to explore some of the issues and lessons emerged from Asian financial liberalization, crisis and restructuring, which need to be considered in the ongoing reforms in Vietnam. It also is my personal hopes that this thesis will contribute to some extent to further the process of financial sector's reform in Vietnam. As the thesis mainly focuses on analysis of the domestic financial system so descriptive inference will be

employed with supports from a number of relevant studies then maximizing leverage of its findings to examine the causalities and effects in finance. The thesis, therefore, emphasizes the problem solving in light of the lessons of the Asian financial crisis and experiences of the ongoing restructuring in the region to gain further insights in the shortcomings of recent financial sector reform in Vietnam and also discusses some measures to contain these problems. Firstly, comparative cross-country analysis will be used to review the financial liberalization process in Thailand, Indonesia and Korea to find out the common weaknesses in these countries, which eventually contributed to the financial crises. The analysis of the ongoing financial restructuring in the affected countries basically relies on the framework of the IMF supported program. Secondly, time-series analysis will be used to analyze the growth pattern of Vietnamese economy in the last decade. The analysis of Vietnam financial sector reform bases on the overall financial indicators of banking and state-owned enterprises sectors. I attempt to assess the soundness of the banking system and highlight the weakness, which should be addressed in the ongoing reforms in Vietnam. Leveraging the relevant lessons from the region will provide further insights. The reforms of state-owned enterprises and external sector will also be discussed since the roots of banking problems deeply sited at the inefficiency of the real sector. Finally, the thesis will discuss some implications for furthering financial reform and liberalization in Vietnam and measures to mitigate the adverse impacts of this process. Data used in the thesis are mainly derived from the IMF and the World Bank or official sources of the countries involved.

The thesis includes four chapters as follows: Chapter I begins with an introduction of purposes, scope, methods and contents of the thesis.

Chapter II briefly overviews financial liberalization, crisis and restructuring in East Asian countries, namely Thailand, Indonesia and Korea. With the benefit of more time and hindsight, it has become clear that the weaknesses in domestic financial system, especially in banking deeply sited at the heart of Asian financial calamity. The shortcomings of financial liberalization in these countries had exacerbated these weaknesses and when triggered by the intrinsic volatility of global capital flows, crises resulted. The ongoing restructuring of the financial sector, despite particular issues faced by each country, shares common features characterized by the IMF supported program, which provides a general framework to build a sound financial system. This survey comes up with some lessons, which, in my opinion, need to be considered in the ongoing reform of financial sector in Vietnam.

Chapter III presents an overall assessment of the economic performance and financial sector reform in Vietnam in the last decade. The findings suggest that the growth pattern was relatively unfavorable and unsustainable especially with more emphasises on financing were given to capital intensive, import-substitute sector. This growth pattern reflected the efforts of Vietnam in the last decade to rapidly industrialize the economy to accelerately catch up other countries in the region. However, it induced distortions in resources allocation creating a complex maze of cross subsidization, for example, bank credit was directed to prop up many inefficiency, loss-making SOEs. It also complicated the trade regime with high levels of effective protection in terms of high tariff and complex non-tariff barriers. As consequences, the banking sector suffered from a rapid accumulation of nonperforming loans and bad assets even in the high growth period. In addition, poor credit assessments coupled with directed and connected lending worsened

the situation. Inappropriate banking regulations and supervision, ineffective legal frameworks and weak market discipline have contributed to further erode the soundness of the banking system. Implementing better accounting standards and greater transparency in financial practices, accelerating the process of disposing non-performing loans, building a sound credit culture, strengthening financial regulatory and supervisory mechanisms and credit allocation made only by commercial rules will help to transform the system to a market-based efficient finance. However, reforming SOEs is the key to the success of financial sector reform. More open trade regime in the accession of Asian Free Trade Agreements (AFTA) and United State Bilateral Trade Agreements (USBTA) will accelerate SOEs reform and help to correct distortions in resource allocation, which eventually contain the underlying causes of banking problems.

Chapter IV briefly discusses the recent recovery and development of Vietnamese economy and its impacts on the financial sector. The changing environment marked with the opening of the stock exchange and abolishing the interest rate ceiling has induced fundamental changes in cultures of business, banking, corporate governance and risk management, which considerably pose greater challenges on both market participants and policy makers alike on the road toward financial liberalization. This chapter provides some implications for further financial sector reform and liberalization with upgrading the regulations and supervisory practices as a key part of the financial reform package. It also discusses some related issues regarding interest rate and monetary policy. The conclusion, once again, highlights the lessons, which need to be considered in the ongoing reforms of the financial sector in Vietnam to mitigate the adverse consequences that may arise from such reforms.

CHAPTER II. FINANCIAL LIBERALIZATION, CRISIS AND RESTRUCTURING IN EAST ASEAN COUNTRIES

I. Rationale for financial liberalization

Banks play a vital role in all modern economies, not only through their intermediation between saving and investment, but also through their operation of the economy's payments system. The financial systems, including banks and other financial intermediaries, equity markets, and debt markets – do a very good job of ***agglomerating*** capital from many small savers, ***allocating*** capital to the most important uses, and ***monitoring*** to ensure that it is being used well. At the same time, the financial systems transfer, pool and reduce risk, increase liquidity, and convey information[1].

In addition, financial markets around the world are rapidly integrating into a single global market place creating an additional funding source and developing countries are increasingly part of this process driven by advanced communications and information technology, deregulation of financial markets and the rising importance of institutional investors that are able and willing to invest internationally. Like free trade, theoretically, capital flows from capital abundant to capital scarce countries raise welfare in the sending and receiving countries alike given that the marginal product of capital is the higher in the latter (developing countries) than in the former (industrial countries)[2]. Financial liberalization generally or capital account liberalization particularly is essentially irreversible and inevitable for all developing countries wishing to take

[1] Stiglitz, Joseph: *The role of the finance system in the development* represented at the Fourth Annual Bank Conference on Development in San Salvador, El Salvado, June 29, 1998, page 1.
[2] Eichengreen Barry, Michael Mussa, Giovanni and others: *Capital account liberalization, theory and practical aspect*, Occasional Paper No. 172, IMF 1998, page 12.

advantage of the substantial benefits of a broad participation in the open world economy. The benefits of capital account liberalization are especially large for developing countries for three reasons as follows:

First, the direct advantages are two folds. These countries can tap the increasing pool of global capital to raise investment, diversify risks and smooth out the growth of consumption and investment thus dampening business cycles [3]. And capital account liberalization also deepens domestic financial system, which in turn promotes its dynamic efficiency of resources mobilization and allocation thus accelerating economic growth[4].

Second, the more important benefits of financial integration, however, are likely indirect. These include knowledge spillover effects, strengthening of domestic financial system and promoting transfer of best practices in finance and production [5].

Finally, in a highly developed international capital market, the policies and its enforcement designed to limit global capital flows will have to be increasingly invasive and distortionary [6]. Moreover, restrictions on inflows have significant negative effects on financial stability and economic growth[7].

These benefits are basically derived from fundamental theorems of welfare economics, which assert that every competitive equilibrium is Pareto efficient. The theorems,

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[3] Greenwald Bruce, Stiglitz Joseph and Weiss Andrew, *Information Imperfections in the capital markets and macroeconomic fluctuations*, American Economic Review, 1984, 74 (2):194-99

[4] & [5] Levine Ross *Financial Development and Economic Growth*. Journal of Economic Literature, 1997 35(2): 688-726.

[6] Cooper, Richard N., 1998 *Should capital account convertibility be a world's objective*? In *Should the IMF pursue Capital account convertibility*, Essays in international finance, No. 207 (May), International Financial section, Department of Economics, Princeton University.

[7] Eichengreen Barry, Michael Mussa, Giovanni and others: *Capital account liberalization, theory and practical aspect*, Occasional Paper No. 172, IMF 1998, page 12

however, provide no guidance with regard to the question of whether financial markets, which are essentially concerned with the production, processing, dissemination, and utilization of information, are efficient. In contrast, the pervasiveness of information asymmetries especially in financial markets or the existence of incomplete markets implies that inefficiency can arise or market outcome is not Pareto efficient [8].

The asymmetric information literature looking at the impact of financial structure on economic activity focuses on the differences in information available to different parties in a financial contract. By definition, borrowers have an informational advantage over lenders because borrowers know better about the investment projects that they want to undertake than do lenders. Information asymmetries lead to three problems: adverse selection, moral hazard and herding behavior, which considerably reduce the efficiency of market outcomes [9].

First, *adverse selection* can occur under asymmetric information because lenders have incomplete knowledge of borrower quality and borrowers who are bad credit risks have a strong incentive to seek out loans resulting good borrowers cannot get the loan but do the bad. Adverse selection may also take the form of the reverse side of tough conditionally designed to minimize moral hazard. Put it differently, patients tend to come to a doctor when their health condition so deteriorated or there is no other choice.

Second, *moral hazard*, on borrowers' side, takes two forms: borrowers have a tendency to take excessive risk and the responses to rescue packages may be lenient in the

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[8] Greenwald Bruce, J. Stiglitz and Andrew Weiss 1984, *Information Imperfections in the capital markets and macroeconomic fluctuations*, American Economic Review 74 (2):194-99

[9] Mishkin S. Frederic, *Understanding financial crisis: A developing country perspective*, NBER working paper No. 56000 (Cambridge., Massachusetts: National Bureau of Economic Research) 1996, pages 5-20

expectation that further bailouts can be obtained. On lenders' side, it also takes two forms. Banks and other financial institutions tend to rely on the assumption that excessive lending cannot be sanctioned by systemic default. Moreover, lenders may not only shut down the borrowing window quite abruptly when something goes wrong but they also shift toward speculative behavior. If the former forces even a healthy borrower to default then the latter can trigger herding behavior of other market participants. Both adverse selection and moral hazard lead to a well-known phenomenon of credit rationing that is lenders reluctant to make loans and as a result, the levels of intermediation and investment will be sub-optimal. Moral hazard creates a variety of market failures while adverse selection implies a drying out of market liquidity when risk is perceived to rise, which in turn may trigger dangerous behavior of lenders.

Third, by incomplete information, in financial market, lenders may be prone to engage in herding behavior, whereby they try to follow the lead of those whom they believe to be better informed. Such behavior gives rise to a sudden market movement and volatility and in an extreme case may create self-fulfilling crisis and runs on the currencies, which eventually lead to market collapses[10].

Even information is complete, international financial liberalization can be welfare reducing with the presence of domestic distortions. That is the case that a small, open, relatively labor abundant country protecting its capital-intensive industries. Because protection of these relatively capital intensive industries artificially boots the rate of return on capital invested in the country, capital keeps flowing in, leading capital

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[10] Obsfeld Maurice 1996, Model of Currency crisis with self-fulfilling features, European Economic Review, Vol. 40, No. 3-5 (April) pages: 1037-47.

intensive sectors to expand and labor intensive sectors to contract. These lead to the misallocation of resources between the capital- and labor-intensive sectors reducing overall efficiency of the economy in both exporting and importing capital country. In short, a free movement of capital is likely to become allocatively efficient only after trade barriers have come down substantially, particularly barriers on capital intensive activities in labor rich countries[11]. Elaborating this point, distortions in banking and financial sector escalate the build-up of resources misallocation, which not only reduce the overall efficiency but also render the whole system vulnerable to adverse shocks both domestic and international.

In short, financial liberalization itself has pitfalls because it generally gives individuals, firms and financial institutions abundant opportunities to undertake excessive and sometime imprudent risks and large inflows provided much of fuel to do so. These dangers if reinforced by information asymmetries or domestic distortions absolutely raise the potential of systemic disturbance and precipitate financial distress. To be faire, the dangers, however, can be mitigated quite considerably through combination of sound macroeconomic policies to contain aggregate financial imbalance and ameliorate the effect of financial disturbance and sound prudential policies to ensure proper private incentives for risk management. These must be backed by adequate supervision and regulations especially of financial sector[12]. With these important safeguards, capital

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[11] Cooper, Richard N., 1998 *Should capital account convertibility be a world's objective*? In *Should the IMF pursue Capital account convertibility*, Essays in international finance, No. 207 (May), International Financial section, Department of Economics, Princeton University; page 23-20

[12] Rossi Marco, *Financial fragility and economic performance in developing countries: Do capital controls, prudent supervision and regulation matters*, IMF WP/99/66, 1999, page 20-24; and Kunt Demirguc and Detragiache Enrica, Financial liberalization and Financial fragility, IMF, WP/98/93, page 32-33.

liberalization and broader, financial liberalization are not only inevitable but also clearly beneficial.

II. Brief overview of financial liberalization in Thailand, Indonesia and Korea

As above mentioned, the world's financial markets are rapidly integrating into a single marketplace and ready or not, developing countries, starting from different points and moving at various speeds, are being drawn into this process. If they have adequate institutions and sound policies, developing countries may proceed smoothly along the road to financial integration and gain the considerable benefits that integration can bring. Developing countries have little choice about whether to follow this path or not because advances in communications and new development in finance have made the course irreversible and inevitable. They can, however, decide how they wish to travel, choosing policies that benefit the economy and avert potential shocks. Reviewing the process of financial liberalization in East Asian economies namely Thailand, Indonesia and Korea (the countries) may help to shed the light on the shortcomings of their journey, which later on contributed to their vulnerability to a sudden change in market sentiments.

1. Thailand's financial integration, financial policies

Thai liberalization of current account transactions was completed in 1990. The domestic banking system, interest rates and directed credit allocations had been liberalized in the early 1990s. The exchange rate was pegged to US dollars, reducing the apparent risk of borrowing in foreign currency. In 1993, capital account liberalization increased sharply and changed in form with the opening of the Bangkok International Banking facility with tax and regulatory inducements in order to promote Bangkok as a regional financial center. At the beginning, it was supposed to raise funds from non-resident and lend them

to other non-resident but later on distortedly began to serve as a vehicle for local firms to obtain foreign bank loans, most of them were short term, un-hedged.

Thailand's high growth in the 1990s partly reflected a massive building boom, with much of the financing coming from offshore, through weak, unregulated financial companies. These companies depended on volatile commercial papers for funding because they could not take deposits. Their rapid expansion partly reflected the hope that the largest one would receive new bank licenses due to restrictions to entry into the banking industry still remained. The banking system was also poorly regulated, directly and increasingly exposed to private sector with much of lending concentration on property development. However, no formal deposit insurance existed.

Fiscal policy probably added to the impact of the inflows. The fiscal surplus fell steadily from 4 percent in 1990 to about 1 percent of GDP in 1996. The Bank of Thailand's attempted to contain the boom with high interest rates only attracted more inflows under the open capital account and fixed exchange rate regime. The economy became overheated and speculative demand dominated especially with regard to stock market and property sector investments. That created a so-called *bubble economy*. One day the bubble burst and that was the case of Thailand. When the economic slowdown began in 1996, the government provided a massive support for financial companies (and investors in the stock market) rather than forcing them to solve their own affairs themselves. Not surprisingly, holders of the bath, were already nervous because of the falling stock market and deteriorating fiscal balance, feared that these policies would rupture the fixed exchange regime and so fled from the currency. The government was forced to float the

baht in July 1997 when its reserves (net of forward contracts) were nearly exhausted. Large external debt and sharply higher interest rates led to widespread bankruptcies.

Table 1. Selected economic indicators of the crisis-hit countries

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999/1
Indonesia										
Real GDP Growth	9	8.9	7.2	7.3	7.5	8.2	8	4.6	-13.6	-3.9
Inflation	7.8	9.4	7.5	9.7	8.5	9.4	7.9	6.6	60.7	25.4
Current account balance/GDP	-2.8	-3.4	-2.2	-1.5	-1.7	-3.3	-3.2	-3	-0.1	2.8
Central Government balance/GDP	1.34	0.04	-1.15	-0.71	0.01	0.77	1.16	-0.67	-4.46	-6.48
Broad Money Growth	29.7	24.6	22.6	21.1	21.8	26.7	27	27.4	61.7	15.6
Private sector credit/GDP	46.1	45.8	45.5	48.9	51.9	53.5	55.4	61	51.6	.
Korea										
Real GDP Growth	9.5	9.1	5.1	5.8	8.6	8.9	7.1	5.5	-5.5	2
Inflation	8.6	9.3	6.2	4.8	6.3	4.5	4.9	4.4	7.5	1.8
Current account balance/GDP	-0.8	-2.8	-1.3	0.3	-1	-1.9	-4.7	-1.8	13.1	7.1
Central Government balance/GDP	-0.67	-1.62	-0.49	0.64	0.32	0.35	0.28	0.28	-3.78	-5.12
Broad Money Growth	17.2	21.9	14.9	16.6	18.7	15.6	15.8	14.1	25.2	.
Private sector credit/GDP	52.5	52.8	53.3	54.2	56.8	57	61.8	69.8	73.6	..
Thailand										
Real GDP Growth	11.6	8.1	8.2	8.5	8.6	8.8	5.5	-0.4	-8	1
Inflation	6	5.7	4.1	3.4	5.1	5.8	5.9	5.6	8.1	0.5
Current account balance/GDP	-8.3	-7.5	-5.5	-5	-5.4	-7.9	-7.9	-1.9	12.2	8.8
Central Government balance/GDP	4.6	4.14	2.53	1.98	1.98	2.49	1.04	-1.62	-2.88	-3.84
Broad Money Growth	26.7	19.8	15.6	18.4	12.9	17	12.6	16.4	9.5	4.7
Private sector credit/GDP	64.5	67.7	72.2	79.8	90.9	97.5	100	116.3	109.5	

1/1999 IMF estimates

Sources: IMF, International Financial Statistics; World Economic Outlook; and national authorities

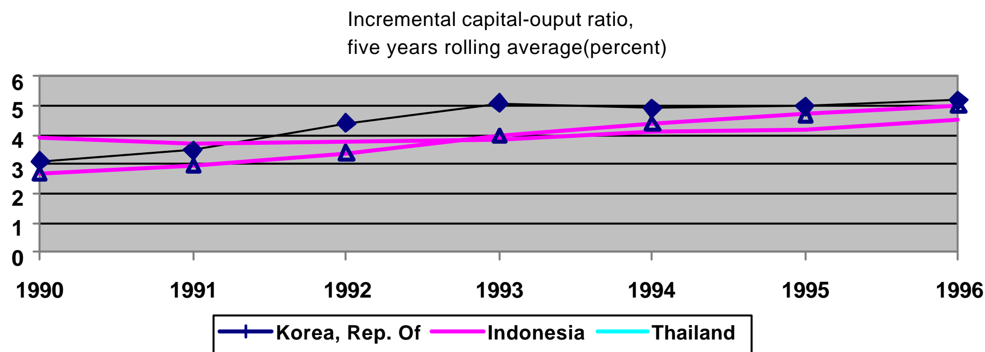
Table 2. Pre-crisis financial depth and selected vulnerable indicators, 1996

Indicator	Indonesia	Korea	Thailand
Savings/GDP	27.5	33.7	33.1
Investment/GDP	30.7	38.4	41.0
Total assets of banking system/GDP	90.0	300.0	190
Stock market capitalization/GDP	40.0	30.0	56.0
Outstanding bond issues/GDP	1.8	45.0	11.0
Corporate debt/Equity (a)	310	518	250
Short term external debt/reserves	176.6	193.0	99.7
Short term external debt/M2	27.7	31.1	25.8
Short term flows>50% of current account deficit (b)	Yes	Yes	Yes
Capital flows > 5% of GDP	N/A	Yes	Yes
Public debt/GDP	22.9	8.8	15.7
Public debt/GDP 1999	91.5	29.5	50.3
Number of commercial banks	238	26	29
State-Owned banks	7	7(c)	7
Merchant Banks	N/A	30	(d)
Other non-bank financial intermediaries (e)	754	310	986

(a) End –1997 data for Indonesia, Korea; September 1998 data for Thailand
(b) Defined as the sum of net portfolio and other investment in financial account
(c) State-owned, specialized development banks
(d) Thai' s financial companies function as merchant bank
(e) Including financial and securities companies, Insurance companies, Investment trust and Mutual fund;

(*Source*: The World Bank and IMF data)

Figure 1. Investment became less efficient before the crisis



(*Source*: The World Bank)

2. Indonesia' s capital account liberalization, policies in the 1990s

Indonesia opened its capital account in 1970. Interest rate ceiling were lifted in 1984. In 1988, to stimulate competition, foreign and new private banks were allowed nearly free entry, and capital and reserve requirements were minimized. The exchange rate regime was shifted in 1994, from a crawling peg to a band around a crawling peg, but the width of the band was kept relatively small. Nonetheless, external loans were offered and Indonesian corporations borrowed directly offshore, in mass amounts. Thus much of Indonesia' s global financial integration and corporate financing did not take place through its banks but directly with international banks. Corporations took no hedges, a risky strategy that paid them large dividends for a time but contributed heavily to the severity of the crisis.

Bank regulation and supervision were tightened but inaction against those not in compliance allowed many weak banks to stay in business. No formal credit insurance existed.

Fiscal policy was tightened in the 1990s with a 2.3 percent of GDP deficit reduction during period of 1992-1996 to offset overheating. Monetary policy was considered the primary stabilization instrument and low reserves requirement were raised in Feb. 1996 and April 1997. This monetary tightening was offset by inflows under the open capital account and relatively fixed exchange rate, and had a little impact on interest rates or credit volumes.

At the beginning of 1997, Indonesia had the lowest current account deficit among the crisis countries, a smaller investment boom and a massive increase in foreign direct investment. But its high private external debt, especially short-term debt, and its open capital account left the economy vulnerable to shock in confidence. Moreover, the country suffered from longstanding, well-known weaknesses in finance and governance. The likelihood of a new cabinet after the election and a deteriorating macro-economy heightened uncertainty in 1997. The float of the Thai bath increased them sharply.

Indonesia responded to Thailand's float by widening its exchange rate band in July and announcing a float of exchange rate in August, with little use of reserves to defend the currency during the interval. Interest rates were raised but soon lowered because of political pressure. To help defend the exchange rate, limits were placed on banks' foreign exchange positions at the end of August.

In addition to macroeconomic conditions, the economic program called for deregulation and the closure of 16 weak banks. A run developed on these banks, spread to others,

despite the announcement of deposit insurance for small depositors that was soon followed by general coverage. The central bank offered large credit to support the banking system and in response to pressure to keep down the interest rates. By the end of December, credit to banks had more than tripled–an increase that would have doubled the money base had international reserves not declined. Concerns about Soeharto's health and the announcement of a budget for 1998-1999 that appeared to bear little resemblance to IMF targets triggered capital flight. By December 1997, the rupiad had fallen to about half its value at the end of 1996. The economic uncertainty coupled with political uncertainty compounded the severity of the Indonesian crisis.

3. Korea's capital account liberalization, financial integration

Korea's capital account liberalization began in the early 1990s. But for three reasons these efforts encouraged a build-up of short-term external debt intermediated mainly through the financial sector. First, short term borrowing for both banks and corporations was liberalized while restrictions on longer-term borrowing, including access to external credits and foreign bond markets, remained. Second, debt flows were encouraged relatively to equity inflows. Although foreign equity flows into the stock market were liberalized in January 1992, they remained subject to restrictions – including a 10 percent ceiling on foreign holding of any stocks (raised to 12 percent in December 1994 and 15 percent in 1995). Third, financial institution's borrowing was liberalized, but corporations' borrowing required government approval, and its uses were restricted. More fundamentally, stemming from export-led growth strategy and in the nearly absence of debt market, short-term loans were rolled over throughout the course of Korean economic development. This practice led to many Korean borrowers to assume

that lenders would roll over the loans when they came due, underestimating the risk of borrowing in short-term. International lenders, however, are marginal because profit margin squeezed in their home countries in 80s and early 90s. Because of information asymmetries and the likelihood of debtor's default they usually set a certain limit of their exposure to a certain borrower including sovereign one. As the borrower's debt stock is approaching the limit, the maturity of the loans becomes shorter and shorter. When time is good, they roll over the loans naturally. When something goes wrong, they absolutely demand their money back at one. That is exactly what happened to Korea.

Korea also resumed domestic financial liberalization in the early 1990s. In 1991 a four-stage plan for deregulating interest rates was announced. Financial institutions were given greater freedom in asset-liability management, including liberalization (in 1993) of foreign currency-denominated lending. In 1994-95, more financial institutions were allowed to offer foreign currency loans through the transformation of 24 financial companies into merchant banking corporations (which could operate in foreign exchange markets) and the opening of 28 new offshore branches by banks.

In addition, the macroeconomic policies used to deal with inflows at least partly encouraged the accumulation of short-term liabilities. To relieve inflationary pressure, the authorities both sterilized a portion of sizable foreign inflows and allowed some exchange rate appreciation. A significant differential between domestic and foreign interest rates was sustained, leading to strong demand for cheaper foreign funds. For all these reasons, external debt grew sharply, particularly short term borrowing, which had been liberalized more.

Korean financial institutions were inadequately prepared to manage these large inflows. There was limited experience with credit analysis, risk management, and due diligence-a legacy of the past development strategy, which, despite its success, had resulted in a passive financial system. As a result, financial institutions became vulnerable to increasing currency and maturity mismatches. Corporations' rate of return were low and fell in the 1990s, while their investment and borrowing did not. External financial flows eased corporations' budget constraints and added to their high leveraging. Thus the approach to financial integration appeared to have exacerbated underlying structural weaknesses.

Until 1995, Korea's strong performance masked these weaknesses. When the economy slowed in 1996, the underlying fragility gave way to corporate distress. Corporate after tax profits declined from 4 percent of GDP in 1989-1995 to less than 2 percent in 1996. Moreover, net corporate borrowing rose considerably – from 4 percent of GDP in 1989-95 to almost 18 percent in 1996. The first evidence of distress surfaced in late 1996 and early 1997. In January 1997, Hanbo group, the 14th largest chaebol, declared bankruptcy with debts estimated at $ 6 billion. This was followed by a string of other business failures.

By mid-1997, it was clear that corporate difficulties would have significant repercussions on the financial sector. The Thai baht devaluation in July raised investor concerns, and growing difficulties in the financial sector heightened nervousness. The decision to bail out the near-bankrupt Kia in October, and the stock market crash in Hong Kong (China), appeared to have triggered more intense pressure on the Won. Foreign banks refused to roll over the loans- adding to pressure on the exchange rate.

Throughout the period, foreign investor uncertainty was fueled by the lack of timely and reliable information on nonperforming loans, foreign exchange reserves, and foreign debt. The government' initial response in August 1997 was to guarantee the deposits and foreign liabilities of financial institutions. But this move may have called into question the Bank of Korea's ability to act as the lender of last resort, and so failed to reassure investors. Attempts to maintain the exchange rate by intervening in the foreign exchange market led to a $ 10 billion loss in reserves between the end of August and the end of November and were abandoned on 17 November. A few days later, Korea sought emergency supports from the international community to avoid defaulting on external debt. In Korea, perhaps the dramatic success of the real economy up until 1997 made financial reform less of a priority than it should have been.

In summary, capital liberalization in the countries has deepened their domestic financial system, attracted sizable capital inflows, accelerated financial innovation with an unprecedented boom in quantity and types of financial intermediaries, and more or less contributed to a high economic growth. Investment efficiency, however, considerably decreased in the run up to crisis (see table 1 and figure 1). Their approaches to capital account liberalization led to an excessive leverage in the economies in terms of short-term external debt to exchange reserves and corporate debt to equity ratios. Korea and Indonesia did financial liberalization actually backward by removing restrictions on short-term borrowings of financial intermediaries or private corporations while maintaining those on long term and foreign direct investment flows or failed to develop debt markets to somewhat balance the structure of capital inflows. Thailand did the same mistake leading to excessive risk taking by financial companies through offshore

financial center. In the context that most of short-term liabilities are un-hedged, under a nearly fixed exchange rate regime with a fragile financial system and in the absence of adequate financial safeguards, the countries were vulnerable to a sudden change in market sentiments generally or changes in foreign exchange or interest rates particularly. When it occurs, they are at risk of speculative attacks and runs on the currencies when markets participants perceived the authorities no longer could remain the peg.

III. The Asian Financial Crisis - A financial view

The Asian crisis caught most analysts by surprise. Some had warned of economic policy flaws in Asia, but few expected them to have a sharp slowdown, and no one predicted the profound crisis that actually materialized. However, most of studies recently came up with the findings that weak domestic financial system was at the heart of the Asian financial calamity. However, the intrinsic instability of the global capital markets accounted for self-fulfilling crisis and contagion spread over the region. Crisis-hit countries had significant shortcomings in their banking and financial sector, corporate governance as well as poorly supervised financial liberalization. The interaction between these factors reinforced each other and when triggered by a massive capital flight, the crisis was the result.

Box 1. Weaknesses in disclosure practices in the crisis countries

The following shortcomings in accounting and disclosure practices undercut market discipline and fueled the crisis:

- High corporate leverage was hidden by related-party transactions and off-balance sheet financing;
- Disclosure of loan classification, loan loss provisioning, and accrual of interest was weak. Although most banks disclosed the accounting policy for loan loss provisioning, they did not disclose in the balance sheet the aggregate amount of loans and advances for which they had stopped accruing interest;

- In Korea, the practice of cross-guarantees made it hard to assess the solvency of the largest borrowers. Consolidation of accounts was generally absent;
- Detailed information on sectoral concentration was largely absent, even though all countries had large exposure limits in place;
- Contingent liabilities of the parent of a conglomerate, or of financial institutions, for guaranteeing loans (particularly foreign currency loans) were generally not reported.

(*Source*: Financial crisis and Restructuring, Lesson from Asia [13])

Box. 2. **Market based (Arm's-Length) versus Relationship-Based (Insider) Finance**

Financial economists have long distinguished between market-based and relationship-based financial systems, broadly characterizing the Anglo-American system as the former and citing many Asian economies as examples of the latter. This generalization can provide useful insights for understanding Japan's persistent financial problems as well as the crisis in East Asian emerging markets. The details, however, differ widely within Asia. In Japan, the best example is the "main bank" relationship that many established firms traditionally have with their primary lenders. In Asian developing countries, the relationships that underpinned financial transactions were often based more generally on personal or political connections. Loans from a bank to an affiliated firm are called connected lending; loans guided by the government are called directed lending.

Although securities markets are more important in market-based systems, commercial banks are prominent in both systems. A crucial distinction concerns the roles that they play. In a market-based system, banks are not only one of many resources of external financing for firms. They compete with bond and commercial paper markets, along with markets for equity, in providing funds to companies. In such a system, bank loans are typically provided through arm's-length market transactions. Loans are contracted for specific periods, and interest rates are competitively determined on the basis of independent assessments of risks.

A decade ago, economists commonly emphasized the benefits that were thought to result from a relationships-based system. It was argued that main banks in Japan, for example, were better able to distinguish between temporary and fundamental problems when affiliated firms got into financial trouble. They could, therefore, continue to lend to those firms whose problems were only temporary. Under such circumstances where impatient, market-based financial systems would not be able to tell the difference and therefore could not lend. It was also argued that relationship banking improved young firms' access to funds. In market - based systems, competition limited a bank's ability to take chances, since nothing prevented its competitors from subsequently stealing its customers if business went well. In relationship-based systems, on the other hand, long-term relationships promised handsome payoffs for banks from those firms that succeeded.

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[13] Lindgren Carl-Johan, Balino JT Tomas and Enoch Charles and others, *Financial secor crisis and restructuring, Lessons from Asia*, Occasional paper, No. 188, IMF 1999 page 14

Some credited this financial system with promoting the Asian economies' high rates of investment and growth. But along with their strengths, relationship-based systems also possess weaknesses, which the Asian crisis has now exposed. Relationship-based systems neglect the information encapsulated in market prices. This information, the product of numerous independent assessments of profitability and risk, possibly becomes more important as economies develop and attractive opportunities for further investment become relatively scarce. Relationship-based systems might also foster the corruption and abuse that have become known as "crony capitalism".

Long-term banking relationships create value when they facilitate the transfer of funds to profitable firms that are either young, or temporary distressed. Perhaps they are also unavoidable if an ineffective legal system forces investors to maintain some types of control to prevent their funds from being mis-used. They destroy value, however, when they misallocate resources.

The Asian crisis seems to offer numerous examples of such misallocation. Borrowers that should have been foreclosed upon, or at least cut off from further lending, were allowed to continue borrowing, which increased their loses and those of their banks. Lack of transparency in financing practices may have enabled bankers and corporate managers, shielded from market constraints, to invest in pursuit of personal priorities rather than in their firm's best interest. It appears, for example, that some Asian firms, unchecked by external market discipline, developed excess capacity in industries such as steel and electronics. Many Asian economies are currently struggling to overcome the adverse real consequences of these misguided financial decisions.

(*Source*: Report to the US President[14]).

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1. Weak banking, financial sector and corporate governance; inadequate financial supervision and regulations; ill prepared financial liberalization and a vulnerable exchange rate regime.

Lending standards in the countries were too lax and heavily relied on collateral with little due diligence paid to credit assessment and cash flow analysis. Because real estate of some types was typically the only collateral asset available, much of the lending was underpinned in some fashions by real estate. Although direct lending to real estate related transactions may not have appeared excessive (except for property's sector in Thailand),

[14] Report to the US President, Economics Advisory Board, Washington DC, USA, 1999, pages 230-231

much of residual lending to other purposes backed by real estate assets. According to IMF estimated data, at the end of 1997, aggregate exposure to real estate sector both directly and indirectly accounted for 20% of total bank credit in the crisis countries [15].

In addition, connected lending and at times, corrupt credit practice rendered the banking sector of the crisis economies fragile. Loans were often directed on non-market base to favored firms and sectors. Bad loans were also made to look good by lending more money to troubled borrowers (the so-called evergreening of bad loan). In an extreme case like Korea, big Chaebols directly or indirectly controlled of the banks and they were considered too big to fail. Before crisis, seven of thirty biggest Chaebols in Korea were at the edge of bankruptcy and many others were destroying value (return on invested capital is lower than capital' s cost) suggesting that financial crisis might happen in Korea even in the absence of an external shock.

Regulations and supervision of banking systems, however, were notably weak and implicit or explicit guarantees that the government would bail out financial institutions in trouble exacerbated moral hazard problem. Such guarantees were part or parcel if an economic development strategy in which banks were the instruments of industrial policy. And perceived local government guarantees may have encouraged foreign investors to lend more to Asian banks and monitor their loans less carefully than they would have otherwise. Moral hazard thus contributed to Asian banks' excessive borrowing from abroad and excessive risky investing at home.

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[15] Lindgren Carl-Johan, Balino J.T Tomas and Enoch Charles and others, *Financial secor crisis and restructuring, Lessons from Asia*, Occasional paper, No. 188, IMF 1999 page 14

In the context of pegged exchange rates that was presumed to continue, if not indefinitely, at least beyond the term of the loan, their banks and non-banks were willing to liberally take the risk to borrow dollars, un-hedged, in short term because the cost of hedging may wipe out the interest rate differential between domestic and international markets. Under the pegged exchange rate, the monetary authorities were forced to sterilize sizable inflows proportionately. Although the authorities took an accommodated action through open market purchases but the sterilization at least drained a portion of liquidity from domestic market. A contracted liquidity at home sent a feed back to increasing interest rate thus inducing further inflows, further fueled the distortion's build-up in the financial systems. When financial intermediaries, in addition, seek low-cost, un-hedged foreign currency funding and in the absence of formal deposit insurance, the dangers of depositor runs, following the depreciation of domestic currency, escalate. When they are undercapitalized, have lax lending standards, and are subjected to weak supervision and regulation, they become a source of systemic risk both domestically and internationally.

These weaknesses reinforced each other. Efforts to upgrade supervision were undermined by political connections of powerful banks or financial companies. Enforcing connected lending rules and consolidated supervision was also problematic given the web of firms, banks and financial companies. Lacking effective legal protection, non-controlling shareholders were routinely exploited. As a result, outsiders preferred to finance firm through debt (which specifies stream of payments) rather than equity (which requires closer monitoring). This tendency toward high corporate leverage was compounded by the controlling owners' reluctance to cede controls or to disclosure much information. The inadequacy of court in enforcing creditors contracts contributed to a shortening of

loan maturity which lenders believing that they could refuse to roll over loans if they detected problem. All those matters weakened market discipline and induced excessive risk taking by banks, non-banks and firms in the crisis countries.

Certainly in Korea, probably in Thailand and Indonesia, a high degree of leverage (the ratio of debt to equity) was permitted to rise to levels that could only be sustained with continued very rapid growth. Exceptionally high leverage often is a symptom of excessive risk-taking that leaves financial systems and economies vulnerable to a sudden withdrawal of confidence. The leverage of South Korea's Chaebols, because of their size and the pervasive distress, has clearly been profound repercussion effects on bank problems with their systemic implications.

These weaknesses manifested in a lending boom and over-investment in projects, especially real estate and certain other sectors not exposed to internationally traded. Before crisis, speculative purchases of assets in fixed supply fed an asset price bubble in Thailand, Korea with equity and real estate prices rising beyond the levels warranted by the fundamentals. In addition, poor corporate governance fed the distortions in the system and fueled the investment boom further. So long as growth was vigorous, the adverse consequences of those weaknesses were masked. The growth, however, was inevitable slowdown in 1995-1996. Business losses, cash flows constrain, and non-performing bank loans surged. Banks' capital base eroded rapidly. As a consequence, funding sources have dried up, and fears of defaults have risen dramatically. In an environment of weak financial systems, lax supervisory regimes, and vague guarantees about depositor or creditor protections, bank runs have occurred in several countries and reached crisis

proportions in Indonesia. Uncertainty and retrenchment have escalated. The state of confidence so necessary to the functioning of any economy has been torn asunder.

The weakening of growth led to lowered profit expectations and contracted net capital inflows of dollars. The adverse term of trade heightened the problem. The combination of continued strong demand for dollars to meet debt service obligations and the slowed new supply destabilized the fixed exchange rate regime. This created a marked increase in uncertainty and retrenchment, further reducing capital inflows thus further weakening local currency exchange rates. In July 1997, the financial bubble burst in Thailand. Stock markets dropped and the emergence of widespread losses, and in some cases outright defaults revealed the low profitability of past investment projects. Non-performing loans already on the rise before the crisis escalated, putting many financial institutions at the edge of insolvency.

2. Self-fulfilling crisis

The wisdom is that the various currencies collapsed because domestic economic entities (many of whom had borrowed extensively in dollars) for known or un-known reasons suddenly lost confidence in their government's commitments to maintain the pegged exchange rate. When this occurred they ran for the proverbial exits by demanding their central bank to exchange domestic currencies for dollars at any costs. When the central banks run out of international reserves, they came to the IMF. Whenever insiders panicked, they absolutely triggered concerted herding behavior of outsiders thus exacerbating the market crash.

To be faire, the international capital markets itself have a serious shortcoming. *The intrinsic instability of international financial markets, subjected to bouts of panic and*

clearly over-reactive: International loans market are prone to self-fulfilling crisis in which, individual creditor may act rationally and yet market outcomes produce sharp, costly and fundamentally unnecessary panicked reversals in capital flows[16].

The Asian firms, banks and investors that have relied heavily on external borrowing were left with a large stock of short term, foreign currency denominated, un-hedged foreign debt that could not be easily repaid. The sudden rush of firms, banks, and investors to cover previously un-hedged liabilities intensified the free fall of currencies. An accelerating currency depreciation inflated the original external debts aggravating widespread of bankruptcy, both banks' and firms'. This episode created a vicious cycle of decline through wealth effects implying a sharp recession followed. In addition, foreign investors' flight, especially by international commercial banks, attributed to worsening the crisis and depleted the local currencies' value, further accelerated the declines. This vicious cycle will continue until either defaults or restructuring lowers debt service obligations, or the low local exchange rates finally induce a pickup in the supply of dollars. And finally, in the period of regional contagion, no one is safe. The financial calamity spread over the region threatening global financial distress followed by Russia's default and Brazilian real depreciation. Alan Greenspan, 1998 quoted interestingly "*In hindsight, the financial turmoil spread over the region coupled with the sharp exchange rate depreciation, did not appear to have resulted wholly from a measured judgment that fundamental forces have turned appreciably more adverse. More likely, its root is a process that is neither measured nor rational, one based on a visceral, engulfing, fear.*

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[16] Steven Radalet and Sachs Jeffrey. 1998 b. *The East Asian financial crisis: Diagnosis, Remedies, Prospects,* Brookings papers on Economic activity 1, page 5

The exchange rate changes appear the consequences, not of the accumulation of new knowledge of deterioration in fundamentals, but of its opposite: the onset of uncertainties that destroy previous understandings of the way the world works. That has induced massive disengagement of investors and declines in Asian currencies that have no tie to reality[17].

In short, financial and corporate sector weaknesses combined with macroeconomic and exchange rate regime vulnerability to spark the crisis. Poorly supervised capital account liberalization led to large short-term inflows inducing rapid credit expansion and inflating assets prices. The inflated asset prices encouraged further inflows, further exacerbated these weaknesses. Lax financial supervision and regulations, weak corporate governance coupled with ineffective market discipline led to excessive risk taking by both banks and non-banks. Implicit and explicit government guarantees heightened moral hazard problem of both domestic and foreign market participants. Inadequate accounting standards and disclosure practices hid growing leverage in the economy. A shift in market sentiment triggered capital flight worsening the crisis and spreading over the region.

Box 3. Financial sector restructuring measures in IMF-supported program

Measures to stabilize the system:

- Provide liquidity support at penal rates and subject to conditionality (all countries)
- Introduce a blanket guarantee (Indonesia and Thailand)
- Cap deposit rates to reduce the ability of weak banks to capture deposits and further weaken the system (Indonesia and Thailand)
- Identify and close fundamentally unsound financial institutions. These included commercial banks (Indonesia), commercial bank and merchant banks (Korea), and financial companies (Thailand).

[17] Greenspan Alan, Remarks before the Annual financial markets conference of the Federal reserve Bank of Atlanta, Miami, Florida, USA, Feb 27, 1998

- Require owners of closed institutions to lose their stakes in these institutions (all countries)
- Share loses of closed financial companies with creditors; restructure some depositor claims to longer maturity (Thailand)

Measures to restructure the financial sector

- Establish a restructuring agency (Indonesian Bank Restructuring Agency)
- Complete diagnostic reviews of financial institutions (Indonesia, Korea)
- Tighten loan classification and loan loss provisioning rules (all countries)
- Allow for full tax deductibility on income for loan loss provisioning (all countries)
- Establish a transparent timetable for banks to meet capital adequacy requirements (Indonesia and Korea) or provisioning requirements (Thailand)
- Intervene in insolvent banks (all countries)
- Agree on memoranda of understanding between undercapitalized banks and the authorities to specify a timetable for raising capital to meet capital adequacy requirements and attain performance benchmarks (all countries)
- Issue guidelines on the modalities for the use of public funds to recapitalize banks (Thailand) and to purchase nonperforming loans from private institutions (Indonesia and Korea)
- Take steps to privatize nationalized banks (all countries)

Measures to reform the institutional framework

- Enact legislation to enhance the operational independence of the supervisory authority (Korea) and central bank (Indonesia)
- Take steps to strengthen bank supervision (Indonesia)
- Improve accounting, disclosure, and auditing standards (Korea, Thailand)
- Issue strengthened regulations regarding connected lending, liquidity management, foreign currency exposure, and large exposures (Indonesia and Korea); cross guarantees were also to be eliminated for the top 30 chaebols in Korea
- Introduce a new bankruptcy law (Indonesia and Thailand).

(*Source*: Financial crisis and Restructuring [18])

Box 4. KAMCO Operations

The Korean Assets Management Corporation (KAMCO) was established in 1962 to collect nonperforming loans for banks. In November 1997, legislation was passed to create a new fund under KAMCO, supported by contributions from financial institutions and government guaranteed bond issues. This KAMCO administered fund was given the mandate to purchase impaired loans from all financial institutions covered by a deposit guarantee. On August 10, 1998, a major reorganization of KAMCO as a "bad bank" was completed with a view to strengthening its asset management and disposition capabilities. KAMCO adopted a structure similar to the US Resolution Trust Company, providing

[18] Lindgren Carl-Johan, Balino JT Tomas and Enoch Charles and others, *Financial secor crisis and restructuring, Lessons from Asia*, Occasional paper, No. 188, IMF 1999, page 47

additional business functions such as workout programs for nonperforming loans and more efficient asset disposal. To enhance the transparency and the efficiency of its operations, KAMCO has its accounts audited semiannually and publishes the results.

As of mid-June 1999, KAMCO has purchased assets with a face value of 46 trillion won (11 percent of GDP). Its purchases comprise two categories of assets: (1) "general assets of companies currently operating and (2) "special assets, which correspond to cases that are currently in court receivership and account for 70 percent of the total portfolio. Only 20 percent of these special assets have been finally resolved by the courts. Until recently, KAMCO only purchased won-denominated assets, owing to lack of funding capacity in foreign excha nge. To overcome this deficiency, KAMCO for the first time issued US Dollar denominated bonds in late December 1998 for $ 518 million to purchase foreign currency denominated assets from commercial banks.

For the purchase of nonperforming loans, KAMCO pays 45 percent of book value of the underlying collateral, which is the average price obtained in auctions of similar collateral in the market. For unsecured loans, the price is set at 3 percent. The prices for ordinary nonperforming loans are final. However, most of the loans purchased so far have been special loans and for these types of loans, KAMCO pays 45 percent of the value of the loans; but once a court ordered repayment schedule is implemented, the price of the purchase is readjusted to reflect the present value of the settlement. KAMCO's sale strategy is to dispose of nonperforming loans in the fastest way possible, but in a manner that maximizes recovery value. KAMCO has used four methods to collect on its assets: it has sold nonperforming loans to international investors, foreclosed and sold underlying collateral; sold nonperforming loans in a public auction; and collected on loans. As of June 1999, KAMCO had recovered - through sales and collections – about 9 trillion won. Details on these operations are provided in the table below.

Table 3. Disposition and Sale of KAMCO's Assets (*In trillions of won, as of June 1999*)

Disposition/Sale	Face Amount	Price Paid by KAMCO	Amount recovered by KAMCO
International sale	2.9	1.1	1.2
Foreclosure auction	2.1	1.0	1.0
Public sale	0.2	0.9	0.1
Collection	11.3	5.9	6.5
Total	16.5	8.1	8.8

Source: Financial crisis and Restructuring, Lessons from Asia[19]

[19] Abstracted from Lindgren Carl-Johan, Balino JT Tomas and Enoch Charles and others, *Financial secor crisis and restructuring, Lessons from Asia*, Occasional paper, No. 188, IMF 1999 page 72

V. Restructuring

The on-going financial restructuring in crisis countries is basically directed by the IMF overall restructuring program with support from the World Bank and other international financial institutions regarding program formulation and implementation toward building sound domestic financial systems and aggressively integrating into the world financial market (see box 3 for restructuring measures under the IMF supported program). For the purpose of the thesis, I would like to briefly focus on relevant issues relating to bank restructuring in the crisis countries, namely banking recapitalization and impaired assets solutions because the strengthening of banking supervision and regulations basically took the court of gradually adopting international best practices in banking and finance. The measures to complete financial integration will be partly addressed in chapter IV of the thesis.

Systematic bank restructuring is complex one. There are a lot of complicated issues involved, ranging from political commitment, public support, structural and institutional reforms, reinforcing market discipline and legal frameworks, strengthening of supervisory and regulatory regime to technical issues making the restructuring process smooth with controllable costs.

In countries going through crises, generally, the restructuring strategy aimed at three economic objectives: (1) restore the soundness of the banking system to maintain payments and provide liquidity for the economy, (2) create appropriate incentives to all participants involved to ensure the efficiency of the restructuring process and (3) control of the cost to the government by fair-burden sharing among related parties. Indonesian experience of bank runs suggested that clear information to the public is the essential part

of the strategy. A nontransparent restructuring process may fail to restore the public's confidence in the government and financial system. The strategies adopted by the crisis countries have been broadly similar as follows:

First, the mandate to carry out the restructuring process was given to a newly set up institution in Korea and Indonesia. In case of Thailand, the Ministry of Finance and the Bank of Thailand shared the mandate but most of important decisions made by the Ministry of Finance. However, Financial Sector Restructuring Agency took charge of assessing the viability of the Thai financial companies. To deal with impaired assets, asset management corporations were also established according to specific conditions of each country.

Second, the authorities did assess banks' viability directly or indirectly (through international recognized accounting firms) based on strict criteria according to international best practices for capital adequacy, assets valuation, loan classification and loan loss provisioning.

Third, all countries moved toward market-based solutions for troubled banks. By doing that, private sector increasingly involved in the recapitalization process. All insolvent banks were foreclosed. Weak banks were encouraged to merge with a strong one on the voluntary basis. Some important, suspended banks were subject to government interventions in forms of take-over, capital injection, involvement in management or strict supervision. The authorities also sought for external funding sources by providing incentives to foreign banks or investors to invest in domestic banking industry and liberalizing regulations on foreign ownership of financial institutions. This required modifying the rules of game in some cases.

To preserve private ownership, the authorities encouraged the banks to recapitalize themselves with capital from existing shareholders. Owners of under-capitalized banks were required to provide timetables to raise the banks' capital adequacy requirements to prescribed levels. In Korea and Indonesia, suspended banks were given a last chance to prove their viability. In cases where market solutions were forthcoming, the authorities sough to assist in forging solutions. In case of insolvency, the authorities intervened. The degree of government involvement largely depended on the degree of insolvency of the banks. Korea and Indonesia have injected public funds into under-capitalized banks while transferring a portion of nonperforming loans to centralized, publicly owned asset management corporations. These corporations are responsible for recovering assets and restructuring the financial liabilities of over-indebted debtors. On the contrary, Thailand has tied the provision of public funds to more stringent conditions imposed on bank owners. In addition, Thailand did not establish a centralized asset management corporation to dispose of nonperforming loans but left banks to recapitalize themselves and devise their own assets disposition strategies.

The most challenging one is to deal with bank's impaired assets to speed up the restructuring process, minimize its costs, and prevent discipline of borrowers from deteriorating. The process of disposing bad assets absolutely takes time and incurs a huge cost. There is no single solution except that someone should take over nonperforming loans for time and try to recover them as much as possible when market backup. A recent study suggested that such agencies tend to be ineffective at corporate restructuring and are good at disposing of assets only when they are used to meet fairly narrow objectives in the presence of certain factors: political independence, appropriate funding, adequate

bankruptcy and foreclosure laws, skilled resources, good information, and transparent operation and processes[20]. In the crisis countries, however, impaired assets may be either held by banks themselves or sold to specialized asset management companies. Centralized, state-owned company has been used in Korea and Indonesia (see box 4 for reference). This style, in one hand, allows government to centralize scarce human resources, ownership of collateral providing more leverage over debtors and impose conditions on purchases of nonperforming loans thus reinforcing operational restructuring of troubled banks. In addition, it helps banks clean up their balance sheet repositioning banks in sound positions as fast as possible. It also promotes merge and acquisition in case that potential buyers reluctant to take a large amount of bad assets as a part of the deal. In the other hand, it may be costly in term of efficiency and effectiveness reduction because its management is often weaker than in private structures. More importantly, value of bad assets erodes considerably when they are outside a bank and often parks longer-term in the company. However, the company, if not effectively managed, could induce deterioration of credit discipline in the banking system. Political concern is another factor reducing its operational efficiency. Thailand, as mentioned above, adopted the decentralized process encouraging each bank to set up its own separate asset management company. However, a public asset management company was created to purchase a residual asset from financial sector restructuring agency. A pool of decentralized companies certainly brings about an asset management industry and secondary market for distressed assets into place. The decentralized companies are also

[20] Klingerbiel Daniel, *The use of assets management companies in the resolution of banking crisis: Cross-country experience*, The World Bank, Working paper, Feb. 2000, pages 1-5 and 20-21.

better informed about borrowers and assets quality. Despite these advantages, the drawback is that bad assets still hang on the bank's balance sheet thus somewhat hampering banking functions and hindering loss recognition up front.

In general, restructuring Korea's biggest conglomerates proved more difficult stemming from social and political concerns, the complexity of their structure, the size of debt stock and their ready access to financing from other domestic financial intermediaries. The reform progress, however, is much faster than that in Japan given their similar features. Bank restructuring in Indonesia imposes a huge fiscal burden, reflecting higher public debt before crisis and more intensive banking losses (roughly estimated about 50 percent of GDP as of mid 1999 according to the authorities). In addition, heavy debt owed by domestic firms to foreign creditors complicated corporate restructuring thus slowing the restructuring progress. In case of Thailand, the private sector-led recapitalization of Thai banks has worked well. Most of troubled financial companies were closed. Interestingly, two private domestic banks have foreign ownership greater than 50 percent.

V. Lessons from Asian Financial Crisis

Modern economics has emphasized the importance of the financial system, ensuring that scarce capital is allocated to wherever it is most productive and that funds are used in the way that the firm promised. Well-functioning financial markets enable risks to be transferred and diversified, so that firms can undertake riskier, and often higher return projects without fear of costly and disruptive bankruptcy. But modern economics has also emphasized that weaknesses in the financial system are a major source of vulnerability. Financial crisis have been frequent, perhaps even more frequent during the past twenty years than earlier in both industrial and developing countries. When they occur, financial

crises impose huge costs on the government and general public to clean up. With the more international sophisticated financial markets, vicious cycles of boom to bust are evidently emerging more often. For once they are triggered, damage control is difficult. Once the web of confidence underpinning the financial system is breached, it is difficult to restore quickly. The loss of confidence can trigger rapid and disruptive changes in the pattern of finance then feed back to the real economy with recession implied. In the period of well-connected finance and contagion, the loss of confidence in one country can quickly spread to others. These virulent episodes occurred in Asia and its devastating consequences remind us that we shall never be able to alter the human response to shocks of uncertainty and withdrawal; we can only endeavor to address the weaknesses that exacerbate them especially those in the financial system as mentioned in previous sections. In developing countries, however, banks often play a dominant role in the financial system at least for the foreseeable future so obviously a strong banking system increases country's resilience to shock. At the same time, capital and debt markets are increasingly important in senses that they not only do business of financial intermediation, provide supervision and stringent discipline on those who raise funds in the markets but also serve as another cushion to absorb a predicted or unpredicted shock. In my opinion, the Asian financial crisis provides some important lessons, which are worth of concerning for Vietnam as follows:

First, the crisis highlighted the linkages between banking and financial sector soundness and macroeconomics stability. There is no substitute for sound macroeconomic policies but high economic growth rates with fairly sound overall macroeconomic indicators are

not enough to warrant sustained development. Close attentions should be paid to address structural weaknesses especially those in banking and financial sector.

Second, bank-based financial systems are intrinsically fragile. Banks, when confronted with a generally rising yield curve, have a tendency to incur interest rate or liquidity risks by lending long and funding short. In such a circumstance, banks tend to be very prone to moral hazard with the knowledge that the government stands ready to bail out troubled banks otherwise has no choice given their implication on systematic failure thus drying up liquidity and disrupting payment system in the economy. A long delay in reforming the banking sector is such a dangerous thing and benefits no one. To reform the banking system, ready or not, the authorities should adopt the best practices in banking and finance as fast as possible, correct incentive structure and reinforce market discipline and bankruptcy procedures. More importantly, building a sound credit culture is an urgent need. Increasing foreign participation in domestic banking will only further the objective of achieving strong domestic banking system. Obviously, equity and debt market are in need.

Third, government intervention in credit allocation of banks eventually incurs a huge cost in terms of losing efficiency and reducing level of bank's intermediation led to distortion's buildup in the system and inducing financial imbalance, which in an extreme case warrant a crisis. The time that the government simply picked up the winner to promote exports has gone. The policy-using bank as a vehicle for industrialization should be carefully designed with clear cost-benefit insights.

Fourth, better accounting standards, greater transparency in financial practices will improve the assessment of banks and firms financial conditions.

Fifth, the economies that have best weathered the regional crisis are the ones that have relied mainly on domestic savings for development and avoided excessive reliance on foreign debt, for example Taiwan and Singapore. Again, sound macroeconomic policies and well functioning financial system promote savings and investment, and management external debt prudently, especially the short term.

Sixth, despite the recent crisis and its aggravating consequences, all the crisis countries took aggressive measures to further the process of financial integration into global financial markets because the trend toward further integrating into the world econo my is irreversible and beneficial for developing countries. Vietnam should properly further the process of liberalizing the economic system with priority paid to financial liberalization with proper sequencing, both domestically and internationally.

Seventh, monetary policy should target assets markets since assets prices are an important variable and included in inflation index. Interest rate in monetary market must be consistent with the rate of return in assets markets given risk premium perceived. And a greater flexibility of exchange rate regime is essential to maintain the competitiveness of the economy and encourage banks and firms to manage currencies risk more prudently.

Finally, in crisis countries, the design of financial restructuring program has been dictated by concerns about maintaining the informational or organizational capital of banking system, about ensuring that owners or managers are not bailed out, about creating right incentive structure going forward and about the budgetary intact. The main focus for Vietnam, in my opinion, should be on providing the right incentives going forward to induce banks operate on commercial rules only.

CHAPTER III. FINANCIAL SECTOR'S REFORM IN VIETNAM

I. Overview of economic reform in Vietnam

Before adopting a reform program (known as Doi Moi), Vietnam pursued a centrally planned economic system, in which the state controlled all land, natural resources and virtually productive activities. The state allocated equipment and raw materials for production and organized agriculture under a collective system. It managed the distribution of agriculture products and consumer goods for personal consumption. It also created monopolies in critical industries and in foreign trade.

By the mid 1980s, the weaknesses of the central planning model had become apparent. Vietnam entered a period of serious socio-economic crisis and the situation was exacerbated by the drying up of aid from the former Council for Mutual Economic Assistance (CMEA). In response to the crisis, in 1986, Vietnam launched the reform program for comprehensive renovation of Vietnam society and economy based on three fundamentals as follows:

- A shift from a centrally planned to a market-oriented economy;
- The democratization of social life with the aim of developing the rule of law in a State of the people, by the people and for the people; and
- The implementation of an open door policy and the promotion of cooperation and relations for peace, independence and development with all countries.

Economically, the two major thrusts of the reform program were i) to introduce a considerable degree of market liberalization and selected structural adjustment, and ii) to open the door for trade, foreign direct investment and official development assistance.

The major reforms implemented in the early years of the reform program are highlighted in Box 5.

Box 5. The early years of Vietnam's Doi Moi program

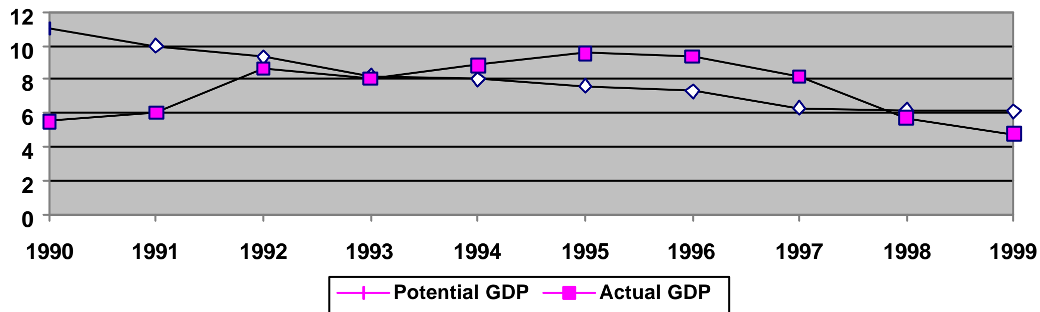
- *Agriculture reform*: The program began in the agricultural sector. Collectives were dismantled in 1988 and land was distributed among farming households. In 1993, a new land Law clarified that peasants has the right to use the land distributed to them for 20 years and that this right could be renewed. Peasants could sell or mortgage the right to use their land
- *Price reform*: Just as important as the reform of property rights, controlled prices for most goods and services were abolished.
- *Reform of macro-economy*: Strong measures to deal with serious macroeconomic problems were introduced in 1989. Production and consumption subsidies were eliminated from the budget. At the same time, interest rates on loans to state firms were raised above the level of inflation. The State Bank made a serious effort to control the growth of credit during the first half of 1989. By 1991, credit was no longer used to finance the budget.
- *Increased integration with international economy*: Vietnam opened itself to international markets including the unification of its multiple exchange rate in 1989. The official exchange rate was devalued from 900 dong per dollar to 5,000 dong per dollar, the rate prevailing in the black market. Structural reform in foreign trade and investment complemented other policies, though in these areas, Vietnam has taken a more gradual approach to liberalization and many barriers remain.
- *Financial sector reform*: Vietnam stabilizes its economy by reducing its fiscal deficit and growth of credit to manageable levels. The country still lacks, however, institutions underpinning sustained good management of the financial sector.
- *State enterprise reform*: In the early 190, the budget constraint for the state-owned sector was hardened. Fiscal subsides were reduced and then eliminated and loans for state owned enterprises (SOEs) were controlled more carefully and priced appropriately. This hardening of the budget constraint led to a major restructuring of the sector. Between 1988 and 1992, about 800,000 workers-one third of the state-enterprises labor force-left the sector, and the number of firms declined from 12,00 to 6,000.

(*Source*: Livack and Rondinelli [21])

[21] Litvack, Jennie, Rondinelli Dennis, Market reform in Vietnam, *building Institutions for development,* (Quorum book, Westport, Connecticut, London, 1999) pages 1 -27

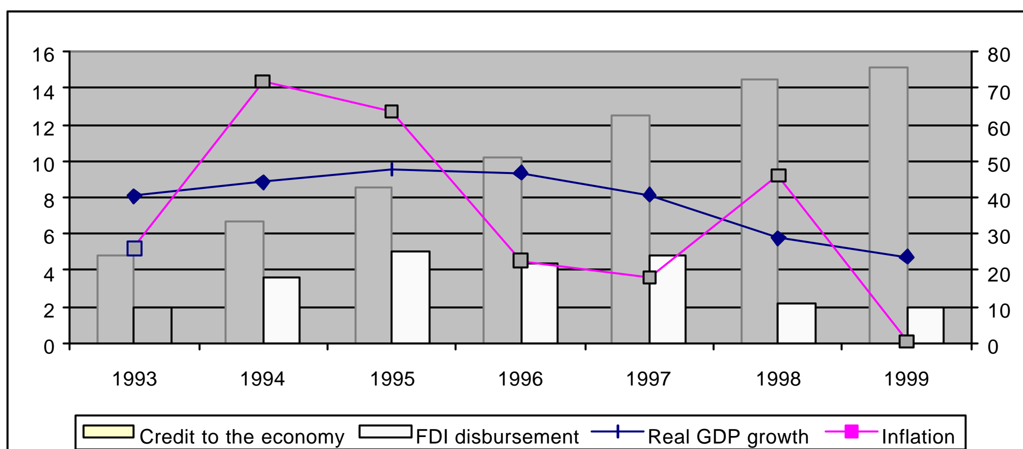
In a little more than a decade since the adoption of Doi Moi, the stimulation of Vietnam's economy catalyzed by the country's market-oriented reforms has enabled Vietnam to weather the shock following the collapse of Soviet block and helped Vietnam to transform the crisis in the 1980s into a rapid growth in the 1990s. On the economic front, the economic growth rate, on average, was spectacular 8.8 percent annually during the period of 1992-1997, low budget deficits of around 1 percent of GDP, single digit annual inflation rate down from triple digits. Both savings and investment increased markedly and external trade expanded rapidly. In addition, sizable FDI and ODA have been attracted from abroad to further economic growth.

Figure 2. Vietnam: Actual and Potential GDP growth, 1990-1999



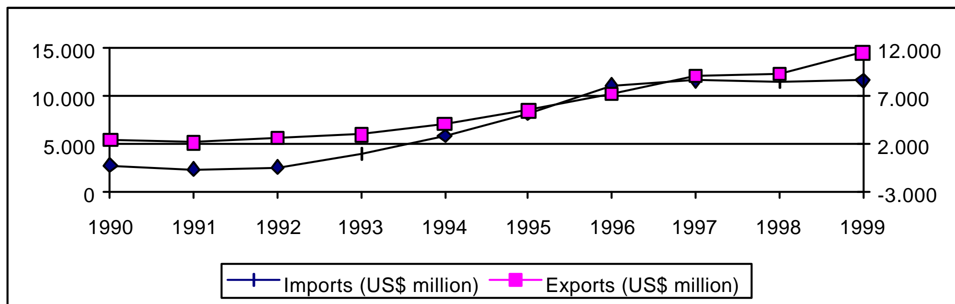
Sources: General Statistics Office (GSO) and IMF staff estimates, GDP at 1994 prices.

Figure 3. Real GDP growth rate, Inflation in percent (left scale) and Credit to the economy, FDI disbursement in trillion Dong (right scale)



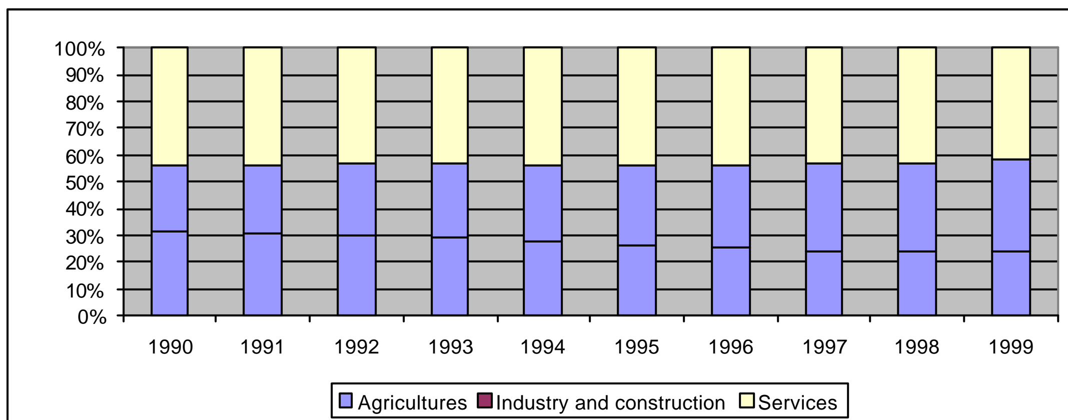
Sources: GSO, the State Bank of Vietnam (SBV) and IMF staff estimates

Figures 4. Vietnam: Imports and Exports performance: 1990-1999



Source: GSO

Figure 5. Vietnam: Structural Adjustment: 1990-1999



Source: GSO

During the high growth period of 1992-1997, there was a positive gap between potential and actual GDP (see figure 2). Owning to fixed exchange rate and relatively tight fiscal and monetary policy, inflation was subdued during the period. This growth pattern suggested that there was a boom in domestic demand, which was further accelerated by sizable inflows of goods, services and capital.

Limited data on real GDP by expenditures at 1994 prices does not allow a more detailed analysis of the sources of growth on demand side. However, data on real GDP at 1992 prices provides some insights. During the period of 1992-1997, domestic demand, on

average, contributed to the growth 13.3 percent annually, in which, private demand and FDI share to the growth accounted for 9.1 and 3.4 percent respectively. On contrary, external sector made a large negative contribution to the growth (-4.6 percent) despite strong performance of exports. Exports were growing rapidly but far outpaced by the growth of imports (29 percent and 37 percent per year on average, respectively). These suggested that the main impetus for the growth came from private consumption and FDI or domestic demand led growth during the period.

In production side, industry, which is dominated by manufacturing sector, contributed the largest share to the growth. On average, it grew at 13.5 percent annually in the period of 1992-1997. Until 1997, however, the main sources of industrial growth derived from foreign-invested enterprises. Their share in industrial production increased to nearly one third and they accounted for more than a half of the increased industrial output. Nevertheless, FDI in Vietnam has been channeled to high cost, capital and imports intensive industries in which Vietnam has no comparative advantage[22]. Moreover, most FDI projects were implemented through joint venture with SOEs, which are considerably less flexibility and effectiveness than the private sector. These suggested that the economic environment and policy gave favors to SOEs operated in import-substitution industries. The components of external sector further confirm this intuition. Although export performance was quite remarkable, raw material still accounted for 70% of total export while most of imports were directed to capital-intensive, import-substitute

[22] IMF staff country report No. 99/55. 1999, page 10

industries[23]. Available data also indicated that, on average, FDI enterprises accounted for 8.5 percent of total exports during 1991-1998 corresponding to one third of their total turnover.

This strategy complicated trade regime, which provided very high levels of effective protection to certain industries and quite low protection to others. This was allowing some very inefficient activities to attract and retain resources at the expense of others, more efficient industries that are viable with low levels of protection. Over 65 percent of FDI has gone into sectors with effective rates of protection are 60 percent, and over 30 percent has gone to sectors with effective rates over 90 percent [24].

Taken all together, the growth pattern in mid 1990s was relatively unfavorable and unsustainable. The country devoted resources to capital-intensive sector, which mainly focused on import substitution rather than labor-intensive sector notwithstanding Vietnam has had such a highly disciplined and literate labor force[25]. This partly reflected the efforts of Vietnam in the last decade to rapidly industrialize the country to accelerately catch up other countries in the region. Given the small size of the economy (GDP is just about $ 30 billion), limited purchasing power of domestic market, relatively scarce resources and lack of institutional capacity in the early stage of development, this development framework was costly in terms of losing efficiency and effectiveness, induced unavoidable distortions in resources allocation, and heightened inherent

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[23] Nguyen Quang Thai, *Economic policies*, 35 years of Vietnam Development Strategy Institute (National political publishing House), 1999, page 20

[24] Center for International Economic of Australia, *Vietnam trade policy in 1997, 1998,* pages 20-35

[25] Center for International Economics of Australia, *Vietnam economic policy 1998*, pages 2-20. The finding is that that during the same period, the share of total factor productivity contributed to the growth was less than that of labor and roughly equivalent to one third of the capital accumulation' s share.

weaknesses of SOEs and financial sector. Many SOEs were inefficient and heavily indebted and as a consequence, the financial sector was fragile and suffered from an increasingly substantial amount of bad debt. The lack of transparency and weak accounting standards preclude detailed assessments of exactly how serious problems are.

Table 4. Vietnam: Foreign Direct Investment Enterprises, 1991 – 1998

(in million of US dollars)	1992	1993	1994	1995	1996	1997	1998
Disbursements							
100 percent foreign-owned	80	186	263	413	554	689	84
Joint Ventures	145	435	837	1,169	1,146	1,337	278
With SOEs	140	423	812	1,145	1,122	1,288	273
With Private Sectors	5	12	24	24	24	49	8
BCC	92	302	537	674	263	47	435
BOT	0	0	0	4	0	2	3
Total	317	923	1,637	2,260	1,963	2,075	800
Turnover by FDI Enterprises							
Heavy Industries	28	65	167	414	683	1,232	1,526
Light Industries	19	73	180	380	582	734	787
Construction	0	3	14	69	43	152	181
Hotels and Tourism	17	31	80	169	89	182	47
Transportation and Communications	115	191	250	399	445	361	54
Others	45	122	334	626	857	967	748
Total	224	485	1,025	2,057	2,699	3,628	3,343
(In percent of total)							
Heavy Industries	12.4	13.4	16.3	20.1	25.3	33.9	45.6
Light Industries	8.5	15.0	17.6	18.5	21.6	20.2	23.5
Construction	0.1	0.6	1.4	3.3	1.6	4.2	5.4
Hotels and Tourism	7.6	6.4	7.8	8.2	3.3	5.0	1.4
Transportation Communications	51.2	39.4	24.4	19.4	16.5	10.0	1.6
Others	20.2	25.2	32.5	30.5	31.7	26.7	22.5
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Memorandum Item							
Export by FDI enterprises							**1531**
As percent of total exports	0.2	11.9	5.9	7.6	12.2	13.4	16.3
As percent of turnover	2.7	73.4	23.2	19.3	33.1	33.8	45.8
Imports by FDI enterprises							**2732**
Number of projects							2606
Number of workers							290955

Sources: Ministry of Planning and Investment (MPI), SBV and IMF staff estimates.

Table 5. Vietnam: Gross domestic product and components at 1992 prices: 1992-98

In Trillion of Vietnamese Dong (VND)	1992	1993	1994	1995	1996	1997	1998
Real GDP	111535	119472	130032	142437	155741	168512	174410
Consumption	88227	107674	119045	130106	145830	155974	165549
Private	81856	98192	107193	117083	131118	140102	148709
Public	6371	9482	11852	13023	14711	15872	16841
Investment	19498	30729	38122	45963	50577	60074	46724
Public	6450	8398	7038	7967	10279	11860	12811
FDI	4326	10239	19619	23358	19193	25293	11240
Other	8722	12092	11465	14629	21106	22921	22673
Change in statistic discrepancy	0	-7920	-7292	-4141	-8329	-25270	-17592
Domestic Demand	107725	130483	149874	171928	188078	190779	194682
Net Exports	2808	-11011	-19842	-29491	-32337	-22267	-20272
Exports	35765	40680	57415	72353	96563	127419	155126
Goods	27668	32244	42623	50004	71117	102228	124388
Imports	32957	51691	77257	101844	128900	149686	175397
Goods	28339	44107	62650	80790	102881	118291	138298
Annual growth rate							
Real GDP	**8.6**	**8.1**	**8.8**	**9.5**	**9.3**	**8.2**	**3.5**
Consumption	16.9	22.0	10.6	9.3	12.1	7.0	6.1
Private	7.6	20.0	9.2	9.2	12.0	6.9	6.1
Public	49.9	48.8	25.0	9.9	13.0	7.9	6.1
Investment	27.8	57.6	24.1	20.6	10.0	18.8	-22.2
Public		30.2	-16.2	13.3	28.9	15.4	8.0
FDI		136.7	91.6	19.1	-17.8	31.8	-55.6
Domestic Demand	18.8	21.1	14.9	14.7	9.4	1.4	2.0
Exports	28.4	13.7	41.1	26.0	33.5	32.0	21.7
Goods	23.1	16.5	32.2	17.3	42.2	43.7	21.7
Imports	42.4	56.8	49.5	31.8	26.6	16.1	17.2
Goods	39.6	55.6	42	29.2	27.1	15.0	16.9
Contribution to GDP growth, percentage points							
Private Consumption	8.8	14.8	7.5	7.6	9.9	5.8	5.1
Investment	6.4	10.2	6.2	6.0	3.2	6.1	-7.9
FDI		5.3	7.9	2.9	-2.9	3.9	-8.3
Domestic Demand	12.8	20.6	16.2	17.0	11.3	1.7	2.3
Net Exports	-4.7	-12.5	-7.4	-7.4	-2.0	6.5	1.2
Contribution to Real GDP growth (In percent of total contribution)							
GDP	100	100	100	100	100	100	100
Agriculture, Fishery and Forestry	27	12.4	10.9	13.8	12.4	13.3	11.3
Industry	42.2	41.4	42.0	41.2	46.3	48.5	57.4
Services	30.8	46.2	47.1	45.0	41.3	38.2	31.3
Contribution to Industry growth							
Industry growth					12.2	13.2	12.7
State					6.0	5.3	5.8
Non-state					2.8	2.3	1.6
Foreign Investment					5.4	5.6	7.3

Source: GSO and IMF staff estimates

The slowdown in GDP growth in 1998 reversed those weaknesses to the surface. Three fifth of SOEs were reported making losses and several banking scandals revealed serious flaws in the system. The default of a number of SOCBs and JSCBs on letters of credit payments, the transmission of the SOEs problem to banks further eroded the confidence in and the financial position of banking sector. In 1998, the situation was bad enough resulting the credit rating of Vietnam was downgraded from Ba3 to C (Moody's investment services). The reluctance of the authorities to accelerate the second round of reforms manifested in the withdrawal of bilateral trade agreement with the United State in 1999 (USBTA). The drying up of FDI to Vietnam clearly reflected continuing deterioration of business environment. The economy's efficiency decreased considerably, ICOR went up almost double in 1998 in comparison to 1992-1996 levels. The competitiveness of Vietnam economy deteriorated, ranking 49/59 in 1999[26]. Owing to cautiously expansionary fiscal and monetary policy, pragmatic measures adopted by the government and strict regulations of the economy, Vietnam still maintained a positive growth and gained an upward momentum recently.

In short, on the basis of most broad macroeconomic indicators, Vietnam's performance in the last decade has been quite impressive. Because of more emphasis on capital intensive, import substitute sectors, the growth was likely unsustainable especially in financing. The economics situation, however, steadily deteriorated and the weaknesses in SOEs and banking sector increasingly threatened the macroeconomics stability. The Asian crisis further compounded these weaknesses. The political concerns about opening domestic

[26] Nguyen Quang Thai, *Economic policies*, 35 years of Vietnam Development Strategy Institute (National political publishing House), 1999, page 22-25

market and insisting SOE' s leading role in the economy constrained efforts to decisively address these weaknesses and bring about new momentum for accelerating the second round of reforms.

II. Financial sector reform in Vietnam

1. Brief overview of banking reform in Vietnam

1.1. First round of banking reform: 1989-1996

In centrally planned economy, the so-called financial institutions did not perform any of the functions that they do in modern market economies. Under this regime, banks were not engaged in selecting and monitoring projects. Production and investment decision were made by the planning agency or elsewhere and the bank provided funds only *under instruction*. In fact, banks provided a set of book keeping entries, a form of record keeping. In transition to market economy, transforming banks from socialist to market institutions is an urgent need to improve the efficiency of resources allocation underpinned a smooth of transition process narrowly or fostered economic growth more broadly.

Like other transition economies, the first round of banking reform in Vietnam was the break up the mono-banking system into two tiers: the State Bank of Vietnam (SBV) responsible for the conduct of monetary affairs and four state-owned commercial and specialized banks (SOCBs) responsible for deposit mobilization, lending and other commercial banking activities, and the establishment of joint stock venture commercial banks (JSCBs).

First, the State Bank of Vietnam began functioning as the Central Bank monitoring monetary policy, overseeing the banking system and conducting the payments system. A

reverse yield curve was corrected in early 1990 to stimulate savings and investment. Monetary policy, however, continued relying heavily on direct controls namely credit ceiling, interest rates' floor and cap, and refinancing facilities (discounted window). Monetary markets remained rudimentary and fragmented due to strict regulations and adverse consequences of interest rate's cap. Prudential regulations provided for off-site and on-site inspection, set limit on lending, and stipulated minimum capital requirements. These regulations and supervision were notably weak, for example capital requirement was low and not based on risk weighted. In addition, supervisors appeared to encounter paramount difficulties in enforcing these rules.

Second, the reform process created confusion regarding to the role of the SOCBs largely because the reform was not automatically accompanied by changes in incentive structures (legal and regulatory frameworks and institutional development) that are necessary for effective transformation to market-based system. In addition, credit allocation of SOCBs implicitly or explicitly directed by the government to SOEs proved a particular problem.

Finally, rules on sectoral specialization were removed and entry into the banking system was liberalized in 1990. Lax regulations and weak banking licensing induced the mushrooming of a large number of JSCBs to which SOEs and SOCBs contributed considerable equity. However, four big SOCBs still dominated the whole system accounting for 76 percent of total credit to the economy, about 80 percent of total banking assets and incurring many types of privileges namely legal preferences, tax exemption or deferred payments, interest rates subsidies, accesses to foreign trade and exchange and so on. Nevertheless, banks started to offer a broader range of financial intermediation's services (see box 6).

Box 6. Vietnam: Banking and Non-bank financial Institutions

As of 1996, Vietnam banking system includes 4 state-owned commercial banks, 52 joint-stock banks, 23 branches of foreign banks, 4 joint-venture banks, 62 representative offices of foreign banks and 68 credit cooperatives; 900 people credit funds, 2 financial companies and 1 state-owned insurance company.

State Owned commercial Banks (SOCBs)
Industrial and commercial bank of Vietnam, whose operations includes: mobilizing funds, lending in local and foreign currency, trading on foreign exchange, processing local and international payments, trading in gold and silver, consulting, and providing computer services.

Bank for Foreign Trade of Vietnam: Dominating trading in foreign exchange and offering services as follows: financing trade, letter of credit operations, guarantees, international payments, credit card facilities, lending and taking deposits.

Bank for Investment and Development is responsible for development investment projects, providing equity participation in development projects, dealing in foreign exchange, and providing medium-and long term lending.

Bank for Agriculture and Rural Development, whose operations are generally limited to the agriculture sector. It also operates the Bank for the poor, a government funded low-income credit scheme.

Joint Stock Commercial Banks (JSCBs): Shareholders of joint stock banks are SOCBs, state owned enterprises and private entities. Most of joint-stock banks were established during 1991-1993. JSCBs offer a wide range of banking services as mentioned above. Their customers are mainly small and medium enterprises.

Foreign bank branches: Foreign bank branches operate mainly in foreign currencies, especially in the area of trade finance, as they may accept only a limited amount of domestic currency deposits (20% of statutory capital).

Joint-Venture Banks: The 4 joint-venture banks, which are partnership between a state commercial bank and a foreign bank – are subject to the same restrictions on deposit taking as foreign banks.

The initial reforms had beneficial impacts on financial sector development. Net domestic assets of the banking system expanded from about 8 % of GDP in 1992 to 16% of GDP in 1996. Domestic currency deposits, on average, increased at annual rate of 49% during the period. Interestingly, the share of credit channeled to state sector decreased to 53% of

total credit to the economy at the end of 1996 from 82 percent in 1992. As of 1996, the ratios of currency to domestic currency deposits and total deposits stood at as high as 85 percent and 57 percent respectively. The ratios of broad money (M2) to GDP and total deposits to GDP, which stood at 24% and 15.5 % at the end of 1996 respectively, were much lower than that of ASEAN countries. These reflected such a low level of monetarization of the economy. Nevertheless, the reform much contributed to impressive macroeconomic performances (see figure 3).

In short, the banking system is still far from performing the key roles of a market based system namely processing information on investment opportunities, spreading risk through assets diversification and providing liquidity services through continuing assets transformation. These weaknesses were in part due to the fragmented monetary market and interest rate's cap that discouraged long-term credit but mainly due to lack of autonomy in banking activities, incomplete legal frameworks and weak, inconsistent regulations. The Vietnamese financial system was in the 1996 shallow, narrow and fragile with a large debt stock inherited from the past and newly accumulated during the high growth period.

1.2. Second round of financial sector reform: 1997-Now

Despite the initial achievements, the first round of banking reform fell short of advancing banking practices and enhancing banking regulatory and legal frameworks. Banks' functioning were mixed between policy and commercial banking, and hampered by directed lending to favored SOEs. In addition, lack of transparency and inappropriate accounting and audit standards combined with weak credit assessment capability of banks gave rise to the amount of bad loans even during the high growth period. In some

cases, corruption and fraud in banking coupled with close tier to interest groups hindered timely corrective actions of the authorities. The banking system was financially fragile and a faltering economy put banks at risk and undermined effective operation. As economic growth slowed down in the late 1990s, the deterioration of financial position of the banking industry accelerated. Although bad loans surged (the overdue loans of JSCBs almost doubled in 1995) in 1996, lending restrictions were liberalized without strengthening banking regulations and supervision contributing to heighten the problems. These can be traced in two dimensions as follows:

Increasing foreign currency exposure: In 1997, foreign currency loans comprised 31 percent of total lending and even bigger share of loans by JSCBs (68.8 percent of lending was made to SOEs). Notably, all foreign currency deposits were short term (with maturity less than one year) while most of loans were used to finance the purchases of capital goods by SOEs thus putting banks at risk of maturity mismatch in foreign currency. However, most banks client, especially SOEs focused on domestic market, they might not generate enough hard currency to repay the loans when domestic demand contracted and the Vietnam Dong' s depreciation following the fall of Asian currencies materialized. Although some traded internationally but at least export incomes decreased proportionally because of lower world prices for raw material and manufacturing items attributed to higher competition from Asian exporters in the world markets. These translated in foreign currency risks that banks incurred indirectly.

In addition, SOCBs and JSCBs started issuing letters of credit (L/C) to carry trade involved by SOEs and other economic entities. This was equivalent to an increase in short term lending of foreign currencies. Amazingly, the total amount of outstanding

letters of L/C grew to about 7 percent of GDP (over $ 1.5 billion) and 40 percent of which became bad loans in early 1997, roughly estimated. The ruling of the Supreme Court in July 1998 failed to enforce payment of the L/C obligations further eroding international creditors' confidence in the Vietnamese banking system. Several banks defaulted on their L/C, which eventually necessitated a costly rescue operation of the State Bank reflecting in a net long position of JSCBs for the first time in second quarter of 1998. Needless to say that, data on foreign currencies borrowing by SOEs guaranteed by banks were not available. Available data suggested that the share of overdue loans was already high, accounting for 16 percent of foreign currency lending at the end of 1997.

Worsening credit quality The Dong lending was equally bad. The adverse consequences of serious banking scandals [27] coupled with concerns about the past credit decisions further constrained lending activities of banks, which translated into low profitability and worsening financial position of banks. Runs on JSCBs occurred in Ho Chi Minh city further weakened JSCBs in the city. As consequences, JSCBs in the city turned out to be the most vulnerable segment of banking industry with systematic implication [28].

The poor performance of SOEs further exacerbated the problem. Overdue loans soared to 12.4 percent of total loans in 1997. Weak accounting standards are likely to underestimate the true figure. Given the relatively low capital base of banking system (about 5% of total assets), the size of bad debt stock suggested that capital base of banking system was depleted sharply. In fact, most of JSCBs in Ho Chi Minh city were at

[27] The collapse of TAMEXCO and EPCO revealed serious corruption, fraud and weaknesses of banking and legal systems threatening several banks with bankruptcy.

[28] JSCBs accounted for more than 25% banks assets in HCM city, which accounts for 25% GDP, 40% of FDI, more than a half of total exports. In addition, JSCBs together with foreign banks, account for 60% of total lending in the city.

the edge of bankrupt because their overdue loans accounted for 14 percent of their total assets with a large portion was bad loans.

Without restructuring banks, better deposit mobilization and more efficient allocation of credit are unlikely. This was the time to review the old lesson. Worldwide experiences prove that the cheapest way to reform banking is to do it in the booming time. In Vietnam, however, the financial position of banking sector deteriorated right before the growth slowed down due to lax prudent regulations and supervision, weak lending standards, incomplete legal frameworks and scarce skilled resources. Needless to say that, the policy more focusing on import substitution hampered the development of banking system because it induced inefficiency in a certain sector of the real economy, especially SOEs thus feeding back to the banking system. The long delayed resolution of bad debt stock inherited from the mono-banks system prevented banks from breaking the close tier with former debtors and footing them at a new, sound position. Directed lending and the outside influences resulted in passive banking practices on non-economic criteria. For example, in 1997, when SOEs were performing poorly and failing to service loans or get loans, the State Bank eased their problem through various instructions asking banks to extend maturity of loans at risk, restructure nonperforming loans and eliminate collateral requirements for loans to SOEs. In addition, banks functioning is not only based on commercial criteria but also going beyond profit seeking, which is *to fulfill the requirements of the economy and the socio-economics targets of the Communist Party and the State* [29].

[29] An official definition of the role of State-owned commercial banks

Table 6. Vietnam: Open currency position of commercial Banks, 1994-1998

	1994	1995	1996	1997	Q1-1998	Q2-1998	Q3-1998	Q4-1998
Net aggregate foreign currency position, long (>0) or short (0<)								
In Million $US	134	144	115	217	338	460	545	753
SOCBs	157	182	211	270	419	451	528	717
JSCBs	-22	-39	-96	-53	-82	9	17	37
As percent of total foreign assets and liabilities	11.3	9.7	11.2	15.2	23.0	25.2	30.7	36.9
SOCBs	13.2	12.3	-5.1	-3.0	-4.5	0.5	1.0	1.9
JSCBs	-1.9	-2.6	-5.1	-3.0	-4.5	0.5	1.0	1.9
Net short term long (>0) or short (0<) Foreign currency position *								
In Million $ US	148	280	332	385	487	629	680	785
SOCBs	252	390	451	452	575	607	643	751
JSCBs	-104	-110	-119	-67	-89	**22**	37	35
As percent of total foreign assets and liabilities	12.5	18.9	17.5	21.6	26.7	35.1	39.5	40.5
SOCBs	21.3	26.3	23.8	25.4	31.5	33.9	37.3	38.7
JSCBs	-8.8	-7.4	-6.3	-3.8	-4.9	1.2	2.1	1.8

* Deposits with foreign banks, less foreign currency deposits of nonresidents and short-term foreign currency borrowing

Table 7 Vietnam: Foreign currency Lending of commercial banks

	1994	1995	1996	1997	Q1-1998	Q2-1998	Q3-1998	Q4-1998
Share of foreign currency loans in total loans (percent)	38.6	38.7	36.6	31.2	29.6	28.3	28.6	25.2
SOCBs	33.8	32.4	29.4	23.2	21.9	22.2	22.8	20.2
JSCBs	61.8	63.1	58.8	58.1	56.9	52.5	52.4	47.0
Foreign currency loans by sector (percent)								
SOEs	81.3	76.3	75.8	68.8	69.1	70.8	71.0	72.2
Cooperatives	0.2	0.2	0.3	0.1	0.2	0.2	0.2	0.1
Joint stock companies	7.7	9.8	7.4	12.1	12.1	12.2	11.7	10.8
Joint venture	4.7	11.4	14.5	17.1	16.2	14.7	14.4	15.0
Private sector	6.2	2.2	2.0	1.9	2.4	2.2	2.7	1.9
Share of overdue in foreign currency loans (percent)	7.2	4.8	5.6	15.9	16.9	18.4	18.5	16.3
By banks								
SOCBs	9.5	6.6	7.2	16.3	17.5	17.9	18.0	15.4
JSCBs	1.2	1.2	3.1	15.4	16.0	19.3	19.5	17.9
By sector								
SOEs	8.3	5.5	6.0	10.9	11.5	12.5	12.9	10.7
Cooperatives	20.0	18.4	23.4	48.9	53.0	51.8	58.1	52.8
Joint stock companies	4.1	4.6	10.3	64.1	67.2	71.1	72.6	70.7
Joint ventures	0.0	0.2	0.5	0.9	1.2	1.9	2.7	2.4
Private sector	1.0	2.8	6.5	22.6	19.3	23.0	14.0	22.4

Source: SBV and IMF staff estimates

Table 8 Vietnam: Bank Soundness Indicators, 1994-1998 /1

(In percent)

	1994	1995	1996	1997	Mar-98	Jun-98	Sep-98	Dec-98
Capital/Total Assets								
Deposit money banks	6	7.7	7.2	7.9	7.8	7.6	7.4	9.1
State-owned commercial banks	5.5	4.8	5	5.5	5.3	5	4.8	7.2
Nonstate-owned banks	7.7	25.1	14.6	16.5	17.3	18.1	18.6	17.5
Loans/Deposits /2								
Deposit money banks	146.3	127.3	122.4	110.5	109.5	101.5	100.4	N/A
State-owned commercial banks	148.1	136.6	125.5	108.6	105.1	99.8	97	N/A
Nonstate-owned banks	140.9	102.6	113.8	117.5	128.2	122.9	117.6	N/A
Profits/Total/Assets								
Deposit money banks	0.1	0.3	0.73	0.77	1.29	1.16	0.92	0.47
State-owned commercial banks	0.2	0.39	0.85	0.75	1.19	1.1	0.85	0.42
Nonstate-owned banks	-0.27	-0.25	0.32	0.83	1.69	1.4	1.19	0.71
Loan Loss Provisions/Total Loans								
Deposit money banks	0.2	0.2	0.3	0.4	0.4	0.4	0.4	1.4
State-owned commercial banks	0.2	0.2	0.2	0.3	0.3	0.3	0.3	1.5
Nonstate-owned banks	0.1	0.2	0.3	0.7	0.7	0.8	0.8	0.8
Capital/Total Loans /3								
Deposit money banks	9.4	12.5	12.3	13.2	12.9	13.1	12.6	15.9
State-owned commercial banks	9.2	8.4	8.6	9.3	8.9	8.6	8.3	12.9
Nonstate-owned banks	10.1	28.5	23.8	26.3	27.2	29.4	30.7	29.3
Loans/Total Assets /4								
Deposit money banks	63.2	61.4	58.9	59.9	60.5	57.7	58.3	56.9
State-owned commercial banks	59.9	57	58.1	59.1	59.7	58.4	57.8	56.3
Nonstate-owned banks	76.3	88.3	61.5	62.8	63.6	61.5	60.5	59.6
Profits/Loans								
Deposit money banks	0.17	0.48	1.24	1.28	2.13	2	1.57	0.83
State-owned commercial banks	0.33	0.68	1.47	1.26	1.98	1.88	1.48	0.75
Nonstate-owned banks	-0.36	-0.29	0.52	1.32	2.66	2.28	1.96	1.18
Loan loss Provisions/Overdue Loans								
Deposit money banks	2.2	3	2.7	3	3	3	2.9	N/A
State-owned commercial banks	1.9	2.7	2.3	2.3	2.3	2.3	2.2	N/A
Nonstate-owned banks	7.4	6.1	6.2	4.9	5.3	4.8	4.5	N/A

1/ Based on the monetary survey of four SOCBs and 24 JSCBs;
2/Excluding Government Deposits.
3/Excluding loans to Government;
4/Reflects recapitalization of SOCBs in October 1998 through conversion of frozen loans from the State Bank of Vietnam;
Source: SBV

Box 7. **Approach to banking reform**

An approach to banking reforms in Viet Nam suggested by the IMF as follows:

- *Diagnosis*: More in depth analyses of loans portfolios and operating practices, with a view to preparing detail business plans for individual banks.
- *Firm exit policies*: Set up an effective resolution mechanism for rehabilitating weak but viable banks including procedures on the timing and nature of action to be taken, criteria for liquidity support and transfer of deposits to safe banks, criteria for acceptance of rehabilitation plans, and conditions for closure, merger or rehabilitation.
- *Operational restructuring*: Replacing management, formulating internal procedures for credit assessment, collateral valuation, risk management and pricing, monitoring the condition of borrowers, ensuring payment of interest and principal and active loan recovery.
- *Strengthening governance structures*: Enforcing internal controls and audit, accounting and assets valuation, creating right incentives structures to align the interests of managers and staff with those of the owners. Twining arrangements, reputable foreign banks are hired to lead the operational restructuring of weak domestic banks and prepare them for equity participation by strategic foreign partners in 2-3 years.
- *Restructuring nonperforming loans*: Arresting further accumulation of bad assets by restricting certain lending operations and any injections of capital and other public resource into SOCBs. A portion of bad assets should be subject to effective loans workout (foreclose or assets sales) process, the remaining transferring to an Assets Management Company or Loan Recovery Agency. It requires clear legal rules on bankruptcy, land-use right and property ownership, collateral valuation and foreclosure.
- *Recapitalization*: After cleaning up the balance sheet of banks, state-owned banks are subjected to be partial or fully privatizing.
- *Market structure of banking industry*: Enhanced competitive and efficient banking systems are characterized by a relatively small number of banks, non-of which has dominant market power, supported by a firm financial regulatory framework.
- *Level playing field* between different types of banking institutions: Further fostering competition and standardization of banking services.

Sources: IMF staff country report 99/55 and SBV

It was time for changes. The second round of reform marked by issuing two banking bills. The new law on the State Bank of Vietnam passed in December 1997, consolidated the existing central banking regulations and clarified authority for monetary policy. The law authorized the National Assembly to approve monetary policy (rather than the State

Bank) and assigned policy coordination to a newly established institution named Monetary Policy Advisory Council. The law on Credit Institutions passed in the same session, required banks to adopt improved business practices. Pursuant to these laws, the State Banks began to promulgate during 1998 and 1999 with international financial institutions' assistance, new government decrees on monetary and foreign exchange policy, prudential regulations and supervision of credit institutions and other key issues. Although the new prudential regulations and supervision still fell short of international standards, improvement have been made in a number of areas as follows:

- The loan classification scheme began reflecting credit assessment;
- Loan loss provisions ranged from 20 to 100 percent of the value of loans which were classified in four different loan-risk groups;
- Minimum ratio of capital to risk-weighted assets set at 10 percent for all banks (previously 5 percent on a nonrisk-weighted basis). The conversion of off-balance sheet items to on-balance sheet items was addressed;
- Banks have to observe various prudential ratios to ensure the safety of their operations, including the ratio of medium and long-term loans to short-term liabilities and the ratio of liquid assets to short-term liabilities. The State Bank was also authorized to establish limits on exposure to interest rate and liquidity risk.
- Adapting capital, assets quality, management, earnings and liquidity (CAMEL) framework for assessing a bank's overall financial condition.

The authorities were continuing their efforts to improve and streamlining these regulations on a risk-based approach and develop risk-based prudential regulations.

These improvements should in time enable bank supervision in Vietnam to move closer to the Basle Committee' s Core principles for Effective Banking Supervision.

The authorities strengthened the rules on banking licensing, bankruptcy procedures (which now covers enterprises and banks under the same regime), foreclosure, collateral valuation and the transfer of land-use right. The need to implement international accounting standards to ensure true and accurate information on the financial condition of banks and bank borrowers has been recognized. To further this path, the State Bank has implemented the new chart of accounts in early 1999.

In early 1998, a Bank Restructuring Committee headed by SBV' s Deputy Governor, was established to oversee banking reforms, particularly restructuring of JSCBs in Ho Chi Minh city.

Rehabilitating JSCBs: they were subject to be classified as follows:

- Group 1: Banks with normal operations that need further improvement to become more competitive (8 urban JSCBs and 12 rural JSCBs).
- Group 2: Banks have some weaknesses in activities or inadequate legal capital (7 urban JSCBs and 3 rural JSCBs). These banks are considered to be viable, but need to strengthen their operation more substantially than the JSCBs in group 1, and during this period the scope of their activities must be limited;
- Group 3: Weak banks with high risk of insolvency and low legal capital that need to be thoroughly restructured (12 urban JSCBs and 3 rural JSCBs);
- Group 4: Banks are insolvent and subject to license withdrawal (3 urban JSCBs and 1 rural JSCBs). Two urban JSCBs have already been closed.

Bank strengthening (Group 1 and 2) would include: amending the banks' charter; recapitalizing banks to conform with minimum capital requirements (the SBV proposed to raise foreign ownership in some banks to 30-50 percent); replacing management and reorganizing the work of executive, management, and supervision boards; improving the skills of staff, especially in credit assessment; improving the quality of deposit mobilization, credit and guarantee operations with a view to promoting safe and sound bank practices, accelerating dispose of non-performing loans and raising profitability.

Restructuring would focus on banks in-group 3 and 4. These banks would not be allowed to carry out external payments or expand the scope of activities during the restructuring process, and if their operations did not sufficiently improve, would be subject to license withdrawal. Restructuring methods would include:

- Mergers (which should be voluntary and would receive government support under certain conditions) and acquisitions;
- Temporary capital injections by SOCBs and appointments of new managers to restructure the operation of a JSCB. The additional SOCB shares would be sold once JSCBs are restructured.
- Placing a JSCB under receivership of a strong SOCB or a JSCB, to which deposits would be transferred. The receiving bank would be provided with the state funds on a temporary basis to recover debt and liquidate the assets of the bank received. Eventually, the bank's license would be withdrawn and bankruptcy proceeding initiated.
- Placing JSCBs under SBV's special control or supervision regime and revoking the bank's license.

In 1999, all JSCBs would prepare restructuring plans for approval by the SBV. Banks in group 3 would be placed under SBV' s special control and an initial round of mergers and closures would be carried out. In 2000, banks in Group 1 and 2 would strengthen their operations, and the remaining banks in Group 3 and 4 would be merged or closed.

Table 9. Vietnam: Capital Adequacy of State-Owned Commercial Banks, 1998

	Sep.1998	Recapitalization amount /1	Oct.1998		Min. legal capital /3	Desirable capital /4	Capital Deficiency /5
			Actual	Adjusted /2			
In trillion of dong							
Capital	4.6	2.4	6.9	3.6	**5.5**	9.8	6.2
In percent of total assets at end Oct.1998							
Capital/Assets	4.6	2.5	7.2	3.8	**5.6**	10.3	6.5

1/ As per SBV decisions on Conversion of loans into capital for SOCBs, October 1998;
2/Capital is adjusted by excluding existing loan loss provisions, and imputed lass equivalent to 50 percent of overdue loans; assets are adjusted by excluding 50 percent of overdue loans as of end September 1998
3/As per Decree of the Government on the Legal Capital for Credit Institutions, October 3, 1998;
4/Based on the assumption that capital adequacy ratios should exceed minimum standards established under Basle principles;
5/Difference between desirable and adjusted capital/assets ratios
Source: SBV and IMF staff estimates

Rehabilitating State owned commercial banks: International standards audits of four large banks were completed in early 1999. Their frozen loans inherited from the mono-bank system were cleared in October 1998 and partly recapitalized by public resources. Major weaknesses of SOCBs identified in these assessments included a high risk profile of the banks' assets portfolios, low profitability, heavy reliance on lending activities and low quality of other banking services, costly operations with overstaffing and inadequate internal controls and information management systems.

Based on these assessments, the SBV launched an overall restructuring plan in early 1999 aiming at improving the competitiveness and soundness of SOCBs, strengthening their

internal operations and management and integrating them with the international financial system. The plan would include structural and operational measures as well as debt workout. On the structural side, the emphasis is on separating commercial and policy lending. Operation reforms would provide for:

- Business autonomy;
- Strengthening and streamlining banking management;
- Establishment of independent committees for internal control and supervision;
- Improvements in information systems management, accounting standards, which would be upgraded to comply with international standards; and
- Human resources development.

Nevertheless, the plan did not make any firm recommendation for solving nonperfoming loans and containing macroeconomic impacts. As a significant step, the plan sees as necessary the selection of one SOCB for equalization on a pilot basis after the year 2000. The sales of share would be opened to strong foreign banks with the allowable cap so as to increase capital and gain management experience.

Establishment of policy banks: As a part of the SOCBs restructuring plan, the authorities intended to separate policy or directed lending from purely commercial operations. In the first, transitional stage, policy lending would continue through existing SOCBs but would be clearly separated in the bank account. In the second stage, policy banks would be established as separate institutions, to be funded from the state budget, and with the precise scope of operations defined by the government. The first such a bank to be established is the Bank for the Poor. The authorities are now planning to establish an import-export and a investment promoting bank to provide concessional loans for the

promotion of exports and infrastructure construction. The remaining activities of the SOCBs will be consolidated and organized on a fully commercial basis.

2. Remaining weaknesses

The weaknesses originated in incomplete reforms of the financial sector and the SOEs. It reflexes in the following aspects:

- Weak banking regulatory and supervisory frameworks; difficulties in enforcing the existing rules and imprudent lending;
- Nonperfoming loans re-surged and continuing deterioration in banks balance sheet;
- Foreign exchange exposures increased;
- Premature recapitalization;
- Poor performance and weak corporate governance;
- Poor performance of SOEs, weak financial discipline; extensive fiscal, trade, and credit privileges.

The restructuring plan somewhat gives more emphases on the surface rather than the core. The banking industry still remains fragility, inefficiency and low level of financial intermediation. Property rights and the rules of game are not clearly defined. There is still directly or indirectly excessive government intervention in allocating funds in favor of poorly performed state enterprises. As long as reforms of state owned enterprises and external sector delayed, the banking reform is still in question. Credit culture is another concern. SOCBs are still running business based on implicit/explicit government guarantees or relationship rather than market-based banking. Inside the banking industry, there are still remaining biases against new entrances and foreign banks. The reform

program wants to increase competition among banks but it plans to do so in a gradual and manageable way. Restrictions on mobilization of dong deposits applied for foreign banks are expected to be gradually reduced. The process of gradual leveling of the playing field is likely slow because the ongoing restructuring makes SOCBs difficult to compete effectively during the next few years. This gradual leveling of the policy-environment will be important in generating competition for all banks. As long as SOCBs stay behind tailor-made protections they still remain weak and incompetitive so a clear sunset should be strictly defined to force SOCBs to improve their efficiency and competitiveness.

3. Implications for further reform

The lessons from the recent financial crisis suggested that delayed or uncompleted reforms of financial sector could undermine macroeconomic stability and to some extent, warrant a financial crisis. Vietnam should move away from government-directed credit toward commercial lending principles. At the same time, banking regulation and supervision should be strengthened in line with international standards in banking and finance. Particularly, there are several important issues as follows:

Getting the number right and greater transparency International experiences suggested that meaningful, accurate and timely information provides an important foundation for the decision of market participants and policymakers and thus is indispensable for imposing market discipline on the conduct of financial institutions. Information must be audited, relevant to users trying to make proper assessments about financial institutions and their risk profiles. Well-informed market participants can bolster financial institution incentives to operate prudently and reinforce effective supervision of these institutions. The Asian crisis also highlighted the importance of sound accounting practices, so too did

it highlight the importance of improving data on financial condition and exposure especially foreign exchange exposure of both banks and enterprises.

Implementing commercial banking principles is likely to be made more difficult by the absence of appropriate accounting rules. The most urgent need for Vietnam is to introduce internationally acceptable accounting and auditing standards. This is not new but Vietnam is still one among very few member countries who have not provided the IMF with timely and reliable data to publish in the World Statistics Year Book. Some has criticized Vietnam is very poor at producing information. It is true in many aspects. First, a lack of appropriate accounting standards for businesses hampered authority efforts to improve accountability and transparency in the system. For example, the profitability's calculation does not capture the cost of capital for all SOEs, overstates the real rates of return on invested capital thus feeding back to low quality of credit assessment. This problem is especially acute for small and medium-size firms, which frequently keep very rudimentary accounts affecting severely JSCBs - their main lenders. Cross-guarantees and subsidies among SOEs make the authorities' assessment of SOEs' financial condition and profitability become extremely difficult, especially for the large ones. Second, lax discipline and ineffective enforcement of existing rules give rise to many economic entities to make the accounting numbers to look good. It was quite common that banks tended to keep rolling over the loans to favored SOEs to hide the size of the hole in their balance sheet. Finally, both banks and firms often keep accounting based on backward looking with lack of frequent adjustment rather than forward-looking principles. As a result, banks find it difficult to evaluate the feasibility of projects they are asked to finance, the value of collateral their customers have to offer and assess the relatively fair

value of assets' portfolio and the levels of capital adequacy of banks themselves. More importantly, accounting standards that reflect the true financial positions of banks is a prerequisite for effective supervision. Supervision should be risk-based and include on-site inspection, off-site surveillance through accounting and auditing. To ensure this, Vietnam accounting standards need to conform to international accounting standards. However, improving accounting standards is not enough. Putting them in practice will require training of more people in surveying, accounting, auditing and managing electronic information systems. Particularly urgent is better information on the ultimate bearer of risk on debts being taken on by SOCBs, JSCBs and SOEs. Moreover, a reliable assessment of the financial position of banks requires well-trained analysts and supervisors since most assets are illiquid and lack an objectively determined market value. The liberalization of banking and financial markets are increasing level of information required to achieve financial stability while the provision of useful, adequate information on participants and their transactions has become essential for maintaining orderly and efficient markets. For the risk-based approach to bank management and supervision to be effective, timely and reliable information must be provided that meets the needs of each key players namely supervisory authorities, banks, depositors, banks' client and general public as well.

In addition, financial information needs to be checked by an independent auditing agency. Under a market-based approach, auditing extends beyond matters directly related to administrative controls and accounting. It comprises measures adopted by within the banks to safeguards the business assets and manage its risks, check accuracy and reliable of accounting and management of information, promote operation efficiency and

encourage adherence to management policies. Put it differently, auditing can serve as an independence appraisal agent to examine and evaluate bank's activities. More importantly, internal audit within a bank serves the same function like external audit but safeguarding the bank' activities in the first place.

Regarding disclosure requirements, financial institutions, generally or banks particularly must report on their financial performance, financial position (including capital adequacy), risk management practices, risk exposures, accounting policies and corporate governance. Those disclosure requirements allow market discipline to work earlier and more effectively, thus reducing the severity of market disturbances and bank's failure. In theory, the disclosure of information can be gradually improved indirectly through peer pressure from powerful parties in the market place. In normal times, such pressure might show banks that disclosure is to their advantage in raising funds. However, the provision of information can be costly because information needs to be examined to ensure that the detriments of disclosures are fully justified. Vietnamese banking legislation has traditionally been used as a way to force banks to disclose information, which historically involved the complication of monetary statistics for a wide range of purposes rather than the provision of information necessary to evaluate financial risks. Disclosure requirements have to be reviewed periodically to ensure that users' current needs are being met and the burden on banks is not unnecessarily heavy.

Since most Vietnamese firms and banks have never had to answer to stockholders or a governing board and the notation of opening their books to outside auditors and accountants has been unthinkable. In such circumstance, there needs a fundamental change in culture and attitude toward reporting and sharing information among concerned

parties. Toughening public information disclosure requirements will help to facilitate the delegation of monitoring responsibilities to the public at large. This paves the way for rating agencies and professional financial markets analysts to take charge of collecting and analyzing information in the future. At the same time, the highly influential media are expecting to play an increasingly important role in enforcing market discipline to influence or to correct bank behavior.

In short, it is urgent to upgrade accounting and audit standards, strengthen disclosure practices and greater transparency in finance practices to generate and to develop far better information collection, dissemination and management systems so that better quality and timely information is readily accessible to facilitate the next round of banking reform process, strategic investment decisions in both financial and real sector as well as evaluating vulnerability and addressing the weaknesses of the system.

Resolution of Nonperforming loans: At present, banks have had difficulty in enforcing payment from clients if loans overdue. The banks' response to this problem largely to extend the loans, but there has also been the possibility of accepting collateral. Although the banks were required to take collateral, the rules on both how to establish the collateral contract, and how to enforce it in the event of debtor's default was largely unclear and ineffective namely private property ownership, housing and land use right. Bankruptcy laws and procedures should be reinforced to ensure that the creditor rights are protected properly. Debt of insolvent financial institutions and assets (loans) of financial institutions to enterprises that have no hope of surviving should be transferred to a centrally public-owned workout institution and sold for market price.

In Vietnam, the price paid for bad-assets is of less concern than it would be in a commercial transaction, since what is at issue is largely which of the public pockets will finance the past losses. However, the most difficulties faced by Vietnam are limited banking and restructuring expertise, lack of limited private markets, and the challenge of coordination with necessary SOE restructuring. Using a centralized approach (like KAMCO) should be the most effective method of overcoming these difficulties. It may be even more effective to divide the asset resolution structure into two separate functions such as SOE related loan assets, and non-SOE related assets, such as agriculture loans. The fiscal implications of the assets resolution agency would need to be carefully reviewed and made consistence with requirements to preserve macroeconomic stability.

Improving legal, regulatory and supervisory frameworks Prudential regulations accompanied by effective supervision of compliance with those regulations are necessary to ensure that prudent banking will be conducted in the future. In particular, improving loan-classification and loan loss provisioning to meet international standards in terms of transparency and accuracy of financial statements and strengthening of SBV supervision will be the key to ensuring that all banks operate prudentially.

Broadly, prudent regulation and supervision should aim at creating a right set of incentives to reduce excessive risk-taking by banks. The financial system is the subject to be regulated sophisticatedly. Activities that regulators can comprehend sufficiently to set appropriate capital' s requirements and to judge the competency, with which activities are being conducted, should be permitted within the bank. Other activities that are not examinable and supervisable, should not be allowed to be conducted by the bank but should be permitted for a separately capitalized affiliate so long as transactions between

the bank and the affiliate are tightly scrutinized. For instance, commercial banks should not be allowed to underwrite securities issuance or focus lending on a certain customer or sector, for example, real estate.

Table 10. Summary of key prudent regulations

Limit on medium and long term lending funded by domestic short term deposits and securities, in percent	
JSCBs	20
Credit Cooperatives	10
SOCBs, Foreign bank branches and Joint-Venture banks	25
Liquidity ratio (short term, marketable assets/ short term liabilities	100
Limit on exposure to one customer, in percent of total equity	15
Limit on purchasing of stocks, in percent of total equity	
Banks	30
Financial companies	40
Limit on total equity shares held in one entity, in percent	
Banks	11
Financial companies	20
Risk-adjusted minimum capital requirement	8
Loan-classification and Loan-losses provisioning (in percent)	
Group 1: undue loans, discounted papers and leasing	0
Group 2: Collateral-backed loans (<181), Non-collateral backed loans (<91); Discounted papers (<31); Guaranteed items (<61); and Leasing (< 181) *	20
Group 3: (> 181 & <361); (< 181 and >91); (>31 and <61); (>61 and <181); and (>181 and < 361) respectively	50
Group 4: (>361); (>181); (>61);(>181); and (>361) respectively	100

* Number of days passed since the last payment date
Source: SBV

The present regulations do not classify the whole value of the loans as overdue when any parts of principle or interest payment is overdue (see table 9). Loan classification criteria also provide a vague concept, which one is sub-standard or doubtful or nonperforming or bad loans. These criteria give disincentives to banks to take timely and effective measures to secure the loans before the situation actually get worse. These regulations should be upgraded toward risk-based and forward-looking principles. For example, a loan will be classified as doubtful or bad loan whenever borrower fails to service the debt and is considered having a little chance to repay regardless how much time has passed. In addition, the regulations do not set a prudent limit on aggregate exposures of banks to a

certain sector or sub-sector in the economy especially real estate. These regulations should be strengthened to avoid over-concentration of banks and force banks to diversify their risk profile.

In addition, banking supervisory should move away from the monitoring of compliance with banking laws and old style prudential regulations. Bank supervision based on an ongoing analytical review of banks, is the key factor in maintaining stability and confidence in the financial system. Risk based analysis includes the quality and style of corporate governance and management; the adequacy and consistency of a bank policies and procedures; the effectiveness and completeness of internal controls; and the timeliness and accuracy of bank financial information. Bank supervision, therefore, is to monitor, evaluate and when necessary strengthen risk management process undertaken by the supervised banks. In addition, tighter supervision may be required where banks are believed to employ inadequate risk management techniques, especially with respect to borrowers who have significant foreign currency liabilities or evade such regulations by using derivative instruments where prudent controls have not yet been extended to cover derivative positions.

In short, unless better regulations are introduced and implemented, on-site inspection of banks and off-site surveillance as well as legal framework are strengthened, there will be insufficient incentives for banks to behave prudentially.

Premature recapitalization of SOCBs Recapitalizing banks without restructuring SOEs will risk another round of recapitalization in the near future. Thirty six percent of all loans to SOEs are currently categorized as "overdue". Utilizing a stricter loan classification system based on international standards to determine what is overdue may

present an even bleaker picture. Trade liberalization may weaken currently profitable SOEs and recapitalized banks may be asked to keep them afloat. The workout on the potentially viable SOEs must be conducted on strictly commercial lines to ensure least-cost solution for the budget. In practice, this means a part of the enterprises' debt would be cancelled and a part converted into equity (to ensure a reasonable debt-equity ratio) like what happened in October 1998.

The high fiscal cost of recapitalization is less important for Vietnam. SOCBs account for three-quarters of banking assets, and a large portion of these are non-performing. But the modest size of the whole Vietnam financial system limits the extent of likely losses. The total credit is less than US$ 6 billion, or little over 20 percent of GDP. The great bulk of this is for short-term self-liquidating purposes. Even if a fourth of this credit is bad and unrecoverable, the cost will be a fraction of those experienced in other countries. Although off-balance sheet exposures can present some unpleasant surprises (as with recent default on letters of credit), the above figure will still be an upper bound on the fiscal cost of restructuring and recapitalizing banks. Nevertheless, loan workout at SOCBs will be accelerated to ascertain the extent of non-recoverability of overdue loans. To put SOCBs at a sound position in the future, the government should raise the minimum legal capital requirement to the level consistent with Basle principles as pointed out in table 8. The capital injection, however, should come after, not before the appropriate accounting standards, prudent banking supervision and regulation, and commercial banking principles have been put in practice.

Selected credit policy Directed credit programs were a major tool of development in 1960s and 1970s. In the 1980s, their usefulness was reconsidered. Experience in most

countries showed that they stimulated capital-intensive projects, that preferential funds were often (mis) used for non-priority purposes; that a decline in financial discipline led to low repayment rates, and budgets swelled. Other Asian countries have long touted the merit of focused, well managed directed credit programs, saying they are warranted when there is a significant discrepancy between private and social benefits, when investment risk is too high on certain projects, and when information problems discourage lending to small and medium-size firms. The assumption underlying policy-based assistance and other forms of industrial assistance (such as lower tax) is that the main constraint on new or expanding enterprises is limited access to credit. The recent crisis provided more hindsight toward selected credit policy. Since Vietnam is planning to establish the import-export and investment promoting bank in the near future, selected credit policy should be carefully designed with clear cost-benefit insights and the following lessons are worth of considering:

- Credit program must be small, narrowly focused, and of limited duration (with clear sunset provision);
- Subsidies must be low to minimize distortion of incentives as well as the tax on financial intermediation that all such programs entail;
- Credit programs must be financed by long-term funds to prevent inflation and macroeconomic instability. Central bank credit to such programs should be avoided except in the very early stages of development when the central bank's assistance can help jump-start economic growth;
- They should aim at achieving positive externalities (or avoiding negative ones). Any helps to declining industries should include plans for their timely phase out;

- They should promote industrialization and export orientation in a competitive private sector with internationally competitive operations;
- They should be a part of a credible vision of economic development that promotes growth with equity and should involve a long–term strategy to develop a sound financial system;
- They should be based on clear objectives and easily mornitorable criteria;
- Programs should aim for a good repayment record and few losses;
- They should be supported by an effective mechanism for communication and consultation between public and private sector, including the collection and dissemination of basic market information.

Building sound credit culture Since every kind of business entails some kinds of risk, every economic agent must decide how much risk it is prepared to take. A cultural attitude toward risk is critical in a credit-granting organization. To transform commercial banks to market institutions, building credit culture is an integral part of the transition process.

To begin with, a bank must decide what its risk profile ought to be and take into account the realities of business in which it concentrates. The bank needs to apply modern portfolio theory in managing its assets and liabilities and develop sound credit analysis practices. In doing so, banks should train its best employees in the tools of modern credit analysis and terminate those high-level credit personnel who are unable or unwilling to adapt. It is necessary for each bank to have risk – rating system using debt-rating model and develop its own gate-keeping procedures such as the adoption of relevant credit analysis model. These models have to be credible and reliable. How can domestic banks

learn the requisite skills? The best way may be the way so many other skills were learned so far, through joint ventures or hiring foreign managers. The very concern that is often raised in the country about turning over control of banking system to foreigners providers part of the rationale for doing so in this case. Again, increasing the presence of foreign banks can serve as an effective alternative to provide additional pressure for appropriate risk-taking by and fostering the transfer of skills and best practices to domestic banks. This requires the government to give the foreign banks the right to establish themselves and to permit the immigration of skilled banking personnel.

To sum up, transforming banks to market-based institutions requires implementing internationally acceptable accounting and audit standards, enhancing transparency in financial practices, strengthening legal frameworks, prudent financial regulations and supervision and building sound credit culture. In addition, implicit or explicit government guarantees on commercial loans should be abandoned or clearly stated and directed credit policies should be carefully designed to minimize the adverse impact of efficiency losses. All these elements aim at creating a right set of incentives toward risk-taking by banks and inducing banks to behavior prudently and purely operate on commercial principles.

III. Other related issues

1. State owned enterprises reforms

The characteristics of SOEs in the centrally planned economy have become known as inefficiency, ineffectiveness and weak competitiveness. The inefficient, loss making SOEs are significant burdens on government budget and scarce resources in the country. These enterprises hinder growth, impede market liberalization and thus both directly and indirectly hamper efforts to accelerate the reform process that are already underway. In

fact, SOE reform in Vietnam started in late 1980s. In 1989, 4,600 of the 12,000 SOEs were losing money. In addition, Vietnam's inability to obtain a sufficient amount of foreign aid and the decline of the Soviet assistance also made restructuring SOE more urgent. At the end of 1991, the total overdue debt owed by SOEs to SOCBs and to each other was estimated at about 10 trillion VND ($ US 900 million) equal to 11 percent of GDP and nearly equal to Vietnam's total 1990 export earnings. About 12,000 SOEs held 75 percent of the country assets and used 86 percent of the bank credit but they generated only 26 percent of GDP and could provide jobs for less than one third of the country labor's force. Between 1989 and 1992, a fairly orthodox stabilization program was put in place. The government increased the interest rate, reduced domestic credit growth by credit ceiling, cut expenditures and devaluated the currencies. In 1993, nearly 7,000 inefficient or insolvent SOEs had to be dissolved. As of 1997, 5,476 SOEs remained.

During the high growth period, as mentioned, a number of SOEs was selected to joint venture partnerships with foreign partners in efforts to upgrade a segment of SOEs. Nevertheless, SOEs still continued playing the leading role in the economy, on average, accounting for about 30 percent of GDP, more than a half of total outstanding credit to the economy during the period of 1992-1997. In addition, the SOE sector was highly concentrated, with the 200 largest SOE accounting for 60 percent of state capital and 40 percent of total debt (see table 10). It was estimated at 300 enterprises accounted for 80% of SOE sector's contribution to government budget. However, most SOEs was reported to operate with obsolete machinery and equipment, low productivity and quality of their products resulted. The rate of over-employment was about 25%. This translated into weak financial performance. Limited data on SOEs performance does not allow any

detailed analysis but available 1997 data revealed the seriously long-standing problem of SOEs.

Table 11. State Owned Enterprises: Key Indicators as of December 31, 1997

	Total number of SOEs		State capital	Total debt	Employment	
	Number	Percent of			Total employment	Average Income of employees (1000 Dong /month)
I Total	5467	100	73272	101361	1614867	588
Profitable SOEs	2174	40	52394	60784	929017	745
Unprofitable SOEs	3293	60	20878	40577	685850	405
II.Central Total	1651	100	47270	65844	899374	680
Profitable SOEs	757	46	38019	44399	583455	903
Unprofitable SOEs	894	54	9251	21445	315919	466

The figures are rounded in VND billion
The table does not include data from certain provinces
Debt includes commercial bank debt, external FDI related debt and inter-enterprises debt.
Source: Ministry of Finance, Government of Vietnam.

Whereas official definition of profitable one is the enterprise that not only reported profits in each of the last three years, but also paid to its workers at least the average salary of the sector, paid it debts, taxes and social and health contribution in full and avoided arrears, and made appropriate provision for depreciation. Unprofitable SOEs are those who did not meet these criteria and whose accumulated losses and bad assets amounted to more than 75 percent of the state capital in the enterprises. These criteria, however, are not sufficient because they do not capture the cost of capital and stipulate a minimum return on invested capital.

Table 12. **Summary of Financial condition of SOEs, 1997**

	Largest 100/1	Largest 200/1	Largest 1,044	Total
In billions of dong				
1.Asset,capital and turnover				
Total state capital	40,492	44,332	50,130	73,075
(Average)	405	222	49	13
Total fixed assets(FA)	62,548	67,354	78,194	
(Average)	625	337	76	
Total turnover(TR)	56,523	77,644	116,363	267,523
(Average)	571	392	115	49
Total taxes and contributions to the budget	14,094	15,651	18,409	23,919
(Average)	141	78	18	4
2.Debt				
Total debt	29,369	40,237	64,511	101,439
(Average)	294	201	62	19
Total bank loans	13,544	18,286	30,573	
(Average)	167	118	38	
3.Profits/loans				
Total profit before tax (EBT)	3,725	4,942	5,658	8,177
(Average)	38	25	7	2
(Number of SOEs with positive profit)	89	180	773	2,196
4.Selected financial indicators				
Debt-asset ratio (DER) 2/	0.47	0.52	0.61	0.58
(Number of SOEs with DER>1/2)	48	111	690	
Gross pretax margin (GMAR=EBT/TR)	6.10%	7.50%	2.50%	3.10%
(Number of SOEs with GMAR>10%)	23	40	73	
Number of SOEs with GMAR<10%)	66	140	700	
Fixed assets turnover ratio (TR/FA)	7.07	7.71	7.72	

1/ Sorted according to the size of the state capital
2/ DER is the total debt divided by total assets (proxied by debt plus equity)
DERs above 1/2 indicate that debts are greater than equity
Sources: Vietnamese authorities and IMF staff calculation

As data suggested, before the repercussion effects of the Asian crisis hit the country, 60 percent of SOEs had been unprofitable with high leverage. Notably, SOEs, on average, had larger debt than equity. The situation of SOEs deteriorated markedly since 1997 for three reasons: (i) a fall in domestic and foreign demand as shown in weakening growth and drop in general prices level (ii) greater imports competition (both formal and informal imports) and (iii) delayed consumption of households due to decreasing

domestic prices. The worsening SOE situation continued to undermine the economy generally and banking system particularly in three ways as follows:

- First, scarce resources like investment, credit and foreign investment were wasted. For example, bank credit was continuously directed to prop up weak and inefficient SOEs rather than using more efficiently elsewhere, especially private and household sector (in 1998, credit to SOEs grew by 22 percent compared with 11 percent for other sector).
- Second, due to low profitability, many SOEs were forced to borrow capital from SOCBs and other SOEs or capital sources, which created a complex maze of cross-subsidization and indebtedness thus making reforms of SOEs and SOCBs even more difficult as the cost of reform increases, both political and economic.
- Third, weak and loss-making SOEs eventually required subsidizing from the budget, which could be effectively used for other purposes such as new investment projects, human resources development and other social goals.

It is likely that an open trade regime, a hard budget constraint, lending decisions made on a commercial basis, and good corporate governance are the best instruments for ensuring efficient and competitive SOEs. The important regime is geared to protecting SOEs and the banks are geared to bailing them out. That must change. Tailor made import protections and preferential treatments of both SOCBs and JSCBs toward SOEs have to go. SOE reform and restructuring coupled with developing a safety net for labor can ease the transition from protection to liberalization and competition. The second round of SOE reform marked with the announcement of restructuring strategy as follows:

- Diversifying ownership through equitization and divestiture of SOEs (outright sale or free transfer of an entire SOE);
- Liquidating SOE that are classified as non-viable;
- Strengthening corporate governance;
- Establishing an adequate and effective social safety net for disposed SOE workers.

The main element of the strategy is *equitization*. In fact, the pace of equalization was very slow due to four reasons. First, the preparation process for equitization though much simplified still remains centralized. Too many parties are responsible for finalizing the valuation and the potential for unrealistic valuation is likely. Second, the level of debt for most SOEs is high and no systematic method of dealing with this has been formalized in current legal frameworks. Third, funds for compensation and training of retrenched workers are not adequate. This increase uncertainty and reluctance of both SOE managers and workers to facilitate the equitization process. Fourth, the government has limited the scope for private sector participation by restricting an individual company's shareholding to only 20 percent of total ownership for minority SOEs. While the intention is to ensure more broad-based diversification of the ownership, it discourages companies, which could have brought additional capital into the enterprises if they got majority control. To further the process, foreign partners need to be involved so as to bring in capital, technical and managerial expertise, and access to foreign markets. They can also raise profitability and employment thus making their shares attractive for others to buy. To this end, it certainly requires a certain degree of financial market opening to attract capital inflows.

Liquidation has made the least way so far. An under-invested social safety net gives rise to the anxiety about the social impacts on worker redundancy. Inappropriate legal frameworks and procedures for liquidation still remain cumbersome, making it more difficult to enforce creditor rights and for the authorities to declare bankruptcies. To move faster in this area, it will be necessary to streamline the legal frameworks for liquidation.

Restructuring large SOEs remaining in State hand: The reform strategy asks for efforts to complete the program of rearranging, restructuring, and reforming managerial mechanism and improving productivity in SOEs within 5 years. The most challenging issue in pursuing that goal is to curtail losses, reduce the accumulation of unserviceable debt and improve competitiveness of SOEs. The SOEs reform agenda in the early 1990s failed to induce large SOEs to behavior in line with the rules of market and restructure themselves with a view to maximizing profits by cutting costs and enhancing efficiency. The current financial condition of the SOEs sector bears testimony to that. Nevertheless, for the ongoing SOE reforms, the government plans to take the following measures:

- Hardening budget constraint by enforcing a ceiling on credit growth for all manufacturing SOEs and a sub-ceiling on a number of highly indebted SOEs as well as by asking banks to lend SOEs money only on commercial-criteria;
- Making SOEs relatively more autonomous and their management more accountable for performance;
- Assessing operational performance through "diagnostic audits" of 100 large and troubled SOEs, and taking follow-up actions to improve competitiveness and profitability;

- Monitoring quarterly performance of another 200 or so large SOEs that are highly indebted or otherwise troubled to prevent further accumulation of non-repayable debts;
- Developing detailed restructuring action plans, on a pilot basis, for 3 big corporations (SeaProdex, VinaTex, Vinacafe covering 140 small and medium SOEs), using international consulting firms then implementing them to improve their competitiveness.

Hardening budget constraint should mean the government must stop giving implicit or explicit subsidies to these firms and directing credit from banks every time SOEs get into trouble. The task is technically simple but politically difficult to do, as evidence in the early 1990s suggested, explicit subsidies from the budget were stopped, but were partly replaced by increased credit from banks. Also, applying tax-rules according to the law is not easy when SOEs experienced difficulties. For example, providing the various new exemptions to the Value Added Tax (VAT) when enterprise claimed problems in paying VAT sends the wrong signal that government's tax regulations do not have to be followed. However, there will be a real tendency to try to substitute one form of hidden subsidy for another. Once inefficient SOEs are blocked from obtaining subsidy through the state budget or banking system, they will seek subsidy in the form of trade protection that could potentially undermine the entire reform efforts. Trade liberalization will provide an additional constraint on inefficient SOEs.

Restructuring enterprises is also a question of setting the right goals for management. Enterprise management is part of governmental bureaucratic bodies and is often required to meet non-economic objectives set by those who appoint and promote them. Profit is

then only one among many other objectives. As long as that practices are still in place, restructuring SOEs is hard to success. To this end, internationally recognized rules of transparency and public accountability should be applicable to large SOEs remaining in state hand. Not only must the government know the actual performance of each enterprise and its financial result each year - which at present the government does not always know due to irregular reporting of financial results - but the market should too. In other East Asian countries, large SOEs keep excellence accounts. Its financial performance is audited annually by independence auditors and publicly informed other participants in the market place. Vietnamese SOEs should be required to perform according to those standards of financial transparency too.

In addition, running a large modern corporation inevitably involves the separation of the firm's ownership from its management. Providing system for, and exercising sound corporate governance is a challenge that all large modern corporations the world over meet. There is a clear consensus that the most successful corporate governance systems are centered on the prudent of commercially based incentives.

In Vietnam, the lack of clear ownership identification of SOEs undermines corporate governance as it leaves the issue of who exactly should be monitoring the management opened. To a certain extent, the identification of a director board overseeing the corporation partially addresses this issue but the difficulty in identifying owners and specifying who will be responsible for SOE liabilities, is typically the constraint of good governance. The mixing of SOE commercial and social functions and the fact that the state is the ultimate owner and regulators of SOEs give rises to unclear governance objectives and conflicts of interests. At the same time, effective corporate governance is

difficult to exercise when the institutions responsible for the management of state assets rarely receive timely, accurate, and useful information about the financial performance of the firms they control.

Relatively few outside monitors, especially banks, exercise strong discipline on Vietnam's wholly state-owned enterprises contributed to weaken corporate governance. The state owned commercial banks are mainly agents of the state, making the owner and creditor, one and the same. SOE mergers (or threat of takeovers) can be effectively disciplining devices against poor management. But to date, most mergers and takeovers of SOEs in Vietnam are engineered by the government and often do not represent commercially driven actions. The bottom line is that without a fundamental reorientation in governance incentives toward modern commercial principles, those wholly state-owned SOEs, will either continue to be ruled (explicitly or implicitly) by the old procedures with the resulting inefficiency and a corporate governance vacuum.

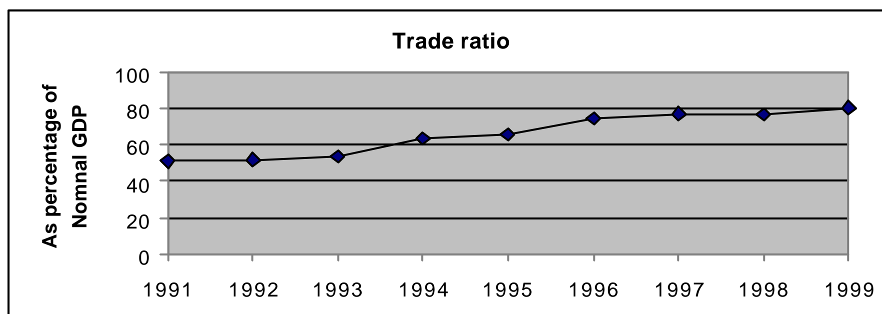
Social safety nets: Liquidation, equitization and the restructuring of SOEs will inevitably entail redundancy. Acceleration in SOE reforms will have to be accompanied by strengthening of the social safety net. To deal with, the government has established an Enterprises Restructuring Assistance Fund to compensate redundant workers. It is estimated that the fund may need about $US 450 million over 5 years to deal with redundancies arising from such restructuring. The actual cost may be higher but matter little since the funding sources come from foreign aids and equitization proceeds (if the government reduces the portion of share held in the equitized enterprises).

2. External sector reform

Before Doi Moi, foreign trade in Vietnam was subject to central decisions by the planning authorities and could be carried out by a small number of state trading monopolies. Domestic prices were isolated from the influence of international prices through a complex system of multi exchange rates and trade subsidies. Exports were discouraged through low procurement prices, while imports were impeded by an extensive system of quotas and licenses. Isolated from the world market, Vietnam relied heavily on its former CMEA partners to obtain basic commodities, while exporters were obliged to fulfil CMEA quotas (arranged through a system of government to government protocols) before they were allowed to export to the convertible currency area.

Changes in trade and foreign exchange policy, along with liberalization of foreign direct investment controls have been key features of the opening up of the Vietnamese economy sine the introduction of Doi Moi. As a result, the trade regime and trade performance has undergone a significant transformation.

***Figure 6*. Increasing openness of Vietnam economy since Doi Moi**



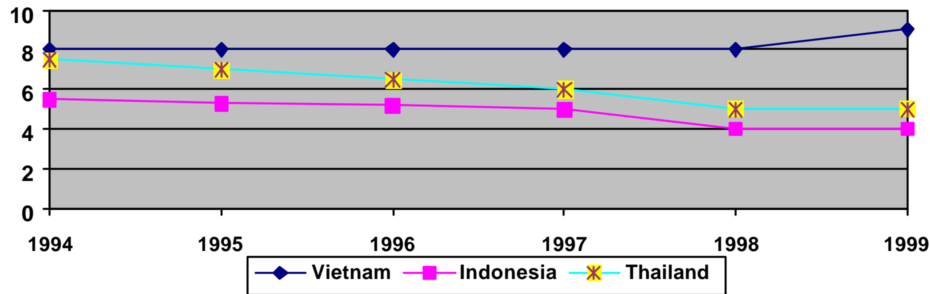
(*Trade ratio is roughly estimated basing on official data provided by GSO*)

As mentioned, the growth pattern somewhat complicates trade regime providing for overprotection on certain ineffective industries though Vietnam is going forward to joint

AFTA and WTO. Despite the changes and the impressive growth in trade, important features of the old regime linger on. An intricate framework of administrative and legislative barriers to trade is still in force. Current account payments have been not free of restriction. Recently, surrender requirements have been imposed on enterprises in receipt of foreign exchange inflows. Imports of key inputs and consumables are sill controlled according to administrative assessments. The import tariff system provides a high level of protection to a wide range of local production and is subject to frequent changes and inconsistent implementation. This characterized by high and dispersed effective rates of protection and uneven incentives. However, non-tariff measures provide most of high protection.

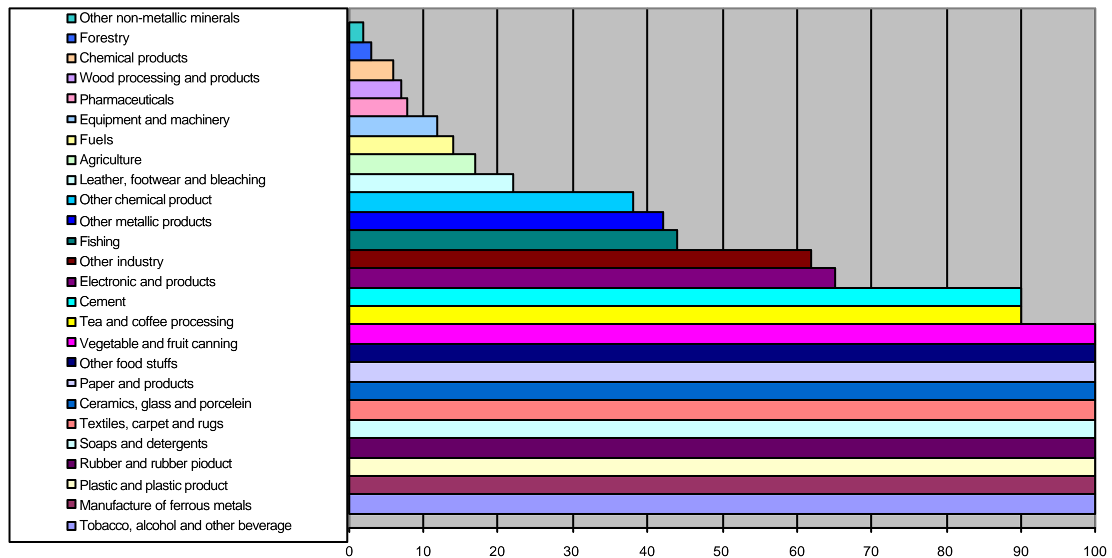
More importantly, trade regime is still manipulated with a view to its effects on other aspects of economic and enterprise management. SOEs are still playing the leading role in the economy and maintaining important sources of resources and influence on decision making process at both central and local authorities. Particularly, SOEs play a disproportionate role in the determination of trade policy facilitated by continuing close links between certain enterprises and policy-making ministries. At the same time, it seems that trade policies are shaped to insist SOE leading role in the absence of full fiscal and financial disciplines as well as restraining competition and maintaining SOEs revenues.

Figure 7. Restrictiveness Rating for selected ASEAN countries, 1995-1999



(*Source*; IMF staff estimates according to the Fund' s index of restrictiveness of trade regime)

Figure 8. Effective protection rate in 1999 (percent)



Note: *The above effective rates of protection exclude the effect of quantitative restrictions. If they were included in these estimates, the effective rates would have been much higher for those products.*
Source: GSO and World Bank estimates.

Accelerating integration with the world economy is now more critical than ever. A more open trade regime will benefit the economy for three reasons. First, putting the bilateral trade agreement (signed in 2000 July with the United States) forward, Vietnam has access to the large US market and export revenues increase remarkably.

Although the government stated that for an efficient industrial sector to develop, protection must be selective, conditional, and temporary, Vietnam's trade system still remains one of the most highly complex, restrictive and interventionist, with considerable cost to the economy. For example, even with domestic prices at about three times the duty free price, all motor vehicles manufactures are losing money.

Second, the current high protection of capital-intensive goods and nontransparent importing procedure discourage exports of light manufactures and processed agriculture, the relatively more efficient sub-sectors of the country. The resulting diversion of investment to capital-intensive sector undermines the country's capacity to boost exports growth and employment creation. Third, all firms, especially small and medium ones need easier access imports to ensure that scarce imports go to the most efficient uses.

The non-transparency of Vietnam import regime implies higher transaction costs of importing and thus exporting than in other countries. So long as Vietnam had extreme labor costs advantages, higher transaction costs mattered less; but now, with less labor costs advantages, these transaction costs will be bigger impediment to exporting than before. Import restrictions, however, are applied on a discretionary and ad hoc basis increasing business uncertainty. For instance, the authorities were increasingly using foreign exchange controls as an instrument of import restriction. High and uncertain import protection keeps state enterprises afloat at the expenses of diminishing exports of processed agriculture and light manufactures.

High protection of capital-intensive industries makes larger profit for producers of those goods. Foreign invested enterprises and SOEs invest more in these sub-sectors. Scarce foreign exchange is allocated to them as priority sectors but they divert funds from

potential export sectors. As long as investment, including foreign investment and export growth rates were high, the cost of such inefficiency could be tolerated. Now, with sharp declines in available savings for investment, the cost is much higher. As a result, investment has been channeled to sectors that are made highly profitable even though Vietnam is not competitive.

Recent legislation has lowered the maximum tariff rate to 50 percent. However, quantitative restrictions still cover around a third of import items and the maximum import tariff of 50 percent is high given that under AFTA, tariffs on 95 percent of tariff lines for Asian countries have to reduce to 20 percent in 2003 and drop further to 5 percent by 2006; and under the USBTA there will be cuts in protection on imports of around 30 to 50 percent on the current tariff rates covering both industrial and agricultural products. These are real challenges for trade reform in the years ahead. There should be three priorities for the trade reform. First, non-tariff measures should be phased out and replaced with tariffs, which do not exceed the current maximum rate. If combined with a significant devaluation, the immediate fall in the domestic prices of imports and thus in import-protection can be dampened. Second, tariff-levels and the number of tariff rates should be reduced. Third, all export taxes and restrictions, except for those imposed for environment reasons, should be phased out at a quick pace, given the need to boost exports.

Given the direction of trade reform, there are at least two ways to minimize the cost of these changes. First, greater efforts must be made to ensure that new investments do not go into incompetitive sectors otherwise newly invested capital will be rendered ineffectiveness soon after these sectors are opened. This can be done by announcing and

publishing an annual road map of changes in quantitative restrictions, tariffs and FDI regulations making it possible for producers and investors to prepare for the changes. Second, even if the medium to long-term effects of planned integration efforts are likely to be favored on economic growth, there will be transitional losses in employment thus the government should already prepare to address it now. However, it is not sufficient. Liberalization of trade must be implemented by reform of the regulatory and institutional framework in order to reduce costs and raise the benefit of the process.

Regarding foreign exchange regime, in early 1990s, following the unification of exchange rates, exchange rate management has been characterized by periodic adjustments to the band within which the official exchange rate was allowed to move. In 1999, there was a shift in exchange rate regime. The rate was quoted daily in the inter-bank market, calculating as the weighted average of rates in the market previous day. However, the Dong's value was not allowed to depreciate more than 0.1 percent compared to the previous day. Official intervention policy in the exchange market aims at maintaining export competitiveness, managing imports, and smoothing out short-term exchange rate fluctuations. In practice, this policy has contributed to the stability of the Dong against the US Dollar. The State Bank of Vietnam has intervened at times when there was uncertainty in the market and when it considered that the supply of and demand for foreign exchange did not reflect underlying market factors. However, the system is still considered restrictive in some ways. First, although the tax rate on profit remittances was reduced but still applied to the repatriation or remittance of profits by foreign enterprises (and not on profit itself). This continued to give rise to multiple exchange rate practice and further exchange restriction. Second, the recent requirement that all

enterprises surrender 50 percent of their foreign currency balances to domestic banks account is undermining perception of and incentives for investment in Vietnam. Investors and exporters already operating in Vietnam, are seeking to evade the surrender regulation by bring less of their foreign exchange receipt into the country. This raises the transactions cost of exporting and reduces the foreign currency balances held by enterprises in Vietnam and has the perverse effects on lowering inflows of foreign exchange. The retention of controls on foreign exchange access seems to reflect the absence of stronger and more direct disciplines on SOEs and of more commercially oriented decision making in the financial sector. The SBV introduced onerous deposit requirements on letters of credit after a number of SOEs defaulted on long term letter of credit where proceeds were reportedly used to finance speculative investments. This suggests that financial and budgetary disciplines on SOEs are still week. Finally, there are other administrative measures and controls that limit the foreign exchange available for imports of certain goods, depending on the foreign exchange situation. For example, importers of consumption goods are required to supply their own foreign exchange for imports and are only allowed to use a immediate payment method. In addition, non-priority goods have been constrained by the availability of foreign exchange at the commercial banks, which somewhat contributed to the low level of imports in the past three years.

The recent relaxation of exchange rate controls are positive. However, reform of the exchange rate arrangements is needed to boost investors' confidence and attract foreign direct investment. All foreign exchange restrictions on current account transaction should be removed to bring the system in line with the article VIII under the IMF agreements.

The band for the movements in the inter-bank market should be widened to allow the rate to better reflect demand and supply conditions in the market. Whenever exchange rate starts to move, it not only reduces the likelihood of external imbalance but also induces market participants to manage foreign exchange risk prudently as recent experiences in the region suggested.

CHAPTER IV. IMPLICATIONS FOR FURTHER FINANCIAL SECTOR'S REFORM AND CONCLUSION

Only after pain will come wisdom. The recent crisis and restructuring has lent urgency and lessons to Vietnam's efforts to tackle systematic weaknesses. It has highlighted the risk of supervisory and regulatory inadequacy, perverse incentives imposed on the productive sector, and weak corporate governance. The fragility of major conglomerates in neighboring economies has raised questions about the wisdom of promoting a similar path for so-called big state-owned enterprises in Vietnam. And prospective accession to AFTA, USBTA and WTO has highlighted the need to ready Vietnamese firms and banks to compete with their foreign counterparts and to make Vietnam regulations and legal systems more compatible with international norms.

Despite decisive measures recently taken by the authorities to strengthen banking system, Vietnamese banks are still weak. Banking skills are weaker than that in the region. Existing financial regulations and supervision remain inadequate. In addition, banks' client, notably many SOEs serving the domestic market are not doing well. Several large SOEs have focused on investment and size rather than profitability and efficiency

incurring a large stock of nonperforming loans. Small and medium-size firms, which have been the most dynamic part of the corporate sector, are having trouble with transforming into efficient enterprises. On average, SOEs have greater debt than equity and the profitability of SOEs is in question when taking into account the cost of capital and interest rates are allowed to adjust to risk premium perceived in the market. In addition, corporate governance and management are poor. Incentives are changing but inappropriate, and are subject to revision. Reducing trade barriers further diminishes SOEs' profitability, which weakens their capacity to service the existing debts thus giving rise to the vulnerability of the banking sector. Political concerns about the leading role of SOEs and maintaining controls of the economy have slowed down not only the pace of reforming financial sector but also the processes of corporatizing SOEs and selling a large portion of stocks held by the State in equitized firms as well. If the former unnecessarily increases the costs of restructuring banks, induces distorted incentives in banking then the latter hampers the efforts to develop capital markets providing an additional channel of funding and hardening market discipline on those who are not willing and unable to adapt to the changing situation.

I. Recent economic recovery and development

Despite strong performances of exports had led the economy recovery, the recovery was fragile in two important aspects. First, the induced pickup in economic growth came from demand stimulus through expansionary fiscal and monetary policy. Last year, civil service wage increased by 25 percent, and the budget deficit now stood at 2.4 percent while the costs of banking and SOE reform could be nearly 12 percent of GDP [30].

[30] Pre-estimates of the Ministry of Finance and The State Bank of Vietnam

If most of the capital costs are financed by swapping SOEs' debt to equity and exchanging government bonds for bank bad debts as what have been done in the crisis countries, the burden on the budget will be mainly the interest cost of the bonds and the cash cost of payment for redundant SOE workers. The budget, however, is coming under strain because trade liberalization and SOE restructuring weaken revenues base. In 1999, credit expanded by 20 percent and in the year 2000 estimated by more than 30 percent, which had increased the risk of inflation. Second, total investment share of GDP has not risen to the levels reached in 1997. There is some recovery in domestic investment but not in foreign investment inflows. In short, the recovery would have negative impacts on the banking sector due to rapid credit expansion given their inadequacy in credit-risk assessment process and the already fragile health of SOEs.

External balance: The balance of payment position remains problematic despite rapid export expansion. Nevertheless, the current account deficit has declined significantly from 12.8 percent of GDP in 1995 to 4 percent in 1998. The strict import controls, which instituted in 1997, reinforced in 1998 coupled with weakening domestic demand contributed to a current account surplus in 1999. In the year 2000, the current account balance is likely deteriorated to the 1998 level[31]. The current account deficit financing matters because FDI have not rebounded yet and the pace of disbursement of ODA has somewhat slowed down. Effective implementation of the proposed reforms and the additional faster disbursement of ODA accompanied such reforms would maintain external balance when trade barriers have to reduce in the accession and implementation of AFTA and USBTA.

[31] Pre-estimates of the Ministry of Finance and The State Bank of Vietnam

Vietnam's external debt and debt services burden is sustainable and is expected to remain so. The total convertible debt stock is at $ 10.6 billion by the end of 1999 (or 37 percent of GDP), about 70 percent of which is public or publicly guaranteed. Slightly over half of the debt is consessional and most related to FDI. However, both the debt stock and flow was rising because of increases in consessional loans and an additional $US 1.7 billion rescheduled non-convertible debt owed to Russia last years. The debt services were about 11 percent of export revenues suggesting that it still remained at manageable and sustainable level.

Regarding the real effective exchange rate, since July 1997, it relatively appreciated by 8 percent against Asian competing partner's currencies (excludes Japanese Yen) largely due to a sharp nominal exchange rate depreciation of these currencies following the onset of the Asian crisis and by 4 percent against main European partners[32]. It is difficult to judge Vietnam's competitiveness because there are still administered prices (such as petroleum, energy etc.,), ceiling on bank lending rates, and subsidized productions (as with loss-making SOEs). In addition, the presence of significant trade and exchange restrictions make it hard to determine an equilibrium exchange rate to serve as a benchmark for comparison. Also, the real effective foreign exchange rate's equilibrium can change over time due to structural changes in both the home and directly competing countries. The task of designing an appropriate foreign exchange rate regime for a small-open economy in the more dynamic and integrated world is far beyond the framework of this thesis.

[32] IMF country report No. 00/116, Vietnam statistical appendix, August 200, page 44

Entering the 21st century, Vietnam aims at ambitious goals of repeating the superb performance of rapid growth in the 1990s, doubled real GDP over the next decade and increasingly liberalize the economy thus accelerating the economy's integration into the region and the world economy as well. In doing so, the investment rate should be about 30 percent of GDP, roughly estimated under a normal course of increasing total factor productivity (saying 2 percent per year)[33]. Obviously, the financial systems play such a critical role as experiences of East Asian economies during the period of high economic growth suggested. These goals can certainly be achieved if needed reforms in economy-wide policies especially financial and SOEs sector reform are implemented quickly. It is clear that domestic savings (official estimated at about 18 percent of GDP[34]) are insufficient to finance investment requirements to achieve such a high economic growth. Vietnam should use effectively every dollar of savings for the most productive project and no less important, to attract a portion of global capital flows to fill the investment-savings gap. The job seems to be simple but without sound macroeconomic policies, robust financial systems and favorable business environment underpinned by appropriate legal frameworks and institutions, it is unlikely. A throughout renovation of the policy regime would be required. The renovation surely include measures to simplify and liberalize the trade regime, reform SOEs, promote private enterprises, strengthen financial systems and increase transparency at all levels of the economy. The on-going reforms programs are supposed to carry forward as follows:

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[33] World Bank in Vietnam estimates

[34] Ministry of Planning and Investment, *draft of development strategy 2000-2010*, reported to the National Assembly, Hanoi , October 2000, pages 2-10.

Trade liberalization: The trade reform program will comprise mainly of implementation of agreements under AFTA and the various bilateral trade agreements, especially the US-Vietnam bilateral trade agreement signed last year. The schedule for AFTA, includes actions, such as:

- Quantitative import restrictions on imports of six key groups of products will be lifted by early 2003 (i.e. cement, steel, glass, paper, vegetable oil and ceramic goods);
- Tariffs on the majority of tariff lines will be reduced to 20 percent or less by early 2003.

State Owned Enterprise Reform: The SOE reform program has set specific measures for a number of small, medium and large SOEs, and a set of general measures for all SOEs, both aimed at improving competitiveness and profitability of enterprises. Key features of the reform program are as follows:

- Five year agenda reforms will cover nearly a half of all SOEs through equitization, divestiture, corporatization, mergers and liquidation. In the first three years, these enterprise-specific measures will cover 1800 SOEs, with 700 being completed in the first years;
- All SOEs, including big corporations, will be held to higher standards of accountability for performance and of transparency of information on performance (e.g. regular auditing of financial statements and better management information system in the Ministry of Finance);
- Management of big corporations will be permitted to experiment with alternative corporate governance systems in order to improve their competitiveness and

profitability. This will include "pilot" restructuring of three big corporations (Vinatex, Vinacafe and Seaprodex), and applying lessons of such restructuring to others);

- All SOEs, except non-business enterprises, will be subjected to a *hard budget constraint* in the sense that they will be expected to repay bank loans on time and receive bank loans on the strength of the commercial viability of their projects;
- The process of equitization is to be improved by removing cap on shareholding of equitized SOEs and advertising equitization and divestitures in the media at least 30 days in advance.

In fact, one critical issue that is not explicitly answered in the SOE reform relates to the criteria for eligibility of SOEs for access to such debt reduction and restructuring. SOEs to be liquidated, equitized, and divested are eligible, but it is not clear under what conditions SOEs that remain in government hands will be eligible for debt-relief. An SOE will be qualified for such debt-relief only (i) if it has a restructuring plan approved by the authorities; (ii) it does not remain delinquent in payment of overdue interest; and, (iii) its products are subjected to rising external competition.

Banking Reform: The banking reform plan comprises four parts: improving the legal, regulatory and supervisory framework; leveling the "playing-field" for all banks; and restructuring JSCBs and SOCBs. The key features of banking reform program include:

- Performance in respect of bank-specific reform measures and operational targets will be assessed each year by an independent, reputed auditing firms on international accounting and auditing standards;

- Banks will move towards the adoption of international accounting standards, particularly loan-classification and loan loss provisioning standards in the first half of 2001;
- Policy loans will be minimized, and clearly separated from commercial lending. If there are such loans in the transition arrangements, they will be funded by the budget;
- Re-capitalization of these banks will be phased over the next three years and each year's funding of re-capitalization will be linked to the banks' meeting pre-specified performance conditions and operational targets.

II. Changing environment

In July 2000, the State Bank of Vietnam introduced a basic interest rate of 0.7 percent per month for domestic currency lending with maximum trading band of 0.5 and 0.7 for short term and long-term loan respectively. Regarding foreign currency, three months Singaporean inter-bank offering rate (SIBOR) served as the base rate and the maximum trading band was 1 percent per year for short-term loans and six month SIBOR for medium and long-term loans with the band of 2.5 percent per year. As a result, credit institutions were entitled to decide the interest rates for loans and mobilized funds at various levels. Nevertheless, the new regulation still limits the offering of high-risk loans since it sets a ceiling on the highest interest rates that banks can demand from their borrowers.

In addition, the stock market opening in July 2000 was much encouraging. Though there has been only 5 companies listed in the stock exchange but government bonds were traded somewhat complementarily. Despite the price movement cap (5 percent per

trading day), at the end of Feb. 2001 the Vietnam Stock Exchange Composite Index increased to 236 from the initial level of 100. However, the cap and other administrative regulations would have discouraged banks and firms to raise funds through initial public offerings. Even though the cap for equity share held by foreign investors was comparable to that in other countries in the region (saying 30-40 percent) but investors still encountered excessive regulations including restrictions on foreign exchange.

The State Bank also introduced open market operations thus setting an essential foundation for modern macroeconomic management of Vietnam growing market economy. The lack of both short term and long-term financial instruments has substantially limited the central bank's ability to effectively manage banks' reserves and liquidity in the market. Recently, new regulations have granted the State Bank and other credit institutions to issue debt instruments with various maturity for widening and deepening the market.

The recent developments, however, have been more form rather than function but they are essential to pave the way to liberalize domestic banking system in parallel with the development of debt and capital market. The changing environment has posed greater challenges to the banking system, particularly both the supervisors and the supervised when interest and foreign exchange rates begin to move and when banks start to step in new risky business lines saying securities and securitization. The new environment also induces fundamental changes in cultures of business, banking, corporate governance and risk management.

The changing environment will eventually lead to more liberalization of financial system in both domestic and external dimension given the need to attract foreign capital to fill

the saving-investment gap to foster economic growth. Recent experiences told that getting financial liberalization right is indeed crucial. If it is done poorly it will be surely going to promote a backlash against not only financial reform itself, but all kinds of reform. In addition, the transition from relatively closed economy with rudimentary, repressed financial system towards a market-based open financially economy makes the job extremely difficult especially at a time when the country confronted a shortage of scarce resources needed to underpin the smooth path toward targeted goals.

1. Interest rate liberalization

The change alters dramatically the environment affecting financial market participants and intermediaries alike, preventing new opportunities and risks. The liberalization affects both the level and the dynamics of interest rates. These changes have far reaching consequences running through the economy and operating in three widely differing dimensions: i) the distribution of quasi rent and the degree of credit rationing; ii) the volatility of assets prices and market expectation; and iii) the incentives for risk management and risk taking and for governance of financial intermediaries as follows:

First, when the price of any good is controlled at below market-clearing level, some potential purchasers will be rationed while other will benefit from the quasi-rent established by the controls. The removal of interest rate controls may allow interest rate to rise to free market equilibrium levels, thereby reducing the degree of credit rationing and the associated quasi-rents as well as the distribution of credit. Translated, some borrowers previously crowded out of the market altogether may have a better chance to secure funds and those who would have secured finance under the former regime lose from the higher price they now have to pay. The impact effect of the loss of quasi-rent for

marginal borrowers especially heavily indebted SOEs is to push them into insolvency. Higher interest rates coupled with uncertainty about real sector reforms may increase adverse selection thus worsening credit rationing. To deal with, more transparency in financial statements of both banks and firms and the schedule of reforming SOEs are needed and better public disclosures would help to discourage continued financing of nonviable banks and firms. Eliminating practices such as the widespread use of cross guarantees would have made it easier to identify borrower' s risk appropriately. Wider use of consolidated financial statements would have helped also.

Second, liberalization of interest rates will increase the interest rate volatility. The liberalization process often added to macroeconomic instability as aggregate credit expanded when financial institution sought to gain market share. Consequential overheating had to be damped down by monetary and or resulted in inflation and nominal depreciation, which also fed back onto nominal interest rates. Another destabilizing impact was through the government deficits financing, hit by the higher interest rates, often either monetarized leading to an inflationary surge, or refinanced at ever higher interest rates in an sustainable spiral crowding out the private borrowers and thereby feeding back onto economic growth and stability. Even abstracting from a transitory inflation and activity cycle triggered by liberalization itself, the new liberalized environment has been associated with higher asset price and macroeconomic volatility on an sustained basic. After all, assets price valuation formulas conventionally discount future streams by discount factors, which are closely related to markets clearing interest rate. Interest rates liberalization can alter these capitalization factors, thereby significantly affecting asset price levels and volatility, which underline the wisdom of understanding' s

bank balance sheets and risk management systems. The so-called balance sheet channel may transmit such volatility to asset price boom and bust cycle thereby destabilizing the banking and financial system.

Because of lacking derivatives market and sophisticated investment institutions in the early stage of development, hedging against interest rates and market risks is not desirable at least in the short run. In dealing with this particular problem, portfolio and speed limits on growth of bank assets need to be considered on the ground that rapid loans growth or assets price inflation has often been associated with individual as well as systematic bank failures. Such limits should aim to ensure risk diversification and reasonably sustainable growth. Growth and portfolio limits should be employed to ease transition to the new, liberalized regime and to pick incipient speculative bubble. As with financial restraints, these should be temporary solutions until banks adopt themselves appropriately to the more liberalized environment.

Third, financial liberalization has the potential to lower bank profitability by increasing competitive pressures though repressed financial systems has been regimes of low bank profitability. Increased competition can yield straightforward efficiency gains and innovation in term of improving service quality. The benefits are not negligible. But the new freedoms often lead to a scramble to retain or gain market share, with banks seeking new business at narrow margins and in unfamiliar territory whose risks they often underestimate. Indeed, the increased macro-volatility that often accompanied liberalization implies new risks even for well-established lines of business. In an environment of strong competition and liberalized interest rates, there may be a tendency for banks to bid up rates to the point where prudent lending practices are no longer

profitable. With a reduced franchise value, banks in particular have little room for errors and may succumb to the perils of excessive risk-taking. As well as having new competitors, financial intermediaries begin to be allowed new scope for their activities. This may induce an increasing trend toward universal banking. In fact, commercial banks were allowed to purchase stocks up to 30 percent of their own capital and disclosed reserves.

This type of competition can increase the likelihood of bank failures, endangering the well being of the financial system through contagion effects. It is also much easier to monitor a small group of large banks than a myriad of tiny institutions. However, there should be enough large institutions for cartelized behavior to be unlikely so it is necessary to set minimum capitalization requirements at higher levels to ensure a minimum size for all banks. Certainly, the economy does not benefit from being over-banked with a plethora of small banks cluttering up the financial playing field. The number of JSCBs should be reduced through merger or acquisition thus giving a room for the healthy to develop. Equally, SOCBs need to be privatized partially or fully to make the banking industry structure somewhat balance to ensure fair competition. In this regard, the monetary authority will probably wish to discourage the close competition of the different categories of financial companies, commercial banks and other financial intermediaries. Restricting competition between different categories of intermediaries makes it both easier to monitor each categories and stops unequal competition between intermediaries with different regulatory status. Also, it will be easier to control the creation of credit by sectors if classes of institution are highly separable and liquidity does not flow between them rapidly. Given inadequate institutional capacity, a narrow

banking approach is a good idea. Commercial banks should not be allowed to include stocks issued by other economic entities in their portfolio. Such a holding should be transferred to an independent affiliate to set a clear firewall between commercial and investment banking. In doing so, the recent regulation allowing banks to purchase stocks should be abolished.

2. Liberalizing constraints on domestic banking

Government controls on the financial system have been exercised through ownership of the major institutions. Worldwide experience suggested that, only the central bank among financial intermediaries is generally considered a natural candidate for state-ownership. Although there are examples of sate-owned banks that perform in a dependent, profit seeking manner, state-ownership is seen by advocates of financial liberalization to have entailed confusion goals, deterioration of credit assessment and credit control functions, higher operating costs and often under pressure of shareholder lending instructions. By separating public policy function from the financial function and leaving the former in the hand of government departments and administrative agencies, privatization of SOCBs are seen as part and parcel of financial liberalization. Only autonomous financial intermediaries can be expected to function well in the liberalized environment. At the same time, the underlying incompatibility between credit programs and profit seeking autonomous financial intermediaries operating in an otherwise liberalized market became quickly evident and resulted in the subsequent dismantling of these programs, although sometimes the implicit subsidy involved has been made up by an explicit budgetary grant. This process has not always been a smooth one, and the persistence of some regulations while others had been moved has led to severe side effects in many cases. In parallel with

privatization of SOCBs and restructuring of JSCBs, the appropriate measures should be taken to gradually remove biases against foreign banks then allow foreign banks to play full roles to further the stability and efficiency of domestic banking sector.

3. Liberalizing capital account

There is a fundamental need for an integrated liberalization of capital account to financial sector reform. The reasons for adopting a coordinated and comprehensive approach to financial sector reforms and capital account liberalization are as follows:

First, from a macroeconomics and balance of payment perspective, the state of development and the stability of domestic financial systems have key influences on the growth and composition of capital movements. Such factors are more important in explaining the volume and nature of the capital flows than the particularly framework for such movements. Countries with developed financial market and institutions have been better able to attract portfolio capital flows than countries where such markets are just emerging. Financial sector weakness may also contribute to currency crises to the extent the weaknesses are seen as limiting the scope for or the willingness of authorities to use interest rates to defend the currency, or cast doubts on the prospects of the economy more generally.

Second, the opening of the capital account can have more important implications for financial markets and institutions. The liberalization helps to develop deeper, more competitive and more diversified financial markets. The sophistication of domestic financial markets can also be improved if foreign financial firms are allowed to operate directly in the country. This also may create pressures on previously protected domestic financial institutions to increase their efficiency. This in turn may depend on the

existence of a well-regulated and supervised financial system and the elimination of various sources of market failures that may be the legacy of previous financial repression. Consequently, there is a need for sequencing the liberalization of capital account transactions consistent with the reforms of domestic financial markets and institutions.

Third, successful and sustained opening capital account requires the existence of a minimum set of instruments, institutions and markets for effective management of monetary and exchange rate policy with an open capital account. High capital mobility alters the effectiveness of different monetary instruments in achieving the objectives of monetary policy. With an open capital account, monetary instruments which operate on the overall cost of money or credit in financial markets may be transmitted more rapidly to credit and exchange markets and allow the central bank to influence the decisions of financial institutions and markets that operate in its domestic currency, both locally and internationally. Indirect monetary instruments such as open market transactions come to play a core role for the purpose of steering interest rates, managing liquidity situation in the market and signaling stance of monetary policy.

Fourth, as a practical manner, controls on capital movements are often exercised through regulations on the underlying capital transactions rather than the associated payments and receipts. A number of capital controls are in the form of financial regulatory measures, including reserve requirements, which discriminate between residents and nonresidents, or may be the consequence of the particular regulatory frameworks for financial market and financial institutions. An analysis of the regulatory factors influencing capital movements requires a more complete understanding the overall financial regulatory framework and the extent to which limitations on capital movements are an incidental

consequence of the need to protect investors and exercise prudential oversight over financial macro –economic and balance of payments reason.

Finally, financial sector reforms often involve a rapid monetarization of the economy and a period during which the growth of credit exceeds that of money as agents adjust to the elimination of financial repression. Capital account liberalization is often associated with initial surpluses in the capital account balance of the balance of payments reflecting the improved investment environment. If confronted separately, each of these factors can create problems for monetary and macroeconomic management. However, if confronted together, the adjustment in the monetary and external sector can be offsetting to some extent. Thus, the more rapid growth of credit than money following domestic financial sector liberalization would, ceteris paribus, tend to place pressure on the balance of payments. This pressure may be offset through capital inflows that may accompany the liberalization of capital account.

On sequencing of capital account liberalization, recent crisis has suggested:

• Direct foreign investment sometime raises concerns about foreign ownership and control but such investment can bring considerable benefits, including technology transfers and more efficient business practices. Because FDI flows are less prone to sudden reversals in a panic than bank loans and debt financing, they do not generate the same acute problems of financial crises as do sharp reversals of debt flows. Thus, liberalizing inward FDI should generally be an attractive component of a broader program of liberalization. More specifically, FDI liberalization is often a significant part of real sector reforms, while the liberalization of portfolio investment is often coordinated with financial sector reforms and the development of financial markets and instruments.

It must go hand in hand with reforms aimed at strengthening real sector and export potential of the economy including reforms of trade and investment regime, liberalization of controls on current international financial transactions and maintaining competitive exchange rate. Such liberalization should have aimed at supporting the development and restructuring of selective industry and sectors though management and technology transfer, injection of foreign capita and liberalization access to trade finance.

• It is usually a mistake to liberalize the domestic banking system or to open it fully to inflows if important parts of the system are insolvent or likely to be pushed into insolvency by liberalization. Where financial systems are weak, the preferred policy would be to address the institutional weakness in advance of or concurrent with the liberalization of the capital account. The country needs to rely on temporarily on selective capital controls as part of their financial regulatory frameworks where institutional capacity to implement prudential regulation in accordance with internationa l best practice is still developing. However, too much reliance cannot be placed on capital controls in protecting particular institutions and markets. As a general rule, nonviable institutions should be weeded out and remaining banks put on a sound footing before liberalizing or opening the domestic banking system.

• Capital inflows are already a reality only highlights the danger of removing most restrictions on capital account transactions too quickly, before major problems in the domestic financial system have been addressed. Inadequate accounting, auditing and disclosure practices weaken market discipline; implicit or explicit government guarantees encourage excessive, unsustainable capital inflows; and inadequate prudential

supervision and regulation of domestic financial institutions and markets can breed corruption, connected lending and gambling for redemption.

• Creating the domestic infrastructure for portfolio investments in equity and debt instrument is necessary before these markets can be opened internationally. Liberalization of portfolio investment has tended to be coordinated with reforms of domestic financial sector, liberalization of interest rates, development of indirect monetary control procedures and strengthening banks and capital markets. What is generally important for managing the volume of capital flows is the overall incentive structure that can give rise to such flows. This incentive structure will be influenced by a number of factors including the particular regulatory frameworks, the stage of development and soundness of the financial systems. However, what is also crucial is the configuration of interest rates and exchange rates. The long run impact of controls on capital flows will depend on whether the regulations increase or reduce risk premium. This leads to the seemingly perverse conclusion that a country restricting capital flows would have to maintain higher interest rates to compensate for the increased risks. Therefore, one of the major considerations in capital account liberalization is the management if the inflows that are likely to follow such liberalization in view of the decline in investor risk premium. Obviously, the economy benefits from the development of domestic financial markets that allow financial flows to be less heavily dependent on the banking system.

Regarding the liberalization of capital outflows, the main concern arises when the restrictions to be removed are supporting either a significant macroeconomic imbalance or a distorted financial system. If an overvalued exchange rate has been maintained with

the help of restrictions on capital outflows, then the authorities must be prepared to adjust the exchange rate when the restrictions are removed. Similarly, if policies have kept interest rates for savers artificially low, market participants must be prepared for a rise in rates. To avoid such costly accidents, it is necessary to liberalize outflows after macroeconomic imbalances and financial distortions have been reduced to manageable proportions.

The consequences of the above analyses are that capital account liberalization should be integrated with the design of structural and macroeconomic policies. Maximizing the benefits from capital account liberalization while minimizing the risks requires a comprehensive approach to reforms. A comprehensive approach will generally involve the coordination of the liberalization of portfolio capital flows with domestic financial sector liberalization and reforms, liberalization of interest rates, development of indirect monetary control procedures, and strengthening banks and capital markets including through improved regulations. Lack of coordination between domestic financial sector and the capital account reforms can create distortions and regulatory incentives for capital movements that are unrelated to the underlying economic conditions, thus risking greater instability in capital movements. At the same time, there would be good reasons to coordinate liberalization of foreign direct investment, with reforms aimed at strengthening the real sector and export potential of the economy, including reforms of the trade and investment regimes, exchange rate adjustments to improve competitiveness, and liberalization of exchange controls on current international transactions.

4. Other issues

Interest rate policy Counter-cyclical interest rate policy should be pursued so that the economy does not experience broad swings in the business climate. This is not to suggest a fine turning mechanism but rather a recognition that changes in interest rates should be determined by conditions in the market. If the market were highly liquid, it would be expected that interest rates would increase to soak up the excess. The focus on managing the interest rate would revoke around keeping the interest rate positive in real term.

Beyond the period of adjustment, a further gain to managed regime is that in retaining control of the interest rate, albeit in a much more dynamic and active manner, the authority can guard against adverse developments in interest rate structure caused by either excessive competition or excessive concentration. Excessive competition among banks, in a purely liberalized regime, can result in competitive institutions bidding for deposits when the market is short of liquidity. If loan rates are pushed up unduly in a scramble for liquidity, the precariousness of the financial system will be increased. If deposit rates are free in a fragile, but competitive banking environment, problems arose from the competition for funds can be large. However, if the banking market is over-concentrated with market power in the hand of few banks, the scope for cartelized pricing of interest rates may allow banking spreads to grow too large. Managing both deposit and loan interest rates in tandem would allow the government to ensure spreads remained at prudent levels, and that the profitability of the banking sector is not at the expense of a beleaguered productive sector.

These effects are one part of the wider changes in capital values that occur when structural reforms, including adjustment of real exchange rate and internal relative prices

taken place. But the high leverage of financial intermediaries makes them unusually susceptible to un-hedged interest rate changes. Higher lending rates may exacerbate adverse selection with a financial disruptive implication. The initial disruption to financial and real activities from a relatively sharp rise in the interest rates following liberalization was a costly feature of liberalization, which might have been avoided if the transition could have been arranged at a time when the controlled interest rates were not too far away from market-clearing levels.

Monetary policy Price stability is essential goal to ensure competitiveness and business confidence, reduce uncertainty and maintain positive interest rates. Also essential are the government's development goals for social progress and the enrichment of the country. The trick is created to support the development process. If price stability is not maintained, cost-push effects occurring through wage indexation mechanisms will be likely to take over and erode any growth in national income. It is likely that if domestic policies accelerate inflation then the IMF will enter the policy making process and most developing countries dislike such outside interference in domestic economic affairs. However, if the development policy is decimated in a quest for the golden chalice of stable prices, growth will grind to a halt and the fall in investment spending will lead to a cumulative fall in development ability. The policy maker is, then, in search of the optimal policy trade off.

It would seem that the basic requirements for price stability in a developing country is fiscal responsibility. The use of inflation as a mean of financing budget deficits in the past has been the main cause of monetary dis-equilibrium in developing countries. It is, therefore, unlikely that the statutory discontinuing of large government deficit will be in

the best interest of the economy. The large increases in aggregate demand emanating from such a policy will almost always be reflected in accelerating price levels. Policy makers must realize that it was such fiscal excess, requiring monetary incontinence, which initiated the purges of the liberalizes in the first place.

A policy structure would start with the recognition that the monetary authority should not target any specific monetary aggregates. Such guarantees tend to be very elusive and the key nexus is not on the banks' liability side. Rather, it is on the banks' assets or credit side. Thus, the focus of government's monetary targeting should be ensuring only the gradual expansion of credit. By targeting credit, the central bank can seek to reduce, or encourage, investment expenditure when it deems most prudent. A central proposal for such credit targeting would then be to switch reserves ratios from liability to the asset side. Thus, instead of being forced to hold reserves against depositors, banks would then be forced to hold reserve against loans. In pushing up such reserves requirements, the central bank could effectively alter (reduce) the flow of credit. Thus, the central bank will be able to manipulate credit more directly, without needing to resort to the maintenance of ceilings.

Further, discriminationary rates could encourage lending in certain areas such as investment and export trade. At the same time, the monetary authority could discourage lending to less desirable activities such as consumer spending, or the speculative purchases, by making the reserve requirements on such lending prohibitively high. Thus, the use of discriminationary required reserves on bank assets could ensure that credit will be issued to support a development plan.

Open market operations Open market operations are desirable as they influence the liquidity positions of banks, making the achievement of monetary policy goals more likely. Also, the use of open market operations fosters the development of primary and secondary debt markets, which pave the way for a future transition to more indirect methods of monetary control. Such a transition will probably be desirable in the indefinite future, once the economy has developed sufficiently to make direct controls impractical.

It is clear that with increased capital mobility, the capacity to assign monetary and exchange policies to achieve different macroeconomic targets will be increasingly constrained. If monetary policy were targeted to constraining inflation, the exchange rate would not be free, for example, to be used as an expenditure-switching instrument to achieve objectives for the current account. Fiscal policy could be used to influence the saving-investment balance to achieve such objectives for the current account, or if the exchange rate were fixed, monetary policy would be left with little autonomy to achieve domestic stabilization objectives.

The interest rate parity condition suggests that the monetary authority could only target either domestic interest rate or foreign exchange rate given the prevailing forward exchange and foreign interest rate in the markets. In a liberalized regime, it is necessary to appropriately combine interest and foreign exchange rate policy to achieve desirable overall balance of the economy. Therefore, assigning monetary policy, consequently the exchange rate policy, the task of domestic stabilization, may require that either exchange rates or domestic interest rates, or both, are allowed to become more flexible. High capital mobility may also result in greater volatility in interest rates or exchange rates in

view of the sensitivity of capital flows to changes in market sentiment and the more rapid transmission of shocks and potential contagion effects. Greater flexibility of the exchange rate or interest rates may help discourage short-term speculative flows that exploit inconsistent interest rate and exchange rate alignments. Where capital is attracted by high domestic interest rates as part of a disinflationary program, temporary appreciation of the exchange rate may help to support the disinflationary strategy and allow for a more rapid lowering interest rates to international levels while meeting the inflation target. Once inflation and interest rates have been brought down, the exchange rate should also adjust to a level consistent with a sustainable balance of payment. The cost would depend on whether export performance would be seriously affected by a temporary appreciation in the exchange rate as well as whether markets exit to hedge the risks of greater volatility.

Debt to equity ratio The biggest limits on monetary policy change are the large debt-equity ratios, which pose a constant threat to macroeconomic stability. The government will want to wean those highly-leveraged if they over rely on credit. The easiest way to accomplish this is to reduce the access of these firms to credit by limiting their eligibility to the discount window and by increasing the reserve requirements on that lending. Such policy measures will force firms to become more imaginative in fund raising without implicit credit subsidies. At the same time, the outstanding debts of firms to commercial banks will be restructured. Once this initial adjustment is under way, interest rate on past loans can be slowly adjusted upwards in real term. Again, the rate of interest should never rise so high as to discourage investment or destroy the incentive of entrepreneurs. Once debt-equity ratios are adjusted downward, freedom for the authority to undertake changes in monetary policy will be enhanced.

Alternatively, the central bank may wish to engineer a limited liberalization in which interest rates are raised to positive levels. However, to maintain the stability of the financial markets during the reform process, the central bank can legislate that the new interest rates will not apply to outstanding debt. As outstanding debt will be repaid at the interest rates at which it was contracted, no serve cost shock will be present and no Ponzi-boom will be stimulated. New expectation formulated under the new policy regime will succeed in changing the borrowing behavior of firms in the way desired by the policy makers but the adjustment costs will be largely reduced.

Regulations and supervision Prudential regulation and supervision will be more important than liberalization in ensuring the unproblematic functioning of the financial system. In general, prudential regulation seeks to (i) reinforce incentives for banks (and other participants in financial markets) to recognize the risks they are taking, and (ii) enable the authorities to monitor potential threats to systemic stability so they can take corrective measures if needed; and the focus of supervision at the sharp end is on the equality of corporate governance, risk management and internal controls of banks. There is consensus that regulation and supervision of banks and nonbank financial intermediaries must be in line with the Basle's core principles for effective banking supervision. Quality implementation of such principles is going to be a long process to build but the following problems should be addressed soon:

First, public infrastructure should be strengthened and developed to protect financial system stability. The infrastructure would include business laws sufficient to establish solid contract and property rights; well-defined accounting standards; a system of

independent audits to validate financial statements; and a secure clearing system for settling financial transactions.

Second, sufficient flexibility to enable problem rising in banks to be resolved in an efficient manner, including, where necessary, the orderly exit of troubled institutions. This is important because forbearance and continued featherbedding of inefficient market participants damage the ability of strong competitors to expand their business and improve efficiency in the sector. Particular emphasis should be placed on the strength of bank' s financial capital. Sanctions for misconduct should be enacted and strictly enforced, which would make financial institution more sensitive to risk.

Third, the newly set up deposit insurance corporation in March 2000 with fully public-funded should quickly move toward risk-correlated scheme on the basis of credit rating or bank capital in order to correct the incentives of those who intend to take more risks since they are already insured (the current scheme covers up to $ US 2,000 of deposits with the policy applied equally for all banks).

Fourth, the critical issue is to deal with credits risk management. Credit should be granted only when the money will generate an additional return that can be used to service and repay the debt and not because the national plan determines that certain industries or projects need financing. Otherwise, bad loans will pile up in the balance sheet of the banks and sooner rather than later the banking system will have to be restructured and supported/bailed out by public money. More fundamentally, the establishment of a prudent approach to credit management at the national level involves the development of credit assessment skills of bank officers. Bank supervisors need the skills to assess whether the bank has an adequate method of evaluating loan applications and, later on,

monitoring the performance of borrowers. Bank auditors need to be properly trained and qualified to pass a judgment in whether the accounts present a true and fair view. The borrowers themselves need the kill to assess a project, arrange the financing and carry out the expenditure in an efficient manner.

Finally, the ability of the supervisory authority to spot trouble depends almost entirely on the quality and the incentives of an individual supervisor. Attractive remuneration, political independence and independence from bankers, immunity against possible legal action are all necessary conditions for creating a successful team of supervisors. Of all the risks, however, the most serious one is captured: the Asian financial collapse demonstrated the cost of corruption in banking and financial supervision. One option is to offer the job to the new generation. This guarantees the separation from bankers, admittedly at the cost of some lack of experience. On the job training can go quite far in building needed skill resources.

Collateralized contracts: The presence of collateralized contracts is very important for banks to manipulate and reduce risk behavior of firms. An even more advantageous policy, however, is to encourage and provide a very close working relationship between banks and industries. To do this, policy makers will want to tie in the long-term success of the financial institution with the long-term success of the firms. An element of such a policy is to encourage a framework of corporate control whereby the commercial banks play an active role in advising firms on matters of finance and ensuring that the firms do not engage in financial mismanagement. Such policies will discourage the control of corporations through the stock exchange thereby undermining short-termism and allowing firms to function with much longer time horizons.

III. Conclusion

In summary, it would be said that Vietnam has already started traveling the road toward financial liberalization. However, the financial system remains repressed. The legacy of financial repression in Vietnam manifests in institutional weaknesses, lack of effective disclosures and transparency in financial practices, weak legal and regulatory frameworks (limited enforceability of contracts and absence of bankruptcy laws), heavy reliance on directed credit at below market price interest rate (credit ceiling), absence of instruments or markets for assessing risks, allocating resources or for conducting monetary controls; and weakness in budgetary finance-through hidden tax and subsidies, and low interest rates. In this context, financial liberalization is undesirable but financial liberalization is the only way to build a robust and well-functioning financial system. A sound financial system is the most important issue for good investment and sustained growth. Successful liberalization depends less on the pace and sequencing than on the strength, consistency and commitment with which the necessary supporting reforms are undertaken. The appropriate responses to financial liberalization would involve an initial critical mass of institutional and structural reform, by sequencing and phasing specific elements of the liberalization accompanied by appropriate macro policies as flows:

- Strengthening banking regulation and supervision is particularly urgent. This should have included monitoring both on and off balance sheet risks, setting much lower limits on exposure to a single borrower or related group of borrowers and on connected lending (especially lending to troubled SOEs). The management of maturity mismatches between assets and liabilities in foreign exchange should take into account the likelihood of domestic currency depreciation whereas

foreign currency loans were made to producers serving domestic market. Failure to meet the best international practices in the area of regulation, supervision, and disclosure not only encourages excessive risk taking but it also undermines market confidence in the soundness of the financial system and discourage the injection of funds into the system. Thus, upgrading these practices should be a key part of the financial reform package.

- Interest rate need to be raised to help reduce the rapid credit expansions that accompany the initial liberalization, and to help improve the efficiency of resources allocation. Liberalization of interest rate should be phased in to minimize the potential for monopoly pricing, and also to take account of the extent and speed with which the SOEs can be restructured. At the same time, stricter credit assessment standards should be put in place to limit the potential of accumulating further nonperforming loans.
- Widening the fluctuation band in the security, money and foreign exchange markets would help market participants to better understand and properly management incurred risks.
- Weak banks need to have their balance sheet restructured (if necessary, blocking the balance sheet growth of insolvent institutions). In restructuring JSCBs and SOCBs, in depth analysis of bank portfolios and of enterprises' financial prospects will cover portfolio problems substantially higher than those identified initially on the basis of the banks' own financial statements and other form of off-site analysis. Thus, the level of resources needed to recapitalize banks and to reimburse insured depositors in failed banks will likely amply exceed initial

calculations. In addition, linkage between corporation and between financial institutions will result in a rapid transmission of risks and costs across financial institutions. Timely adoption of prompt corrective action measures, including exit of financial institutions when appropriate should be put in practice to reduce excessive risk taking on the part of such institutions.

- As recent experiences suggested implicit or explicit exchange rate guarantees against a background of inconsistent monetary and exchange rate are risky in the context of external liberalization process. This has given substantial incentives for large and volatile short term capital inflows. Therefore one of the key supporting reforms in capital account liberalization is to adopt a consistent monetary and exchange rate policy mix, as well as phasing in the appropriate prudential regulation to deal with the additional dimensions of risks involved in cross border capital flows.

Finally, the government has a central role to play to help market to work better by providing appropriate financial regulations and infrastructure. Rules should be designed to promote and induce prudent behavior. Such incentives can lead financial market participants to interalize rules in their decision-making and induce market institutions to monitor and enforce compliance of each participant. This underscores the importance of government taking full responsibility for policies to reform the domestic financial system. It will be presupported that the government has already formulated a coherent development strategy of the direction in which the economy should be going, and ensured that the tool of finance is used to stimulate an entrepreneur climate along those lines while discouraging over bureaucratization of the financing of the development process.

The government should have a vision and finance will be the lubricant, which will help private enterprises achieve those goals. It is interesting to recognize that no country in the region succeeded if it would rely heavily on SOEs in the process of development. After all, reforming the finance sector involves a lengthy and complex process of institution building and incentives orientation, whose success requires full ownership of, and participation in, the process by the society and the government.

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