Investment of rice mills in Vietnam

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Chapter 3

The financial system in Vietnam

3.1 Introduction

A well-functioning financial system is likely to contribute to economic growth by mobilising financial resources and allocating them to the most efficient uses (King and Levine, 1993; Levine, 1997). In this chapter, the functioning of the financial system in Vietnam will be examined from this perspective. More specifically, access of Vietnamese private enterprises, like the private RMs in the MRD on which this dissertation concentrates, to external finance will be the central subject. This chapter will try to explain why Vietnamese private enterprises, which appear to be more efficient than SOEs, have limited access to external finance, especially to bank credit.

The remainder of this chapter is structured as follows. First, the formal financial system in Vietnam, consisting of state-owned commercial banks, foreign banks, domestic joint-stock commercial banks, stock market, *etc*., will be analysed in Section 3.2. Section 3.3 explores the informal financial sector, which includes moneylenders and rotating savings and credit associations (ROSCAs). Section 3.4 deals with the government policies *vis-à-vis* the financial system. Section 3.5 presents a characterization of the financial system in Vietnam. Finally, conclusions are formulated in Section 3.6.

3.2 The formal financial system in Vietnam

3.2.1 *An overview*

Until 1988 the financial system in Vietnam only consisted of the State Bank of Vietnam (SBV), which had several affiliates aimed at distributing credit to SOEs and other entities under directives of the central plan and handling deposits of these SOEs and entities (O'Connor, 2000). In 1988-1989 the government initiated the banking reforms that transformed the then monobank system into a two-tier banking system, meaning that the SBV restricted itself to acting as the central bank, and its commercial banking activities were taken over by four sector-specialised state-owned commercial banks.[23] In 1990 the rules on the sectoral specialisation of these banks were removed (IMF, 1998).

During the 1990s, the government stimulated the entry of new players into the financial sector. This policy led to a substantial, sharp increase in the number of representative offices and branches of foreign banks and the so-called joint-stock commercial banks as well. Joint ventures between foreign banks and state-owned commercial banks were also established, but the services they offered were strictly circumscribed.[24] Non-bank financial institutions, such as finance and insurance companies, have come to exist as well, but they are unimportant in terms of financing firms.[25] The stock market, established as recently as in July 2001, is still in its infancy. The components of the financial system in Vietnam, as of June 2001, are presented in Box 3.1.

Box 3.1 shows that Vietnam has a number of commercial banks, few non-bank financial institutions, and a newly-established stock market. This box, together with the fact that banks have accounted for 85-90 per cent of financial intermediation (O'Connor, 2000), suggests that Vietnam has a bank-based financial system. The size of the Vietnamese banking sector, measured by the M2-to-GDP ratio, has increased (Table 3.1). Despite this, bank credits appear to be an unimportant source of finance because the domestic-bank-credit-to-GDP ratio in Vietnam has been low. In 2000 this

[23] These state-owned commercial banks are: Bank for Foreign Trade (Vietcombank), Industrial and Commercial Bank (Incombank), Bank for Agriculture and Rural Development (BARD), and Bank for Investment and Development. Nowadays, there are another two state-owned commercial banks, the Housing Development Bank for the MRD and the Bank for the Poor (see Box 3.1). As a matter of fact, these two state-owned banks are policy-oriented ones. Therefore, we do not include them in our later discussions.

[24] Due to the circumscriptions these banks do not offer credits to private enterprises. This is the reason why we do not refer to them in our discussion any further.

[25] Because finance and insurance companies were not important, we do not include them in our discussion.

ratio stood at 34.9 per cent (see Table 3.1) while in the same year it was 63.6 per cent in Indonesia, 63.1 per cent in the Philippines, 79.2 per cent in Singapore, 100.4 per cent in Malaysia, and 111.4 per cent in Thailand (ADB, 2002).

Box 3.1 Components of the Vietnamese financial system, as of June 2001

Formal financial system:

- Six state-owned commercial banks: Bank for Foreign Trade (Vietcombank) with 32 municipal and provincial branches; Industrial and Commercial Bank (Incombank) with 68 municipal and provincial branches; Bank for Agriculture and Rural Development (BARD) with 86 municipal provincial branches; Bank for Investment and Development with 64 municipal and provincial branches; Housing Development Bank for the Mekong River Delta; and the Bank for the Poor.
- 31 branches and representative offices of foreign banks;
- Four foreign joint-venture banks;
- 43 domestic joint-stock commercial banks;
- 959 people's credit funds and cooperatives;
- Few finance and insurance companies; and
- One stock exchange, established in July 2000 in Ho Chi Minh City.

Informal financial system:

- Moneylenders, relative and friends; and
- Rotating savings and credit associations (ROSCAs).

Source: World Bank (2002a).

In the following, we will analyse the relevant components of the formal financial system in Vietnam, *i.e.*, state-owned commercial banks, foreign banks, joint-stock commercial banks, and the stock market, so as to identify the difficulties of Vietnamese private enterprises in terms of access to external finance.

Table 3.1 Vietnam: some financial indicators, 1986-2000

Year	*M2/GDP* (*per cent*)	*Domestic credit/GDP* (*per cent*)	*Year*	*M2/GDP* (*per cent*)	*Domestic credit/GDP* (*per cent*)
1986	18.7	25.5	1994	24.0	21.2
1987	16.4	18.5	1995	23.0	20.6
1988	16.7	17.0	1996	23.7	20.3
1989	26.4	23.9	1997	26.0	21.3
1990	27.1	23.7	1998	28.3	22.4
1991	26.4	18.4	1999	35.7	22.4
1992	24.6	15.5	2000	50.2	34.9
1993	23.0	19.3			

Source: Computed from Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries* (2002); World Bank, *Vietnam Development Report* 2002, Table 4.1.

3.2.2 *State-owned commercial banks*

State-owned commercial banks have dominated Vietnam's financial system. As of December 2001, they held 75 per cent of total bank assets, the foreign bank branches and joint venture banks made up 18 per cent, and the joint-stock commercial banks represented 7 per cent (The Banker, June 2002). Table 3.2 shows that the state-owned commercial banks accounted for 68-83 per cent of total outstanding loans during the 1994-2000 period. More than half of the credit from the state-owned commercial banks was extended to SOEs (Table 3.3). If the amount of credit extended to farming households were subtracted from that to the non-state sector, the resulting amount would have revealed that only a small share of the credit from the state-owned commercial banks was given to non-farm private enterprises (Webster, 1999). There are at least three factors that can explain why non-farm private enterprises in Vietnam did not receive much of the credit from the state-owned commercial banks: (i) the government-directed lending in favour of SOEs, (ii) the information problem of the banks regarding private enterprises, and (iii) the cumbersome lending procedure and collateral requirement (Webster, 1999).

Table 3.2 Vietnam: sources of formal credit, 1994-2000

Year	*Total bank credit*		*Credit extended by state-owned commercial banks*		*Credit extended by non-state commercial banks*	
	Amount (VND billion)	*Per cent*	*Amount (VND billion)*	*Per cent*	*Amount (VND billion)*	*Per cent*
1994	33,345	100	27,610	82.8	5,735	17.2
1995	42,277	100	33,647	79.6	8,630	20.4
1996	50,751	100	38,320	75.5	12,431	24.5
1997	62,201	100	48,042	77.2	14,159	22.8
1998	72,597	100	59,087	81.4	13,510	18.6
1999	112,730	100	76,559	67.9	36,171	32.1
2000	155,720	100	114,193	73.3	41,527	26.7

Source: IMF (1998); IMF (2000); IMF (2002a).

Government-directed lending to SOEs

The government has been decisive in the allocation of the credit from the state-owned commercial banks. The banks are required to allocate a substantial share of their credit to SOEs at concessionary interest rates and without collateral (The Banker, October 1992; The Banker, January 1996; Dinh, 1997; IMF, 1998; Moreno *et al.*, 1999; The Banker, June 1999; O'Connor, 2000; Gates, 2000; IMF, 2002a) as a matter of policy rather than because the loans are profitable. This policy reflects the fact that the government has remained in favour of a leading role for SOEs (see Chapter 2). The overriding importance of the policy lending has, among other things, brought into the banks' loan portfolios a high share of non-performing loans (IMF, 2002b) because SOEs have usually failed to honour loan repayment obligations (O'Connor, 2000). As of November 2001, non-performing loans made up 11.8 per cent of the total outstanding loans of the state-owned commercial banks, and 60 per cent of the non-performing loans were due to SOEs.[26]

Table 3.3 Vietnam: distribution of bank credit, 1994-1998*

Year	*Credit extended by state-owned commercial banks to:*				*Credit extended by non-state commercial banks to:*			
	SOEs		*Non-SOEs*		*SOEs*		*Non-SOEs*	
	Amount	*Per cent*	*Amount*	*Per cent*	*Amount*	*Per cent*	*Amount*	*Per cent*
1994	18,604	67.4	9,006	32.6	2,400	41.8	3,335	58.2
1995	20,855	62.0	12,792	38.0	3,224	37.3	5,406	62.6
1996	22,030	57.5	16,290	42.5	4,780	38.4	7,651	61.6
1997	26,625	55.4	21,417	44.6	4,597	32.5	9,562	67.5
1998	34,218	57.9	24,869	42.1	3,858	28.6	9,652	71.4

Source: IMF (1998); IMF (2000).
Note: * More recent data broken down by type of borrowers from each sector of the banking system are unavailable (IMF, 2002b).

Since the state-owned commercial banks play an important role in the banking system as well as in the economy, the government recurrently bails them out when they get in trouble (soft budget constraints).[27] The government refinances the banks by using general revenues, by selling government bonds to the public, or by printing money (Perkins, 2001). This is likely to lead to moral hazard problem because the bailing-out taking place irrespective of whether or not the banks adjust their behaviour would mean that they continue to make bad loans to SOEs. The credit from the state-owned banks then becomes an instrument to help inefficient SOEs to survive. Any financial deterioration of SOEs will thus create difficulties for the banks, but it may also induce the banks to give more credit to SOEs because they cannot get back the previous loans if those SOEs fail.[28] Berglof and Roland (1998) argue that soft budget constraints of banks lead to soft budget constraints of SOEs. This phenomenon is also

26 *Source*: Saigon Economic Times, November 15th, 2001.

27 Soft budget constraints refer to "a situation in which a state-owned enterprise manages to survive even though it has made persistent losses, because time and again the state rushes to its aids" (Kornai, 2001).

28 This means that private enterprises, which are more efficient than SOEs, may receive only a small portion of the credit from the state-owned commercial banks.

documented in other studies, *e.g.*, Kornai (2001), Lizal and Svejnar (2001). Therefore, bank reforms and SOE reforms have to be undertaken jointly (Van Wijnbergen, 1997).

Although the government has directed a substantial fraction of the credit from the state-owned commercial banks to SOEs, there was still some credit from these banks that private enterprises could apply for. Unfortunately, for many private enterprises access to this residual credit is restrained by the information problem that discourages the banks from lending to them.

Information problem of state-owned banks with respect to private enterprises

Since Vietnamese private enterprises, particularly small ones, often do not have bookkeeping (O'Connor, 2000; Nguyen D.N., 2002), it is difficult for them to communicate information to the banks and also difficult for the banks to acquire information about them. Moreover, although the banks have branches all over the country (see Box 3.1), these branches are mainly based in large cities or provincial towns, implying that they are substantially distant from private enterprises, especially those situated in rural areas. This adds to their lack of knowledge and information about private enterprises.[29] In addition, the state-owned commercial banks' officials may be misinformed about private enterprises because the media often reported the latter's frauds, bankruptcies, and misconducts (Webster, 1999).

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

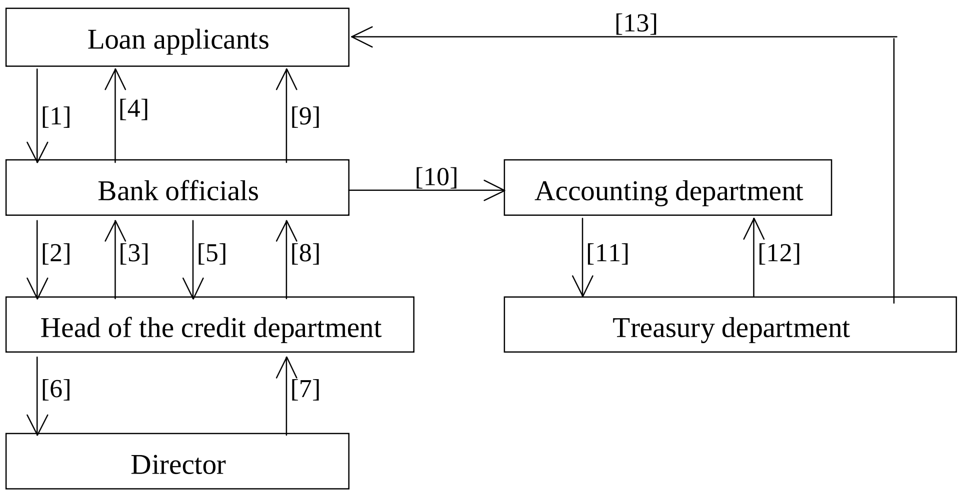
Lending procedure and collateral requirement

The lending procedure maintained by the state-owned commercial banks is shown in

[29] Petersen and Rajan (2002) argue that the use of computers and other communication equipment will help to get information about borrowers available for lenders at a distance, making distance less important for lenders in terms of gathering information about borrowers. This argument may not hold for Vietnamese private enterprises because impersonal communicating between them and the banks is still unusual.

Chart 3.1. This procedure is mainly applied to private borrowers. The aim of this procedure is to select creditworthy borrowers. Unfortunately, this cumbersome procedure, coupled with the presence of unskilled and unmotivated bank officials, turns out to be an obstacle for private borrowers.

Chart 3.1 Lending procedure in Vietnam



Note: [**1**] Bank officials receive loan application forms from the applicant; [**2**] After receiving loan application forms, bank officials report to the head of the credit department; [**3**] The head of the credit department assigns a bank official to examine the loan application forms to see if it is filled in properly; [**4**] The assigned bank official appraises the applicant, mainly based on collateral; [**5**] The assigned bank official informs the head of the credit department about the applicant; [**6**] The head of the credit department assesses the information and reports it to the director of the bank; [**7**] Director of the bank decides on the loan and informs the head of the credit department; [**8**] The head of credit department informs the assigned bank official about the decision; [**9**] The assigned bank officer informs the applicant; [**10**], [**11**], [**12**] Internal information among the bank's specialised departments; and [**13**] The treasury department disburses loans to the applicant, if accepted.

Source: Adapted from Mai (2001).

There were usually long delays between the submission of loan applications and the rendering of loan decisions by bank officials. Tran (1999) reveals that the delays were sometimes as longs as 35 days. Entrepreneurs also reported that the lending procedure required too much unnecessary documentation. As a result, borrowers incur high transaction and opportunity costs, making credit from the state-owned commercial banks even more expensive than that from informal lenders (Nguyen *et al.*, 2001). This helps to explain the phenomenon that in Vietnam many private enterprises do not even apply for bank loans.[30] Nguyen H.D. (2000) finds that around 20 per cent of private enterprises in Vietnam were reluctant to apply for loans from commercial banks.

In Vietnam, private enterprises are required to collateralise assets for loans whereas SOEs are exempted from this. Collateral requirements make it more costly for the banks to lend to private enterprises as compared to SOEs because the banks have to spend resources to assess the collateral. More importantly, the absence of regulation to enforce credit contracts and to support the sale of collateralised assets in case of default adds to the reluctance of the banks in giving loans to private enterprises, even if the loans are secured with collateral.[31]

In Vietnam, unlike immovable assets (land and buildings), movable assets (such as inventories, equipment, *etc*.) are often not accepted as collateral. While land is the principal concern of banks, as many as 90 per cent of land users do not have use-right certificates.[32] Resolution 11/2000/HQ-CP stipulates that the total value of collateral plus own capital (equity) of an enterprise must be at least 30 per cent of the amount of loans it applies for. This requirement does not seem to be very strict. Yet, banks often undervalue the collateralised assets, thus reducing the amount of money that enterprises can borrow.

In early December 2000, the SBV finalised a decree that allows all credit institutions to make unsecured, or collateral-free, loans.[33] From the perspective of enterprises, this policy will help them to get better access to bank credit. Yet, the feasibility of this policy largely depends on the improvements in banking skills as well as in contract enforcement. Both may take time before being realised adequately.

In sum, due to the policy lending, the information problem and the cumbersome lending procedure, the credit from the state-owned commercial banks in Vietnam have been allocated mainly to SOEs, leaving private enterprises with limited access to that credit.

3.2.3 *Foreign banks*

Perceiving the benefits of foreign banks to the economy, the Vietnamese government has stimulated the entry of foreign banks into the domestic financial sector. In 1991 it started to permit the establishment of foreign banks' branches. Foreign banks benefit the economy in several manners:

30 *Source*: http://www.fpt.vn.
31 *Source*: http://www.fpt.vn.
32 *Source*: *Dien Dan Doanh Nghiep* (Business Forum), December 3rd, 2001.
33 This policy may lead banks in Vietnam to higher risks if the regulation and financial information transparency are not improved properly.

- they may bring modern banking technology and management expertise into the domestic financial market;
- they may trigger competition in the market, thereby improving its efficiency;
- the presence of foreign banks may promote foreign investment; and so on.

Since foreign banks viewed Vietnam as a country with a high growth potential, they came into the country in substantial numbers in the early 1990s. For instance, in August 1993 there were 28 foreign banks operating in Vietnam, and this figure stood at 39 in June 1994 (The Banker, June 1994).

Initially, the regulation surrounding foreign banks' activities was restrictive. For instance, foreign bank branches were given licenses for only 20 years. They were required to have a minimum local capitalisation of USD15 million (The Banker, February 1992). They were allowed to take *dong* deposits, but only up to an equivalent of USD 1.5 million (The Banker, January 1993). Foreign banks were not allowed to lend more than 10 per cent of their capital to a single project (The Banker, January 1993). In June 1993 the SBV removed this loan cap. It also removed the requirement that loans to the ten largest borrowers must not exceed 30 per cent of a bank's total loans (The Banker, November 1993). On October 1st, 1998, the SBV imposed a rule that limited commercial banks, both foreign and domestic, to maximum loans to single customers equivalent to 15 per cent of their registered capital. Since the foreign bank branches in Vietnam have registered capital of between USD15 and 20 million, this would mean that they were allowed to lend USD2.25-3.0 million per customer at maximum.

Since the financial crisis that dragged over Southeast Asia, foreign banks in Vietnam have suppressed lending. In 1997 the outstanding loans of foreign banks accounted for as much as 28 per cent of total outstanding loans of the whole banking system; this share dropped to around 25.7 per cent in 1999 (Nguyen and Nguyen, 2002) and to 15 per cent as of November 2002 (Saigon Economic Times, November 28th, 2002). The number of foreign bank branches has also declined. According to The Banker (June 1999), 19 foreign bank branches ceased operation in 1998. In June 2002 the number of foreign bank branches and joint-venture banks operating in Vietnam was 27.[34]

Berger *et al*. (2001) argue that foreign banks are generally less likely to lend to small enterprises than domestic banks. This argument seems to be applicable to foreign banks in Vietnam. First, foreign banks are usually headquartered at a distance from small enterprises, especially those located in rural areas. In Vietnam, foreign banks mainly concentrate in Hanoi and Ho Chi Minh City. Second, since foreign banks operate in unfamiliar environments with different languages, cultures, supervisory and regulatory structures, *etc*., it may be difficult and costly for them to gather

[34] *Source*: http://www.ivietnam.com.

and process information about small enterprises. Specifically, private enterprises in Vietnam were not allowed to collateralise land to get loans from foreign banks. This may discourage foreign banks from lending to them.[35] According to Dinh (1997), foreign banks in Vietnam have primarily been involved in highly specialised areas of trade finance. They have also lent to or through Vietnamese banks and to large domestic SOEs (The Banker, January 1997), but not to private enterprises.

3.2.4 *Joint-stock commercial banks* (*JSBs*)

Joint-stock commercial banks are private banks established using money pooled by shareholders. In the course of the banking reforms, especially since the mid-1990s, a number of JSBs have been established. There are three factors that can explain the rapid expansion of JSBs (O'Connor, 2000). Firstly and most importantly, it was due to the more liberal regulations permitting non-state banks to enter the financial sector in association with an increasing demand for credit. Secondly, the state-owned commercial banks have become more risk-averse as "the government attempts to hold them accountable for their loan losses" (O'Connor, 2000), especially after some fraud-related scandals with the involvement of those banks;[36] consequently, they restrict their lending activities, thus leaving room for other banks to operate. The third factor, which may be least important, regards the desire of some SOEs to secure their own sources of finance by setting up JSBs.

In fact, many JSBs were set up out of the ailing credit cooperatives in the early 1990s, which brought these JSBs an enormous amount of bad debts right at the outset (see Box 3.2 below). Some other JSBs were founded by families or groups of related

[35] This restriction was removed in November 2001 (Vietnam Investment Review No.525, November 5th-11th, 2001).

[36] The scandals include bankrupt companies such as Epco-Minh Phung and Tamexco. Epco-Minh Phung was a Ho Chi Minh City (HCMC)-based big private textile and property group. Executives from Epco-Minh Phung, together with a number of government officials and bankers, were accused of offences ranging from fraud to misappropriating state assets. The losses of USD280 million caused by the scam were mainly borne by state-owned commercial banks on loans used for land speculation. Those defendants consisted of bank executives like Pham Nhat Hong (Deputy Director of the HCMC Branch of the Industrial and Commerce Bank of Vietnam – Incomebank) and Nguyen Ngoc Bich (Deputy Director of the HCMC Branch of the Bank for Foreign Trade of Vietnam – Vietcombank).
Tamexco was a state-owned trading company in HCMC. Its director, Pham Huy Phuoc, was convicted of siphoning off USD26 million of state money from the company. The corruption concerned fraudulent land deals at inflated prices, transactions that got crucial assistance from officials at the Bank for Foreign Trade of Vietnam (Vietcombank).

SOEs, which act as influential shareholders (The Banker, January 1993; IMF, 1998; Le, 2000; O'Connor, 2000).

Box 3.2 Crash of the credit cooperatives in the early 1990s

> In the late 1980s, due to the absence of proper legal framework, credit cooperatives, *i.e.*, collectively-owned credit institutions that accepted deposits and made loans to borrowers, mushroomed. In 1990 there were around 300 credit cooperatives holding deposits of VND400 billions, equivalent to USD100 million (Fforde and De Vylder, 1996). Many of the credit cooperatives attracted deposits by offering very high interest rates, sometimes up to 15 per cent per month (Fforde and De Vylder, 1996), but they could not lend at all because no investment could have profit rates comparable with the interest rates these credit cooperatives offered (Vo, 2001). The interest-rate bubbles then burst because many of the cooperatives could not stand the loss. In 1990 a number of credit cooperatives collapsed with billions VND of unpaid deposits. Some bad ones were closed by the government. This panicked people. They rushed to withdraw money, causing many other credit cooperatives to go bankrupt. Only few urban credit cooperatives survived the crisis, but they suffered from serious lack of confidence, deposit withdrawals, and debt. This crisis was thought to lead to a downfall of more than 2,000 small private enterprises (Fforde and De Vylder, 1996). After this crash, the government imposed minimum reserve requirements on credit institutions and started other regulatory reforms (Dinh, 1997).

JSBs in Vietnam appear to be undercapitalised. In 1998 as much as 70 per cent of the number of JSBs failed to meet the minimal chartered capital requirement, VND65 billion for urban JSBs and a mere VND2 billion for rural ones.[37] Although capital of these banks has recently increased,[38] they remain small: more than 40 JSBs held only around 7 per cent of total assets of the banking system as compared to 75 per cent by just four state-owned commercial banks (see Subsection 3.2.2).

Most of the JSBs have performed poorly (Le, 2000). Poor management is the major cause of the problem; in the 1990s many JSBs that were engaged in financing property deals with letters of credit (L/C) failed afterwards because the property market suffered a dramatic downturn (IMF, 1998; The Banker, June 1998). Moreover, the interests of the influential shareholders have dominated the credit-allocating policies of the JSBs, leading to over-extensions of credit to related parties, *i.e.*, individual borrowers or influential shareholders including SOEs (IMF, 1998; Le, 2000; O'Connor, 2000; World Bank, 2000a; Saigon Times Daily, No. 1589, December 31st, 2001).[39] The management of JSBs also committed themselves to fraudulent activities. For in-

37 *Source*: Saigon Times Daily, No. 1589, December 31st, 2001.

38 *Source*: Saigon Times Daily, No. 1589, December 31st, 2001.

39 Table 3.3 shows that credit from non-state commercial banks to SOEs accounted for around 29 to 42 per cent of the total credit given by these banks between 1994 and 1998.

stance, in the late 1990s some JSBs opened L/Cs for importers but did not make payments.

The SBV has taken action on consolidating the failing JSBs. In 1998 six JSBs were placed under special care of the SBV, and 14 were viewed as problematic and in need of being restructured (Le, 2000). In 1999 the SBV increased the minimum amount of chartered capital of various types of banks and credit institutions. Those JSBs that had chartered capital lower than the minimum were forced to raise capital or to merge with other banks. In the last few years, eight JSBs were merged, reducing the total number of JSBs from 51 to 43. Another four banks will undergo the same process this year.[40] All the mergers to date have occurred between domestic JSBs and at the discretion of the SBV.[41] The SBV also revoked operating licenses of some JSBs with chronically poor performance. After consolidation, JSBs appear to be better (The Banker, June 2002).

In summary, JSBs in Vietnam appear to be small and weak. Consequently, although the JSBs are supposed to be a source of finance for private enterprises, their financial contribution to the private sector of the country remains limited. This once again hints at limited access to external finance for private enterprises**.**

3.2.5 *Stock market*

Vietnam's stock market was established as recently as in July 2000 in Ho Chi Minh City, the commercial hub of the country. Shares issued by companies and bonds issued by the government and by the Bank for Investment and Development of Vietnam are traded in this market. As of February 2003, there were 21 companies listed on Vietnam's stock market;[42] four kinds of government bonds, one kind of treasury bonds, and two kinds of bonds issued by the Bank for Investment and Development are also traded in the market. Shares issued by companies have accounted for more than 90 per cent of total value of stocks traded in this market. Stock prices appear to be highly volatile. The VN-index, which measures prices of the stocks traded in Vietnam's stock market, increased up to its peak of 571.04 points on June 25th, 2001; afterwards, it dropped to 203.12 points on October 5th, 2001 and rebounded to 265.03 points on November 2nd, 2001; eventually, it fell again to 164.61 points on February 28th, 2003.

Before June 25th, 2001, the demand for shares was higher than the supply of shares because there were only five companies issuing a small number of shares, and

[40] S*ource*: Saigon Times Daily, No. 1618, February 18th, 2002.

[41] The World Bank (http://www.worldbank.org.vn) refers to several mergers and acquisitions between JSBs taking place at the end of 2001.

[42] These companies are former state-owned companies that were equitised.

60-70 per cent of these shares were not traded (Vietnam Economic Times Supplement 2001).[43] Therefore, stock prices went up. After that, due to the administrative controls over the market (such as the limit on the amount of stocks that an individual is allowed to buy,[44] the stock price fluctuation band of 2 per cent, and the price ceiling, *etc*.) stock prices started to drop. This drop was intensified by the so-called herd behaviour, or herding, which means that as stock prices fell, many investors sold them out, making stock prices to fall further. After October 5th, 2001, stock prices recovered because investors might see better chances of success as newly listed companies started trading their shares in the market, and existing companies issued new shares. However, this recovery lasted for only one month, up to November 2nd, 2001. Afterwards, stock prices fell again due to this increase in stock supply and again herding.

Since the stock market is only a source of finance for big firms, it is not helpful to private enterprises, which are often small and not qualified to be listed.

3.2.6 *Summary*

Since the late 1980s, the Vietnamese formal financial system has experienced major reforms. The reforms have encouraged the presence of several types of banks and financial institutions. Despite this, state-owned commercial banks still dominate the financial system. These banks appear to be in favour of making loans to SOEs as a matter of government policy. The entry of foreign banks and domestic JSBs has broadened the scope of the domestic financial sector. Yet, foreign banks may not be acquainted with domestic private enterprises. Moreover, JSBs remain relatively small and undercapitalised. Finally, Vietnam's stock market is still young. As a result, private enterprises have poor access to formal external finance.

3.3 The informal financial sector in Vietnam

Due to such a poor access to formal external finance, private enterprises in Vietnam have to seek credit from the informal financial sector. Informal credit includes that from professional moneylenders, relatives and friends. It also comes from the so-called rotating savings and credit associations (ROSCAs), which enable individuals to jointly collect and distribute personal savings.

In developing countries, informal financial sectors exist mainly because of the

[43] The untraded shares are those held by the government and members of management boards of the companies (Vietnam Economic Times Supplement 2001).

[44] The government set a limit that allows a single investor buy only up to 5.000 shares in one transaction (http://www.fpt.vn).

underdevelopment of the formal financial sectors.[45] Like these countries, Vietnam has a relatively large informal financial sector. It is, however, difficult to exactly measure the size of this sector in terms of financial services provided. The informal financial sector in Vietnam was estimated to make up around 60-70 per cent of credits given in the early 1990s (Far Eastern Economic Review, March 4th, 1993). The Asian Banker (April 1996) points out that 35 per cent of total value of financial transactions took place outside the banking system. According to information from the Global Development Research Centre,[46] a 1990 survey by Vietnam's Ministry of Agriculture and Rural Development discovers that between 68 and 94 per cent of farming households borrowed in informal credit markets. This source of information also reveals that around 73 per cent of total loans of rural households were obtained from informal sources, of which professional moneylenders accounted for around 33 per cent and relatives and friends for around 40 per cent. According to IMF (1999), only one-fourth of total savings was held in the banking system, and around 25 per cent of broad money was in form of cash balances kept outside banks.[47] O'Connor (2000) pinpoints that in Vietnam a significant part of savings has been held in non-liquid assets or in USD outside the banking system.

3.3.1 *Moneylenders*

Moneylenders, including professional moneylenders, relatives and friends, are among the sources of credit in Vietnam. Moneylenders may satisfy part of the excess demand for credit resulting from the underdevelopment of the formal financial system.

In general, an advantage of moneylenders is the fact that they are part of their clients' communities because moneylenders are usually wealthy families who live in the communities or villages where their clients reside. Local information about clients is a by-product of moneylenders being part of their clients' communities. Intimate knowledge about clients enables moneylenders to mitigate the problems of adverse selection and moral hazard.[48] Being proximate to clients also helps moneylenders to exercise proper monitoring, thereby being able to take the right actions to stop imprudent activities of borrowers and/or to recover loans when the borrowers are still sol-

[45] According to Montiel *et al*. (1993), in developing countries the informal financial sector supplies between 30 and 75 per cent of total credits provided.

[46] *Source*: http://www.gdrc.org.

[47] This information seems to match with the fact that only four per cent of those eligible to open a bank account actually have one (EIU, 1999).

[48] Adverse selection, to be discussed at a greater length in Chapter 5, means that due to asymmetric information lenders may select risky borrowers. Moral hazard refers to the situation where, after a loan is supplied, the borrower may take actions that reduce the possibility of repayment.

vent. As a result, moneylenders often do not need collateral but mutual trust, which is created through long and/or close relationships between them and borrowers. It may be that the degree of (mutual) trust also determines interest rates. In many cases, informal credit is tied to other activities, such as the provision of labour and the sale of output, so as to overcome information problems (Floro and Ray, 1997).[49] These features appear to apply to moneylenders in Vietnam.

In Vietnam, interest rates charged by moneylenders are substantially higher than those charged by commercial banks. Tran (1998) finds that monthly interest rates charged by moneylenders were 4.14 per cent on average as compared to 2.11 per cent per month maintained by state-owned commercial banks. According to SEBA (1999), monthly interest rates charged by moneylenders were around 6 per cent. Hill (2000) uncovers that in Vietnam interest rates charged by informal lenders were around 3-4 times the interest rates charged by commercial banks.

Due to such high interest rates, borrowers may resort to moneylenders only for temporary shortages of capital or for immediate consumption needs. According to the Global Development Research Centre,[50] in Vietnam the rural poor mainly borrowed from moneylenders to meet their emergency consumption needs such as those related to illness, funeral or wedding. There were also those who borrowed from moneylenders to repay the loans they borrowed from commercial banks in order to maintain credit relationships with the banks, which charge much lower interest rates than moneylenders do.

In Vietnam, moneylenders seem to be able to borrow from commercial banks on the basis of collateral and relend the money they borrowed to end borrowers. The profit earned by moneylenders with this activity is the spread between the interest rates they charge to clients and the interest rates they pay to banks. The profits made in this way may be substantial (Nugent, 1996).

Although moneylenders are a source of finance, they do not seem to be important in terms of financing investment for two reasons. First, moneylenders may face

[49] A moneylender can at the same time show up in several guises (Bell, 1990). For instance, a moneylender could be a village trader, whereby allowing himself to create market interlinkages. Market interlinkages indicate the process of contracting between two parties that relates to two or more market exchanges (Yotopoulos and Floro, 1992). The market exchanges may consist of one related to credit and the other to commodity or labour. Delinquents of spot transactions on the commodity (or labour) are judged by moneylenders as a signal of failing to honour credit repayments in the future. Threats of disrupting commodity and credit transactions are usually used as an enforcement device by moneylenders.
All this indicates the differences between moneylenders and commercial banks in the way they deal with information asymmetry. Whereas moneylenders rely on trust or market interlinkages, commercial banks use formal procedures like application forms, collateral, *etc*. to screen and monitor borrowers and to enforce repayment.

[50] *Source*: http://www.gdrc.org.

resource constraints, *i.e.*, they often do not have much money to lend. In addition, informal lending is illegal in the view of the government, making moneylenders reluctant to give as much money as what investment often requires. The observation that moneylenders are not an important source of investment financing appears to be supported by some empirical sources. A survey conducted by the Saigon Marketing Group in 1998 shows that only 14.2 per cent of the sample, which included entrepreneurs, borrowed from moneylenders.[51] Our survey (to be discussed in Chapter 7) reveals that as few as 18 out of total 210 rice mills surveyed (around 9 per cent) borrowed from moneylenders (see Table 7.2 of Chapter 7). Houghton (2000) argues that moneylenders are almost never used by those who need larger funds for capital investments.

3.3.2 *Rotating savings and credit associations* (*ROSCAs*)

In general, ROSCA refers to a setting in which a group of individuals who know and trust each other meet on a regular basis to place a fixed amount of money in a kitty; the kitty will then be allocated to a particular group member at each meeting. Who wins the kitty is decided on the basis of the bidding principle: the one who bids higher, *i.e.*, pledging higher contributions, will receive the kitty first. This type of ROSCA is called a bidding ROSCA. There is another type of ROSCA, called random ROSCA, where the winning of the kitty is decided by random drawing of a lot but not by pledging higher contributions (Besley *et al*., 1993). The setting continues until every group member receives the kitty once. The earlier a member wins the kitty, the higher (implicit) interest rates he/she has to pay; those members who lean to the end of the circle are interest recipients. ROSCAs bring borrowers and savers together, with early winners of the kitty being borrowers and the late ones being savers (Callier, 1990; Levenson and Besley, 1996). In Vietnam ROSCAs present themselves in the form of *huis*.

Huis are a way of circumventing the difficulties in getting access to other sources of external finance. *Huis* may fill in at least part of the gap between the supply of credit (by commercial banks and other sources of finance) and the demand for credit of individuals and private enterprises. In some cases, the money *huis* agglomerated also came from foreign individuals. Freeman (1996) reveals that some *huis* in Cholon (China town of Ho Chi Minh City) drew capital from Hong Kong and Taiwan. *Huis* have sometimes managed to amass quite a substantial amount of savings of several millions of dollars.

Since *huis* are part of the informal financial sector, they are not legally pro-

[51] *Source*: Saigon Marketing Weekly No.3, January 16th, 1999.

tected. This means that the members may encounter high risks. Given the lack of legal protection, there have been problems around *huis* recently. Although their aim was to raise capital for financing business activities, in several instances *huis* turned into dangerous financial pyramids in which members of a given *hui* borrowed money and invest it at higher rates in other *huis* where the newly acquired money was used to pay interest on old loans. This led to serious financial scandals, even with the involvement of foreign individuals.[52]

According to an estimate, around 60 per cent of credit in the urban areas was provided by *huis*.[53] However, *huis* do not appear in our survey, indicating that they might not be an important financing source of private rice millers in the MRD. This may be because it is too risky for private rice millers to participate in *huis*.

3.3.3 *Summary*

Like other developing countries, in Vietnam an informal financial sector (including moneylenders, ROSCAs, *etc.*) exists. The informal financial sector may fill in part of the credit gap left by commercial banks. However, due to resource constraints and illegality, moneylenders are not important in terms of financing firm investment, which usually requires a large amount of money. *Huis*, the Vietnamese version of ROSCAs, are important in some cases; yet, they are subject to defaults, making them very risky as a source of financing firm investment.

3.4 Government policy *vis-à-vis* the financial sector

3.4.1 *Regulation concerning banking*

Vietnam's government has promulgated a number of laws and provisions to enhance the soundness of the credit institutions and to stimulate the provision of credit to the most productive sectors. In this subsection, we focus on those aspects of the laws and provisions that influence the access of borrowers, particularly private enterprises, to credit from financial institutions.

The first two fundamental banking codes (the Ordinance on the State Bank and the Ordinance on Banks, and Credit Cooperatives and Finance Companies) came into force on October 1st, 1990. These ordinances marked a crucial step towards institutionalising banking operations and a new structure of the banking system. These ordinances were replaced by the Law on Credit Institutions, which took effect on Oc-

52 *Source*: Vietnam Investment Review, 1998.
53 *Source*: Far Eastern Economic Review, March 4th, 1993.

tober 1st, 1998. This law provides a wide range of products that credit institutions are allowed to offer, ranging from the traditional financial products to funds management and insurance services. It has provisions to ensure the safety of the activities of the credit institutions, including capital norms, restrictions on asset/liability management, deposit insurance, and limits on credit institutions' investment in real estate.

According to the new law, a credit institution is allowed to lend to a single client an amount up to 15 per cent of its own capital (equity), instead of 10 per cent as previously ruled by the Ordinance on Banks, Credit Cooperatives and Finance Companies. Since the level of own capital (equity) of commercial banks in Vietnam is normally low, this rule in facts limits the amount of money that an individual firm can borrow.[54] As part of the financial sector policy, regulations aiming to enhance loan procedures of commercial banks have also been implemented. For instance, the feasibility study of investment projects must go into banks' credit decisions. This is expected to improve efficiency and transparency, to contribute to commercialising banks' behaviour, and to limit the accumulation of bad loans into banks' balance sheets. The SBV issued Decision No. 415, effective on January 1st, 2000, requiring commercial banks in Vietnam to provide information about their clients to the SBV on a regular basis. Specifically, this decision stipulates that commercial banks have to give details about a client to the SBV within three days after a "credit relationship" is established; commercial banks also have to provide the SBV with the details on financial health (derived from balance sheet data) of their clients on quarterly basis. These measures are important in terms of enhancing the prudential supervision of the SBV on commercial banks. Yet, they are likely to further suppress the limited access to credit for private enterprises, if they are effective, since private enterprises often do not have bookkeeping, from which their financial health can be observed. However, it is likely that these measures are not effective because the government seems to fail to enforce them.

In sum, the SBV has attempted to improve the soundness of the commercial banks by setting limits on loans given to single borrowers and tightening of the requirements on information transparency. These measures seem to crowd out private enterprises because private enterprises usually do not have good financial records.

[54] Due to difficulties in enforcing prudential regulations, this rule could be easily circumvented, especially by joint-stock commercial banks, which have often lent excessively to shareholders (Oh, 2000).

3.4.2 *Monetary policy*

Monetary policy covers a central bank's actions to influence the cost and the availability of money and credit. Thus, it serves as a means of helping to promote national economic goals. Two instruments of monetary policy that central banks normally use are interest-rate policies and reserve requirements. While interest-rate policies affect the cost of credit, reserve requirements determine the availability of credit. Both, therefore, play an important role with respect to access to credit of firms.

Interest-rate policy

Until 1993 the SBV maintained a lending interest rate differentiation regarding borrowers (households had to pay higher interest rates than economic entities) and sectors (economic entities in agricultural and industrial sectors were charged lower interest rates than those in commercial and services sectors) (Vo, 2001). In 1993 the SBV abolished this differentiation.

In the early years of *doi moi,* deposit interest rates were higher than lending interest rates. For instance, in March 1989 the spread between the interest rates on industrial loans and the three-month household deposit rates was minus 1.5 per cent, and it reached minus 3.3 per cent by the end of the year. This spread has become positive since December 1992 when deposit rates fell below lending rates (IMF, 1994; IMF, 1995a; Dodsworth *et al*., 1996).

Until March 1989 the official interest rates had been low, and the real interest rates had been negative. In March 1989 the nominal interest rates on three-month deposits of households were doubled, from 6 to 12 per cent, leading the real interest rates to a positive level of 4.7 per cent (Gates, 2000). As inflation has declined, the government became concerned that the real lending rates were becoming too high, and have thus cut the lending interest rates several times since 1995 (see Table 3.4).

Up to August 2000, the SBV maintained an interest-rate ceiling mechanism. According to this mechanism, formal credit institutions were not allowed to lend at interest rates higher than the ceilings. On August 5th, 2000, the SBV replaced the ceiling mechanism with the base interest-rate mechanism regarding domestic currency-based lending. Under this mechanism, the SBV sets a base lending rate and margins above this rate to serve as limits for the lending interest rates charged by banks. This new mechanism provides adequate flexibility to credit institutions and should help to enhance firms' access to credit (IMF, 2002a) because credit institutions may be more inclined to grant loans if they are able to price loans according to credit risks. At the same time, the government also adopted a market interest rate mechanism as for foreign currency-based lending activities; the interest on dollar deposits is now based on the SIBOR, *i.e.*, Singapore Interbank Offered Rate.

Table 3.4 Vietnam: lending interest rates on fixed capital (medium term) (per cent per month; in December), 1990-2001

Years	*Interest rates*	*Years*	*Interest rates*
1990	0.8	1996	1.4
1991	0.8	1997	1.2
1992	1.8	1998	1.3
1993	1.2	1999	1.0
1994	1.7	2000	0.9
1995	1.7	2001	0.9

Source: IMF (1994, 1995a, 1996, 1998, 2000, and 2002).

Reserve requirements

Reserve requirements are an instrument used by central banks to manage the availability of credit. Therefore, reserve requirements will affect the amount of credit that firms in an economy can receive. The SBV has at its disposal the instrument of reserve requirements, but this instrument has not been actively employed as a tool of monetary management because it is not enforced; several state-owned commercial banks had reserve deposits far below the required minimum. Until February 1994, the SBV maintained a formal reserve requirement ratio of 10 per cent of all deposits. On March 1st, 1994, the SBV introduced new reserve ratios for both domestic and foreign currency deposits: 7 per cent for time and savings deposits and 13 per cent for demand deposits. In 1995 the reserve ratio of 10 per cent was applied to all types of deposit, except for domestic currency deposits with a maturity of over 1 year (IMF, 1998). In February 1999 the SBV reduced the reserve requirement ratio of 10 per cent to 7 per cent for short-term deposits. Since May 2001 the reserve requirement ratio was further reduced to 3 per cent (Table 3.5). The reductions in reserve requirement ratio imply the government’s intention to relax credit supply in order to encourage firm investment.

Table 3.5 Vietnam: reserve requirement ratio on *dong* deposits (per cent)

Time	*Reserve requirement ratio*	*Time*	*Reserve requirement ratio*
March 1994	13	June 1999	6
1995	10	July 1999	5
February 1999	7	May 2001	3

Source: IMF (1994); Vietnam Economic Times Supplement 2001.

3.5 Characterization of the Vietnamese financial system

This section aims to provide a characterization of the Vietnamese financial system in terms of the properties that are usually discussed while describing financial systems. Wherever possible, comparisons are made with other economies in the region and/or other transition economies.

Previous parts of this chapter have made clear that, in terms of the type of financial intermediation, the Vietnamese financial system should be characterized as a bank-based, as opposed to a market-based, financial system. By itself, this does not mean anything about the stage of development of the financial sector. As explained by Allen and Gale (1995), there is no consensus about whether a market-based financial system or a bank-based financial system is more advanced. Yet, evidence on transition economies suggests that the financial systems of the most successful countries among a group of twelve transition countries are strongly dominated by banks (Berglof and Bolton, 2002).

Although Vietnam has a bank-based financial system, the quantity and quality of its banks are inadequate. Concerning the quantity of banks, the characterization by the World Bank that Vietnam is an underbanked country still seems to be valid, even if there has been an increase in the number of banks in the period since the time this report appeared. The nature of Vietnam as an underbanked country is shown by the figures in Table 3.6. The M2-to-GDP ratio, the most usual measure of the size of the banking sector, was much lower in Vietnam than in other Asian countries. In terms of the deposits-to-GDP ratio, the gap was even greater. In addition, the high currency-to-deposit ratio implies that Vietnam is an economy where cash payments remain predominant. On the basis of these figures, Vietnam can be described as a country with shallow finance.[55]

Table 3.6 Vietnam: financial deepening, end-1997 (per cent)

Countries	*M2/GDP*	*Deposit/GDP*	*Currency/deposit*
Vietnam	27.6	10.0	42.7
Japan	143.8	103.7	11.8
Singapore	93.1	85.0	9.5
South Korea	48.3	46.8	7.8
China	119.6	88.5	15.1
Thailand	89.9	82.8	8.4
Indonesia	57.0	40.8	12.1
Malaysia	116.9	100.5	8.5

Source: Oh (2000).

[55] See, *e.g.*, Kitchen (1986) for this terminology.

Qualitatively, commercial banks in Vietnam should be exemplified as fragile (Oh, 2000). They have a high level of non-performing loans. The foreign banking community estimated that in 1999 non-performing loans accounted for 20 per cent of the total outstanding loans of the whole banking system (Oh, 2000). The high share of non-performing loans is to an important extent a result of the loans that state-owned commercial banks have to grant to SOEs as part of the policy of directed lending, as discussed in Subsection 3.2.2.

The quality as well as the quantity of Vietnamese banks may be seen as having suffered from government policies that can be categorised as financial repression.[56] The directed lending to SOEs dealt with before is part of this phenomenon; so are the interest rate controls characterizing Vietnam's monetary policy. Another element is formed by the reserve requirements on commercial banks. It can be seen from Table 3.5 that the reserve ratio in Vietnam was more than 10 per cent in the early 1990s, as compared to five and three per cent in South Korea and Thailand, respectively. The situation seems to improve as the reserve requirement ratio has gone down.

Finally, the underdevelopment of the Vietnamese financial system in terms of the quantity and quality of banks will at least partly be responsible for the low resource mobilisation in the country, reflected in the relatively low gross domestic savings rate (see Table 3.7). Although the saving rate has increased, it was still low as compared to those in many other Asian countries.

Table 3.7 Gross domestic savings by country (per cent of GDP), 1993-2000

Countries	1993	1994	1995	1996	1997	1998	1999	2000
Vietnam	17.4	16.9	17.0	16.7	17.7	21.5	24.6	27.0
China	41.5	42.2	41.9	41.4	42.6	40.8	39.5	38.9
Indonesia	32.5	32.2	30.6	30.2	31.0	26.5	19.5	25.2
South Korea	35.4	36.5	36.8	35.2	34.5	34.4	33.5	32.6
Malaysia	37.7	38.8	39.5	42.6	43.8	48.7	47.3	46.7
Myanmar	11.4	11.7	13.4	14.0	14.6	11.8	13.0	11.1
Philippines	15.2	17.0	16.8	18.8	19.2	12.4	14.3	16.7
Singapore	46.3	48.8	51.0	51.2	51.8	50.8	48.8	49.3
Taiwan	27.0	25.8	25.6	25.1	24.7	26.0	26.1	25.2
Thailand	35.6	36.0	33.6	33.7	31.0	35.2	32.9	32.9

Source: Oh (2000); computed from Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries* (2002).

[56] See, *e.g.*, Kitchen (1986) for this terminology.

3.6 Conclusions

Vietnam's government has undertaken a number of reforms towards the financial system. The reforms have led to a diversification of the financial system. However, the Vietnamese financial system is still underdeveloped, and finance remains relatively shallow. The reforms created four large state-owned commercial banks, which are oriented to providing credit to SOEs according to directives of the government. In addition, these banks may not be able to solve the problem of information asymmetry between them and private enterprises. Therefore, they tend to maintain a stringent lending procedure and require collateral, which limit access of private enterprises to their credit.

Although foreign banks have operated in Vietnam, costly acquisition of information about private enterprises due to different cultures, supervisory/regulatory structures, *etc*. has barred them from lending to these enterprises. As a result, they have lent to or through state-owned commercial banks or to SOEs. Joint-stock commercial banks seem to be the weakest actor in the banking sector. Due to small capital base, high ratios of non-performing loans and liquidity problems, joint-stock commercial banks in Vietnam are not very helpful to private enterprises. Finally, Vietnam's stock market is young, and only few large companies issued their securities in this market.

In Vietnam an informal financial sector exists, filling in part of the credit gap left by the formal financial system. The size of this sector, albeit difficult to measure exactly, seems to be considerable. The informal financial agents have for most of the time extended consumption credits but not credit for productive purposes because they may face resource constraints and are illegal.

In the course of the financial reforms, the SBV has issued laws and provisions to enhance the soundness of the country's banks. These laws and provisions help to secure of the loans given by formal credit institutions and improve their financial transparency. The SBV also reduced lending rates as well as reserve requirements. All in all, the Vietnamese financial system is ill equipped to finance private enterprises like private RMs in the MRD. The possibility of banks to finance private enterprises is limited by government policies and regulation that partly work out as financial repression.