HARVARD Kennedy School
JOHN F. KENNEDY SCHOOL OF GOVERNMENT

VIETNAM PROGRAM
79 John F. Kennedy Street, Cambridge, MA 02138

TEL: (617) 495-1134
FAX: (617) 496-5245

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

Jay K. Rosengard[1] and Huỳnh Thế Du[2]

Prepared under UNDP – Harvard Policy Dialogue Papers

"Series on Vietnam's WTO Accession and International Competitiveness Research"

Policy Dialogue Paper Number 2

[1] Jay K. Rosengard is a Lecturer in Public Policy and Director of the Financial Sector Program at the Harvard Kennedy School.
[2] Huỳnh Thế Du is a Lecturer at the Fulbright Economics Teaching Program.

ACKNOWLEDGEMENTS

This paper is a joint collaboration between the Fulbright Economics Teaching Program (FETP) in Ho Chi Minh City and Harvard Kennedy School – Harvard University, with financial assistance from the United Nations Development Program (UNDP). The paper is part of the UNDP–Harvard "Series on Vietnam's WTO Accession and International Competitiveness Research" policy dialogue papers.

ACRONYMS AND ABBREVIATIONS

ABC: Agriculture Bank of China
ACB: Asia Commercial Bank
ADB: Asian Development Bank
AMC: Asset Management Company
BIDV: Bank for Investment and Development of Vietnam
BOC: Bank of China
BTA: Bilateral Trade Agreement
CADB: China Agriculture Development Bank
CAR: Capital Adequacy Ratio
CBRC: China Banking Regulatory Commission
CCB: China Construction Bank
CDB: China Development Bank
CEIB: China Export-Import Bank
CIRC: China Insurance Regulatory Commission
CSRC: China Securities Regulatory Commission
DAF: Development Assistance Fund
DATC: Debt Asset Trading Company
FDIEs: Foreign Direct Investment Enterprises
FED: US Federal Reserve (central bank of the United States)
FETP: Fulbright Economics Teaching Program
GDP: Gross Domestic Product
HASTC: Hanoi Securities Trading Center
HCMC: Ho Chi Minh City
HOSTC: Ho Chi Minh City Securities Trading Center
ICB: Industrial and Commercial Bank of Vietnam
ICBC: Industrial and Commercial Bank of China
ILO: International Labor Organization
IMF: International Monetary Fund
IPO: Initial Public Offering
JSCB: Joint Stock Commercial Bank
LDIF: Local Development Investment Funds
MHB: Mekong Housing Bank
NGO: Non-Governmental Organization

NIM: Net Interest Margin
NPL: Non-Performing Loan
OTC: Over the Counter
PBOC: People's Bank of China
RMB: Chinese currency (remimbi or yuan)
ROA: Return on Assets
ROE: Return on Equity
ROSCA: Rotating Savings and Credit Association
Sacombank: Saigon Thuong Tin Commercial Joint Stock Bank
SBV: State Bank of Vietnam
SCIC: State Capital Investment Corporation
SEZ: Special Economic Zone
SOCB: State Owned Commercial Bank
SOE: State Owned Enterprise
SS: State Securities Commission
TVEs: Township and Village Enterprises
UNDP: United Nations Development Program
USD: United States dollar
VBARD: Vietnam Bank for Agriculture and Rural Development
VBSP: Vietnam Bank for Social Policy
VCB or Vietcombank: Bank for Foreign Trade of Vietnam
VDB: Vietnam Development Bank
VDI: Vietnam Deposit Insurance
VND: Vietnamese dong
VNPT: Vietnam Post and Telecommunications Corporation
VPSC: Vietnam Postal Savings Company
WB: World Bank
WDI: World Development Indicators
WTO: World Trade Organization

TABLE OF CONTENTS

TABLES....vi

FIGURES....vii

ABSTRACT....1

SECTION I: STUDY OBJECTIVES, METHODOLOGY AND LIMITATIONS....2

SECTION II: CONCEPTUAL FRAMEWORK FOR ASSESSING FINANCIAL SECTOR REFORM....3

SECTION III: FINANCIAL SECTOR OVERVIEW IN VIETNAM AND CHINA....4

III.1. Establishment and Structure of the Formal Financial Sector....4
- III.1.1. Vietnam....4
- III.1.2. China....6

III.2. Provision of Key Financial Sector Functions....8
- III.2.1. Monetary Policy....8
- III.2.2. Financial Sector Regulation and Supervision....10
- III.2.3. Financial Intermediation....10
- III.2.4. Non-Bank Financial Institutions and Markets....17

SECTION IV: FINANCIAL SECTOR REFORM IN VIETNAM AND CHINA....22

IV.1. Financial Sector Liberalization....22
- IV.1.1. Interest Rate Controls....22
- IV.1.2. Credit Lines and Directed Credit....23
- IV.1.3. Reserve Requirements....24
- IV.1.4. Foreign Exchange Policy and Exchange Rate Management....24
- IV.1.5. Capital Flows Policy and Capital Account Management....26

IV.2. Financial Sector Deregulation....26
- IV.2.1. Barriers to Entry, Expansion, and Diversification....26
- IV.2.2. Privatization/Equitization....28

IV.3. Financial Sector Stabilization....31
- IV.3.1. Restructuring....31
- IV.3.2. Bad Debt Resolution....32
- IV.3.3. Recapitalization....34
- IV.3.4. Regulation and Supervision....35

SECTION V: CONCLUSIONS AND RECOMMENDATIONS....36

V.1. Synthesis of Similarities and Differences Between Vietnam and China....36

V.2. Policy Recommendations for Further Financial Sector Reform in Vietnam....37

TABLES

Table 1: A Snapshot of Vietnamese Banks in 2005 13
Table 2: A Snapshot of Chinese Banks from 1997 to 2003 15
Table 3: The Spread between Official and Free Market Exchange Rates 25
Table 4: Foreign Investors in China’s three Largest Banks 29
Table 5: Foreign Investors in Vietnam’s Joint Stock Commercial Banks 30

FIGURES

Figure 1: Economic Growth, Money Supply Growth, and Inflation in China and India...10
Figure 2: Distribution of Vietnamese and Chinese Banking System Assets.....................16
Figure 3: VN-Index and Shanghai Composite Index Trends Since 1990.........................18
Figure 4: The Structure of Financial Assets in China and Vietnam (% GDP)..................21
Figure 5: Vietnam's WTO Commitments in the Financial Sector....................................30
Figure 6: The Bad Debt of Chinese SOCBs...33

ABSTRACT

This study analyzes financial sector development in Vietnam and China within the framework of financial sector reforms introduced in the two countries to: assess progress to date and future challenges for each country; compare and contrast financial sector reform strategies and performance; and formulate policy recommendations for further financial sector reform in Vietnam. The study focuses on three key dimensions of reform: financial sector liberalization; financial sector deregulation; and financial sector stabilization. The study concludes that: the structure, development, and reform sequence of Vietnamese and Chinese banking system reform are basically quite similar, and that both countries have made significant progress in their reform programs; the reform process is far from over in both countries; and a closer look at financial sector reforms in Vietnam and China reveals key differences in the progress to date in each country. Recommendations for further financial sector reform in Vietnam include, in descending order of importance: establishment of a strong banking supervisory agency with effective monitoring tools to secure the stability and sustainability of the banking system; promotion of domestic bank restructuring, especially SOCBs, to create strong, competitive banks that can serve as true financial intermediaries; development of institutions, products, and delivery systems to provide formal financial services to Vietnam's low-income households and family businesses; and prudent liberalization, in keeping with capacity to identify and mitigate the risks of a market-based financial sector.

SECTION I: STUDY OBJECTIVES, METHODOLOGY AND LIMITATIONS

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

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

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

SECTION II: CONCEPTUAL FRAMEWORK FOR ASSESSING FINANCIAL SECTOR REFORM

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

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

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

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

SECTION III: FINANCIAL SECTOR OVERVIEW IN VIETNAM AND CHINA

III.1. Establishment and Structure of the Formal Financial Sector

III.1.1. Vietnam

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

The shortcomings of this approach became evident during the 1980s, as SBV could control neither money supply nor credit quality. This resulted in high inflation, negative real interest rates so low that they were less than deposit rates, and substantial non-performing loans (NPLs), leaving Vietnam with acute vulnerability to both a banking crisis and macroeconomic instability. Thus, in 1988, Vietnam launched the first major reform of its financial sector by: transferring SBV's fiscal management function to the newly created State Treasury; transferring SBV's commercial banking function to the SOCBs; establishing two more SOCBs, VBARD (Vietnam Bank for Agriculture and Rural Development) and ICB (Industrial and Commercial Bank of Vietnam), to provide financing to their respective economic sectors, namely agriculture/rural development and industry/commerce. It also allowed all economic organizations, including private entities, to borrow and raise money from the public, precipitating a Credit Cooperatives and Credit Funds crisis in 1990, together with a more general loss of public confidence in the nation's banking system[3].

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

However, the SOCBs were not market-based commercial banks: both their lending and deposit rates were set by SBV; lending rate differentials were determined by relative investment priority (economic sector) and loan use (working capital or fixed asset investment) rather than relative loan risk. The loan eligibility criteria reflected government policy preferences rather than market potential; and savings rates were based

[3] See: http://www.sbv.gov.vn/home/gioithieu.asp.

on type of depositor (household or business) and currency (VND or foreign) instead of market prices and a bank's liquidity needs. The period from 1986 to 1988 was very unstable: as the government printed money to finance its budget deficit, hyperinflation surged up to triple-digit rates; the financial liberalization initiatives were conducted without reform of SOEs, manufacturing, or trade - only the agriculture sector had been liberalized, and prices of many goods were seriously distorted; and liberalization went so far that all economic organizations were allowed to trade currency, without any financial monitoring system.[4]

However, the Vietnamese banking system did not begin to operate formally as a two-tier banking system until two years later, when the Vietnam State Council promulgated the banking ordinances of 1990. At this time, due to their collapse, credit cooperatives were renamed people's credit funds. [5]

Other key developments in the evolution of Vietnam's banking system since 1990 are: JSCBs (Joint Stock Commercial Banks) have been permitted and foreign banks have been allowed to enter the market via the opening of branches or establishment of joint ventures with domestic banks; three policy banks and another SOCB were established (VBSP – Vietnam Bank for Social Policy, VDB – Vietnam Development Bank, VPSC – Vietnam Postal Savings Company, and MHB – Mekong Housing Bank[6]); relations with international financial institutions were normalized; the Law on the State Bank of Vietnam 1997 confirmed the role of SBV as the central bank; VDI (Vietnam Deposit Insurance) was established; four AMCs (Asset Management Companies) were established as wholly-owned subsidiaries of the SOCBs; this same model was followed as other AMCs were established under JSCBs; DATC (Debt Asset Trading Company) was established as a commercial enterprise with the mandate to generate profits from the purchase and sale of bad SOE assets; SCIC (State Capital Investment Corporation) was established to manage State capital in all but the 19 largest SOEs; and Vietnam has continued to gradually open its financial sector to foreign institutions by signing a bilateral trade agreement with the United States in 2001 and joining the WTO (World Trade Organization) in 2007.

At present, Vietnam is equitizing its SOCBs in a manner similar to China's equitization program, but the process has been relatively slow to date. Only VCB and ICB have had an IPO (Initial Public Offering); the other three SOCBs (BIDV, VBARD, and MHB) hope to go public soon. In addition, unlike China, VCB had its IPO without first finding strategic investors, so although the sale went reasonably well, public confidence in VCB has fallen sharply since the IPO, as indicated by a roughly 70 percent drop in its share price after a year, then IPO's price of ICB shares was less than one fifth of those of VCB. To foster capital markets development, the SSC (State Securities Commission) was established in 1995, followed by creation of HOSTC (Ho Chi Minh City Securities Trading Center) in 2000 and the HASTC (Hanoi Securities Trading Center) in 2005.

---

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

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

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

III.1.2. China

PBOC (Peoples Bank of China) was established on 1 December 1948 under the Ministry of Finance, and like SBV in Vietnam, operated as a monobank. Shortly thereafter, three specialized banks were created to serve the function of financing the economy: BOC (Bank of China), ABC (Agriculture Bank of China), and CCB (China Construction Bank[7]). China also issued a new currency in 1951, called the remimbi or yuan.

One of the reforms launched by Deng Xiaoping in 1978 as part of his plan to transform China from a centrally planned economy to a "socialist market economy" was the Chinese State Council's decision that PBOC should become the country's central bank in September 1983. BOC and ABC were also made SOCBs in 1979. These two key decisions formally converted China to a two-tier banking system. In addition, another bank - ICBC (Industrial and Commercial Bank of China), was founded in 1984 to join the other three specialized banks listed above. These four banks are now the largest commercial banks in China. At that time, these banks were responsible for financing their assigned economic sectors, working closely with PBOC. Regional banks and JSCBs were also established, and foreign banks were allowed to participate in the form of joint ventures, branches, or 100 percent foreign-invested banks.[8]

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

As part of capital markets development, the Shanghai and Shenzhen Securities Exchanges were established in 1990 and 1991, respectively, and the CSRC (China Securities and Regulatory Commission) was established in 1992. CIRC (China Insurance Regulatory Commission) was established in 1998. Also in 1998, PBOC was restructured, consolidating its provincial branches into nine regional offices.[9]

In 1999, under the joint management of the Ministry of Finance and PBOC, four AMCs were established with $20 billion funded by the Chinese government to resolve $169 billion in bad debts of the "big four" SOCBs[10]. Unlike the AMC model in Vietnam

---

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

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

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

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

where the AMCs were part of the SOCBs, these were separate institutions from the SOCBs.

In the first meeting of the Tenth National Assembly in 2003, China decided to establish CBRC (China Banking Regulatory Commission) to separate the regulation and supervision function from PBOC. The establishment of CBRC has helped PBOC focus more on the function of monetary policy execution. [11]

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

An important subject in the development of China's banking system is credit cooperatives. Numbering approximately 60,000 at their peak, both rural and urban cooperatives have become an integral part of China's banking system. They now play a critical role, as well as create significant vulnerabilities in the Chinese banking system. [12] Reforming credit cooperatives, especially the rural ones (RCCs), is considered a high priority of the Chinese central government over the next five years, beginning with a reform of ownership and governance structures and an injection of $20 billion in recapitalization funds. [13]

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

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

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

III.2. Provision of Key Financial Sector Functions

III.2.1. Monetary Policy

III.2.1.1. Vietnam

SBV is responsible for monetary policy as well as bank regulation and supervision. SBV is a ministerial agency under the government's executive branch, with its headquarters in Hanoi and offices in most cities and provinces. The SBV governor is appointed by and serves at the will of the government, like a cabinet minister.[14] Given its legal status and organizational structure, SBV's policies and operations are significantly influenced by the central and local governments, as has been evident during the current macroeconomic crisis.[15] SBV's provincial branches are considered departmental agencies similar to other sectoral offices of the government, and a standard branch template is applied regardless of location, leading to overstaffing and local political interference.

A plan to transform SBV into a modern central bank has been approved by the Prime Minister, and both the Law on the State Bank and the Law on Credit Institutions are expected to be amended in 2009 to reform SBV on the lines similar to the Chinese strategy. This entails moving the function of banking supervision to a new departmental agency, thereby leaving SBV to focus only on managing monetary policy.[16]

III.2.1.2. China

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

---

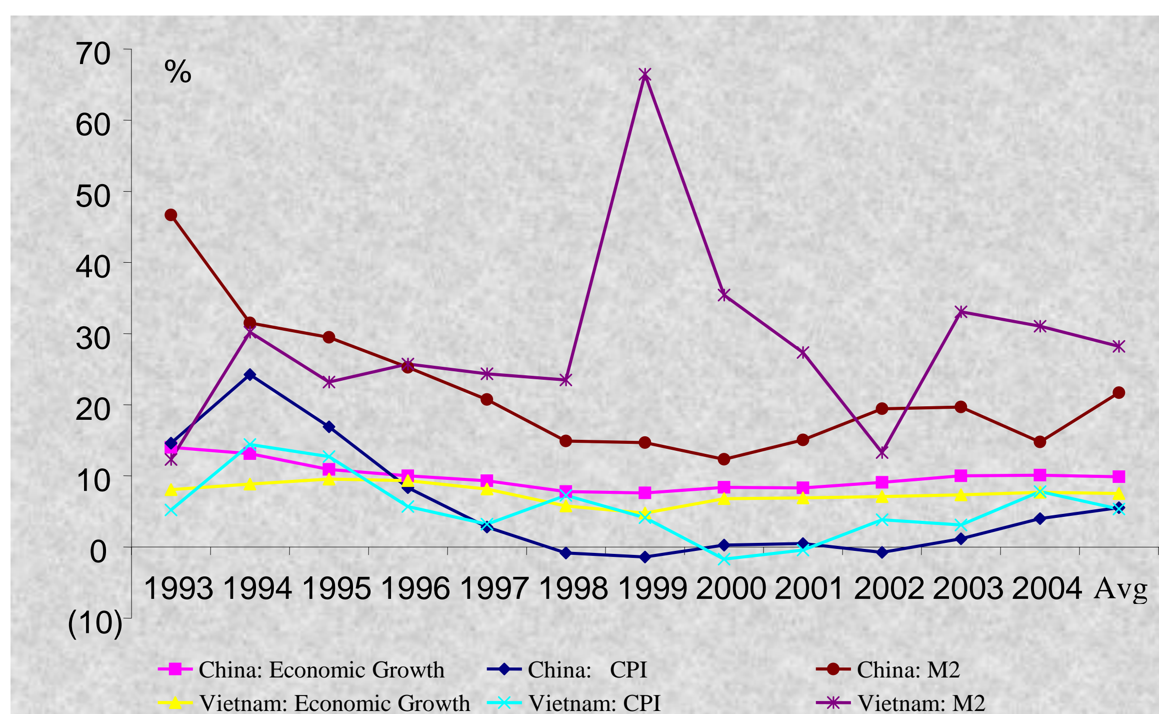
[14] The Law on State Bank of Vietnam 1997, amended in 2002, Article 1.

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

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

Both SBV and PBOC have not managed monetary policy by inflation targeting; instead, they have relied on controlling the money base. This is a passive policy that is not well suited to controlling inflation, and easily leads to implicit currency depreciation, current account deficits, and potential monetary financial crises.[17] Some experts have recommended executing monetary policy more actively, as well as setting a low inflation target as a nominal anchor for monetary policy.[18] Moreover, both central banks currently rely heavily on rather blunt administrative measures instead of open market operations to execute monetary policy. In fact, especially in Vietnam, many monetary policies seem to follow rather than lead the market, perhaps another sign of central bank's lack of independence.

Figure 1: The relation of Economic Growth, Money Supply Growth, and Inflation



Sources: WDI and SBV.

For the last two decades, the Chinese economy has grown at an average annual rate of 10 percent, while money supply has increased at an average annual rate of 22 percent and the average annual inflation has been 5.5 percent.[19] During the same period, the Vietnamese economy has grown at an average annual rate of 7.5 percent, while money supply has increased at an average annual rate of 28 percent, and the average increase in prices has been slightly lower than in China until recent rapidly accelerating inflationary pressures in Vietnam. Unlike China, a significant problem in managing monetary policy in Vietnam is that three "currencies" are used in transactions rather than a single currency. Vietnam is probably the most dollarized economy in the region, with approximately 30

[17] Comment by Mr. Le Xuan Nghia, the Head of Banking Development and Strategy Administration, SBV.
[18] Marvin Goodfriend and Eswar Prasad, *Monetary Policy Implementation in China*, BIS Paper No. 31, p. 30; see: http://www.bis.org/publ/bppdf/bispap31c.pdf.
[19] The inflation rate is much lower if the fluctuations of the early 1990s are excluded.

percent of deposits denominated in U.S. dollars.[20] Gold is also a popular medium of investment and exchange in Vietnam, adding yet another challenge to SBV in managing monetary policy.

III.2.2. Financial Sector Regulation and Supervision

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

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

Despite weaknesses in bank regulation and supervision, SBV and CBRC capacity is still greater than that of their sister institutions tasked with regulating and supervising capital markets in Vietnam and China (SSC in Vietnam, CSRC and CIRC in China). Moreover, there are even larger markets, such as the over-the-counter (OTC) market in Vietnam, which function with virtually no supervision.[21]

III.2.3. Financial Intermediation

III.2.3.1. Vietnam

In Vietnam, the five SOCBs had a dominant market share of bank assets in late 2005, totaling 70.7 percent, with the remaining market segmented as follows: 37 joint stock commercial banks accounted for 17.2 percent; 31 foreign bank branches and 5 joint

---

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

[21] Nhat Linh, "SSC Publicizes IMF's Report on Vietnam's Stock Market," *VietNamNet Bridge*, March 2, 2007 (http://english.vietnamnet.vn/biz/2007/03/668812/) and Kay Johnson, "Vietnam's Stock-Market Madness," *Time*, February 22, 2007 (http://www.time.com/time/magazine/article/0,9171,1592579,00.html).

ventures had 10.7 percent[22]; people's credit funds had only 1.4 percent; and other financial institutions (VDB, VPSC, VBSP, and local investment funds) were not taken into account.[23] In contrast to China, Vietnam did not have 100 percent foreign-invested banks by the end of 2006[24], but foreign banks nevertheless had a significant market share in Vietnam.[25]

Just as in China, foreign banks were restricted in terms of scope of operations, products, and capital to be raised when they started up in Vietnam in the early 1990s. Over time, restrictions have been phased out, and foreign banks are going to receive equal national treatment in 2010 according to WTO commitments and the Vietnam-USA Bilateral Trade Agreement (BTA).[26]

In addition to banks, Vietnam also has non-bank financial institutions[27]: 5 finance companies under the management of five state-owned corporations; 10 financial leasing companies under the management of SOCBs; a few joint ventures; and Foreign Direct Investment Enterprises (FDIEs).[28] At present, these non-bank financial institutions seem to have no clear role other than acting as "financial intermediaries" for state-owned corporations. Despite having no urban banks like China, Vietnam has a similar structure in the form of the Local Development Investment Funds (LDIF). These funds operate under the provision of the Budget Law and are not governed by banking regulations.

Three other key financial institutions in Vietnam are VDB, VPSC, and VBSP. At the end of 2006, VDB's total loan balance was VND85 trillion,[29] just slightly lower than that of VBARD, which had the highest loan balance at the time. VDB is essentially an off-budget mechanism to channel resources to state enterprise investments, primarily from VPSC. VPSC was established in 1999 under VNPT (Vietnam Post and Telecommunication Corporation); similar to the Japanese postal savings model, the operations were based at the post offices. The main duty of VPSC is to raise funds to then loan to VDB, and purchase government securities. VPSC's total raised capital was about VND50 trillion at the end of 2005, higher than half of the total average of the four SOCBs. Finally, VBSP, established in 1995 to serve policy beneficiaries, had a total capital and loan balance of approximately VND20 trillion at the end of 2005. [30]

Compared to China, Vietnam's banking system is much smaller, both in absolute and in relative terms, as a proportion of the country's economy. At the end of 2006, the total

---

[22] Foreign banks do not yet hold shares in SOCBs, but they do have shares in joint stock commercial banks. If included, the market share of foreign banks could be as high as 20 percent in Vietnam.

[23] SBV, IMF, and the authors' calculations.

[24] According to WTO commitments, the establishment and operations of 100 percent foreign-invested banks will be permitted in Vietnam from April 1, 2007.

[25] In recent years, JSCB operations have increased rapidly, but the market share of SOCBs is still more than 50 percent.

[26] Appendix on Vietnam's service commitments to WTO accession, p. 48.

[27] Financial institutions are usually classified as bank and non-bank institutions. However, Vietnamese Law classifies financial institutions as bank credit and non-bank credit institutions.

[28] See: http://www.sbv.gov.vn/home/hethongTCTD.asp, August 25, 2006.

[29] See: http://www.sbv.gov.vn/home/TinThoibao.asp?tin=717, August 25, 2006.

[30] See: http://www.mof.gov.vn/Default.aspx?tabid=612&ItemID=34869.

loan balance of Vietnam's banking system was only about VND 693 trillion,[31] or 71.3 percent of GDP. Vietnam's credit to GDP ratio, a measure of financial deepening, is very modest compared not only to China, but also to other countries in the region.[32] However, with a more than 25 percent growth recently in annual credit, the loan balance is expected to exceed GDP in a short time. As noted by the IMF and the World Bank, such a high growth rate for credit can create inflationary pressures and lead to economic overheating, which can undermine macroeconomic stability and long-term development.

Similar to China, Vietnam's banking system is dominated by SOCBs. In addition, banking products and services are still meager and out of date as domestic banks' activities revolve around raising funds and then lending. Their main income comes from lending, and interest margins are even higher than those in China and Western European countries; the net interest spread is estimated at more than 2 percent in Vietnam. For example, in 2005, the interest margins of commercial banks considered to be most efficient in Vietnam – Sacombank (Saigon Thuong Tin Commercial Joint Stock Bank), ACB, and Vietcombank – were 3.9, 2.8, and 2.9 percent, respectively,[33] and their non-lending activities were very limited. Banking operational efficiency and financial capacity are also weak, especially for SOCBs: ROA (Return On Assets) was only 0.6 percent and CAR (Capital Adequacy Ratio) was about 5 percent at the end of 2005[34]; the SOCBs had the lowest results. According to official data, the bad debt ratio appears to be very low: except for BIDV's bad debt ratio of 10.8 percent, the ratios of other banks are safely below 5 percent, with many below 2 percent.[35] However, several international institutions contend that this figure is 15 to 20 percent, and some independent researchers estimate the number to be closer to 30 percent.[36], [37]

Especially worrisome is the potential negative impact of policy banks because of their detrimental effect on the ability to allocate capital efficiently. There is considerable concern about VPSC's capital mobilization, because it may take away the funds that should have been raised by banks to lend to the growing private sector.[38] Addressing this concern is problematic given its political dimensions: VDB focuses mainly on SOEs, and its operations are dominated by the Ministry of Finance - it is not subject to SBV regulations and supervision. This poses significant risks, given that VDB is now one of

---

[31] SBV statistics, 2005.

[32] In 2007, for the first time, total bank assets exceeded GDP, but the total loan balance was still less than 70% percent of GDP. In the first half of 2009, total outstanding loans already exceceeded GDP.

[33] "Finding the mystery of banks' profit", *Saigon Economic Times*, no. 2/2007, on 25/01/2007, p. 12.

[34] Fitch Ratings, *Country Report: The Vietnam Banking System*, 2006, p. 5.

[35] See: http://www.hvnh.edu.vn/modules.php?name=News&op=detailsnews&mid=452&mcid=5 ; http://www.dddn.com.vn/Desktop.aspx/TinTuc/Tintuc-Sukien/BIDV_cong_bo_ty_le_no_xau_theo_thong_le_quoc_te/ ; 08/02/2007.

[36] Huỳnh Thế Du, *Dealing with NPLs in Vietnamthe Vietnamese banking system,; experience from China and other countries, 2004, p. 2;* http://www.fetp.edu.vn/index.cfm?rframe=/research_casestudy/facresearchlist.htm.

[37] In recent years, many commercial banks generated both large profits and losses from trading securities, especially stock trading. Speculative activities not only fail to improve the stability of bank operations, but they also create more risk for banks, as well as the financial system as a whole. Moreover, although it is reported that the CAR, profits, and NPLs of banks have improved significantly, lack of transparency continues to raise questions about these claims.

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

Vietnam's largest financial institutions, with outstanding loans estimated to be more than 10 percent of GDP.

Table 1: A Snapshot of Vietnamese Banks in 2005

Amounts in trillions of VND

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

Source: Compiled by the authors from various sources.

III.2.3.2. China

The four largest SOCBs accounted for 54.6 percent of total bank assets at the end of 2004. Not only do these banks operate in the domestic market, but they also have foreign branches. Moreover, three of them have gone public, although the State still retains majority ownership. The rest of the Chinese market was segmented as follows: three policy banks accounted for 11.4 percent of assets; 11 joint stock commercial banks had 15.0 percent; 112 urban banks, each of which is connected to a city, had 5.4 percent; 191 foreign bank branches and 100 percent foreign-invested banks (including 15 foreign-invested banks, 157 branches, and 11 sub- branches) had just 1.6 percent;[39] approximately 35,000 rural credit cooperatives and 1,000 urban credit cooperatives had 10.4 percent; and the remaining 1.5 percent was taken by other financial institutions.[40]

Foreign banks have been set up in China since 1981. Initially, their scope of operations and services allowed were very restricted. Over time, these restrictions have been phased out, and foreign banks, in principle, now receive equal national treatment in accordance with WTO regulations.[41] However, foreign banks' operations are still very modest.

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

[40] García-Herrero and Santabárbara, op.cit., Table 1, p. 342; Nicolas Hope and Fred Hu, *Reforming China's Banking System: How Much Can Foreign Strategic Investment Help?*, Stanford Center for International Development, 2006, p. 44; see: *http://scid.stanford.edu/pdf/SCID276.pdf*.

[41] Li Ruogu, *Revisit to China's Financial Reform*, 2001, p. 15 at http://www.emeap.org/review/0111/speach.pdf.

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

The Chinese banking system is quite large when compared to its economy. In 2005, total domestic credit was USD3 trillion (RMB24.8 trillion),[42] 150% of GDP. It is also big compared to the world, the fifth largest, after the United States, Japan, Germany, and the United Kingdom. However, there is now considerable concern over the Chinese banking system's soundness. Since it is still dominated by SOCBs, and hence, the competition is quite low, Chinese banks have a relatively high interest margin of 1.79 percent, compared to 1.38 percent in Western European countries.[43] Lack of competition also breeds inefficiency in operations. Loans account for 61 percent of total bank assets, with 85 percent of these loans going to firms. Within the business loan portfolio, although private firms are now generating more than a half of China's GDP, they receive only 27 percent of total credit - the remaining 73 percent is loaned to SOEs. Modern forms of lending such as mortgage loans and consumer finance comprise a very modest share of total lending, and other forms of bank investments are also a very small share of bank assets. In terms of liabilities, deposits and short-term raised capital constitute to 89.1 percent of total assets, while this figure is only 78.1 percent in Western European countries, reflecting a paucity of banking services now available for bank customers in China.

Since conventional market standards have not been widely applied, loans are of very bad quality, and the bad debt ratio is quite high. China uses the 2004 bad debt figure of USD480 billion, or 36 percent of GDP.[44] However, Ernst & Young estimates the bad debt of the Chinese banking system to be as much as USD900 billion, or 40 percent of total loan and 55 percent of GDP, despite a withdrawal of its report in 2006.[45] According to the official figure announced by CBRC, the total bad debt of the Chinese banking system (excluding what has been transferred to AMCs) was USD170 billion as of the third quarter of 2006, of which SOCBs accounted for USD132 billion.[46] Whatever the actual number is, bad debts are certainly a very serious problem in the Chinese banking system.

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

[42] See: http://www.pbc.gov.cn/english/diaochatongji/tongjishuju/gofile.asp?file=2005S4.htm, 22/08/2006.
[43] According to Ligang Songbieen, interest rates had been increasing significantly in the late 1990s. For a one-year loan, the interest margin was as much as 3.6 percent in June 1999 (Huang, 2006, p. 122).
[44] Huỳnh Thế Du, *Triangle Relationship among State-Business - Banks*, 2005, p. 2 at http://www.fetp.edu.vn/index.cfm?rframe=/research_casestudy/facresearchlist.htm.
[45] *The Financial Times*, May 4, 2006 at http://www.chinadaily.com.cn/china/2006-05/15/content_590282.htm, 09/02/2007; and Ernst & Young, Global Nonperforming Loan Report 2006 at http://www.chinalawblog.com/chinalawblog/files/ey_rehc_nonperformingloans_may20061.pdf.
[46] See: http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=2887, 08/02/2007.

percent, compared to 8 percent international standard and 12.35 percent Western European average.[47] CARs of equitized banks, however, have been significantly improved.

Table 2: A Snapshot of Chinese Banks from 1997 to 2003

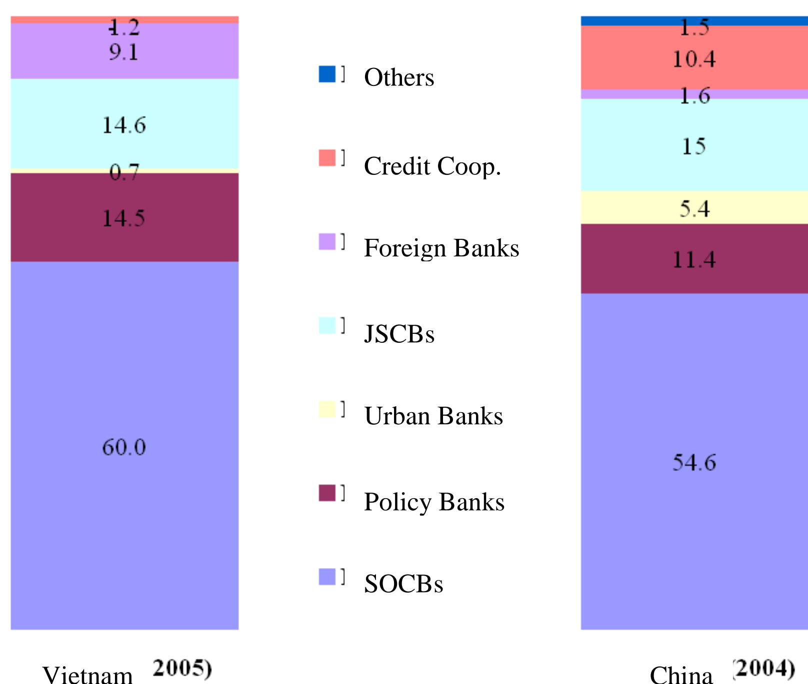
Items	1997	1998	1999	2000	2001	2002	2003
ROA (%)	**0.43**	**0.22**	**0.2**	**0.26**	**0.23**	**0.22**	**0.14**
SOCBs	0.19	0.09	0.13	0.22	0.16	0.18	0.08
Other commercial banks	1.05	0.75	0.49	0.41	0.41	0.37	0.32
JS commercial banks	0.78	0.58	0.45	0.4	0.39	0.34	0.29
Other	1.5	1.03	0.57	0.43	0.46	0.51	0.47
Policy banks	0.12	0.07	0.06	0.14	0.26	0.01	0.03
ROE (%)	**9.39**	**4.19**	**3.48**	**4.59**	**4.21**	**4.48**	**3.05**
SOCBs	5.94	2.08	2.35	4.07	3.16	3.78	1.73
Other commercial banks	14.61	10.55	7.22	6.49	8.1	9.33	8.56
JS commercial banks	13.76	10.47	8.69	8.42	9.5	9.17	8.07
Other	15.42	10.62	5.86	4.54	5.86	9.81	10
Policy banks	2.68	1.4	1.21	2.97	4.99	0.23	1
NIM (%)	**2.03**	**2.07**	**1.9**	**2.22**	**1.93**	**1.95**	**2.03**
SOCBs	2.4	2.47	2.07	2.35	1.98	2.02	2.11
Other commercial banks	2.49	2.5	2.25	2.24	2.1	2.18	2.19
JS commercial banks	2.38	2.57	2.2	2.3	2.32	2.21	2.27
Other	2.68	2.4	2.32	2.14	1.43	2.04	1.89
Policy banks	0.06	0.02	0.81	1.63	1.47	1.01	1.21
Expenses/Income (%)	**54.51**	**65.4**	**62.22**	**56.61**	**54.51**	**55.52**	**51.68**
SOCBs	49.31	66.33	59.16	56.18	55.52	51.76	47.87
Other commercial banks	49.56	59.96	64.07	59.8	51.17	50.92	45.67
JS commercial banks	56.05	63.13	55.33	52.24	50.48	50.64	44.71
Other	38.61	54.47	77.17	75.2	54.47	52.04	49.52
Policy banks	65.94	34.25	48.49	23.47	6.23	64.93	67.22
Equity/Total Assets(%)	**4.54**	**6.03**	**5.72**	**5.56**	**5.16**	**4.54**	**4.34**
SOCBs	3.15	5.61	5.28	5.32	5.04	4.59	4.38
Other commercial banks	7.2	7.01	6.6	5.99	4.22	3.81	3.76
JS commercial banks	5.68	5.36	4.95	4.53	3.86	3.56	3.55
Other	9.72	9.63	9.7	9.07	5.91	4.78	4.57
Policy banks	4.6	4.73	4.59	4.72	5.98	2.81	2.95
Equity/Debt (%)	**4.76**	**6.41**	**6.07**	**5.89**	**5.44**	**4.76**	**4.55**

[47] García-Herrero and Santabárbara, op.cit., p. 309-311.

SOCBs	3.26	5.94	5.57	5.62	5.31	4.81	4.58
Other commercial banks	7.76	7.54	7.07	6.37	4.41	3.96	3.97
JS commercial banks	6.02	5.66	5.2	4.75	4.01	3.69	3.77
Other	10.76	10.66	10.75	9.97	6.28	5.02	4.79
Policy banks	4.82	4.97	4.81	4.96	6.36	2.9	3.04
Risk Provision/Loan(%)	**1.03**	**1.26**	**1.55**	**1.46**	**1.81**	**1.81**	**3.3**
SOCBs	1	1.12	1.52	1.24	1.66	1.82	3.91
Other commercial banks	1.83	2.43	2.99	3.82	2.93	2.32	2.08
JS commercial banks	1.05	1.63	2.23	3.94	3.35	2.6	2.24
Other	3.06	3.84	4.69	3.52	0.8	1.01	1.32
Policy banks	0.73	1.06	0.79	0.73	1.64	1.02	1.01
Risk Provision (USD mil)	**2,197**	**2,957**	**3,662**	**6,971**	**10,277**	**10,379**	**14,061**
SOCBs	2,109	2,409	3,203	5,565	7,989	8,798	11,025
Other commercial banks	74	113	371	756	1,008	1,582	3,036
JS commercial banks	74	113	355	715	906	1,229	2,603
Other	0	0	15	41	102	353	433
Policy banks	0	436	89	650	1,281	0	0

Source: García-Herrero and Santabárbara.

Figure 2: Distribution of Vietnamese and Chinese Banking System Assets[48]



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

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

III.2.4. Non-Bank Financial Institutions and Markets[49]

III.2.4.1. Stock Markets

III.2.4.1.1. Vietnam

HOSTC began operations with two listed companies on July 28, 2000. [50] The VN-Index has frequently fluctuated since then to reflect changing and sometime volatile market conditions. After almost eight years (June 22, 2008), the VN-Index was at 368, reflecting an annual growth rate of 17.8 percent. Although this is quite high compared to other exchanges with similar conditions, it is less than 69 percent of its March 2007 peak of 1,171. By end of April 2008, there were about 300 listed companies on Vietnam's two bourses with a total capitalization of USD20 billion, equivalent to 28 percent of Vietnam's GDP. Like China, the role of stock market in Vietnam is growing, but it is still quite modest compared to the dominant role of banks. Although difficult to document, total OTC capitalization is estimated to be three to four times greater than the formal stock exchanges.[51] Vietnam's stock market is also relatively illiquid, although the volume of transactions was growing rapidly until October 2007: the average daily turnover in August 2007 was USD51.5 million, six times greater than the 2006 figure of USD8.3 million. However, in the first half of 2008, during which time the government narrowed the trading band, the daily turnover has fallen to less than USD 10 million.

III.2.4.1.2. China

In China the stock markets were created in early 1990 with establishment of two stock exchanges: the Shanghai Stock Exchange in 1990 and the Shenzhen Stock Exchange in 1991. There are two kinds of shares traded on these exchanges: A-shares in domestic currency that are bought by domestic investors and foreign investors who meet China's requirements as specified in the Qualified Foreign Instutional Investors regulation; and B-shares in foreign currency (US dollars in Shanghai and Hong Kong dollars in Shenzhen), only for foreign investors until 2001, but now open to domestic investors with legitimate foreign accounts. After almost seventeen years (June 22, 2008), the Shanghai composite – one of main indices, was at 2,760, reflecting an annual growth rate of 21.5 percent, quite high compared to other exchanges with similar conditions, but still less than 55 percent of its October 2007 peak of 6,092. As of June 1, 2007, market capitalization was 17.21 trillion yuan (USD2.25 trillion),[52] 89.3% of China's GDP in 2006. Although the role of the securities market is growing in China, it is still quite modest compared to the role of banks.

---

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

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

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

[52] Xinhua News Agency, June 3, 2007

Figure 3: VN-Index and Shanghai Composite Index Trends Since 1990

Source: Global Financial Data

Figure 3 compares VN-Index and Shanghai Composite Index trends since 1990. A key characteristic of stock market transactions and trends in both Vietnam and China is that share prices and investor behavior are driven more by speculation than by the fundamental values of listed firms, as indicated by: extremely high turnover velocity with relatively low concentration[53]; synchronous stock prices[54]; and a high correlation between buy and sell trades.[55] This is commonly attributed to weak protection of minority shareholders and poor market regulation and supervision, resulting in insider manipulation and trading.[56]

III.2.4.2. Bond Markets

III.2.4.2.1. Vietnam

In Vietnam, at the end of 2007, outstanding bonds totaled USD9.79 billion, equivalent to 13.7 percent of GDP, of which government bonds accounted for USD8.28 billion, or 84.6 percent.[57] The remaining debt securities consisted of education and infrastructure bonds, Ho Chi Minh City and Hanoi municipal bonds,[58] DAF/VDB (Development Assistance

[53] "Turnover Velocity" is the total turnover for the year as a percentage of total market capitalization; "Concentration" is the fraction of total market capitalization of an exchange measured by the combined capitalization of the largest firms ranked in the top 5 percent (by capitalization).
[54] "Synchronous" means that sock prices move up and down together, like herd behavior.
[55] "High Correlation" means that buy and sell trades occur in the same time period, such as the same day.
[56] For examples from China of the three indicators summarized in this paragraph, as well as of the numerous lawsuits against insider manipulation and trading, see: Allen, Qian, and Qian, op.cit., pp. 25-28.
[57] Authors' calculations from a variety of official and unofficial sources – these figures are significantly larger than those presented in Thanh and Quang (p. 17).
[58] Ho Chi Minh City and Hanoi are authorized to issue municipal bonds up to 100 percent of their annual investment budget; the limit for other cities is 30 percent of their annual investment budget.

Fund/Vietnam Developmen Bank) bonds,[59] SOCB recapitalization bonds, [60] BIDV bonds, Vietcombank convertible bonds, and other corporate bonds.

III.2.4.2.2. China

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

In both Vietnam and China, the bond market is quite small compared to bank loans (especially in Vietnam), and in both countries, most bonds have been issued by the government. The liquidity of bond markets in both countries is very low, as most investors hold bonds until maturity given the lack of comparable alternative investment opportunities. In Vietnam, most long-term bonds (10 to 15 years), comprising roughly 40 percent of the total, are purchased by insurance companies; short-term bonds (mostly 5-year bonds) are purchased by SOCBs.[61]

III.2.4.3. Insurance Markets

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

III.2.4.4. Microfinance

III.2.4.4.1. Vietnam

Microfinance is a mixture of formal, semi-formal, and informal activity. The government views microfinance as poverty alleviation rather than financial intermediation. It believes that it can best help the poor by income transfers via subsidized credit and savings programs, rather than by promoting sustainable financial services for low-income households and family businesses. Thus, the government tries to help poor people through special programs implemented by state-owned financial institutions and its credit fund system, comprised of semi-state controlled institution. NGOs (Non-Governmental Organizations) also play a significant role: according to the International Labor

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

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

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

Organization (ILO), there are 57 international NGOs now supplying microfinance services, mostly credit, in Vietnam.[62] Although NGO implemented microfinance is a fertile ground for experimentation and innovation, these initiatives are often not sustainable and they are difficult to scale-up for greater geographic coverage. A large part of microfinance consists of informal activity called *hụi* or *họ*; these are Vietnamese ROSCAs - Rotating Savings and Credit Associations for relatives, friends, and neighbors to pool and distribute their savings. ROSCAs were once illegal in Vietnam, but are now permitted. Although *hụi* or *họ* do help to mobilize savings, their function is as much social as financial, and they complement rather than substitute for formal financial services. 1,000 people's credit funds with about VND 10 trillion in loans outstanding have also had a role in supplying microfinance services (mostly loans) for the poor. In sum, Vietnam does not yet have a commercially-based model for the delivery of essential savings, credit, and payment services for most of its population, known elsewhere as the "unbanked majority." Thus, there remains considerable potential in Vietnam to develop a much more inclusionary financial sector.[63]

III.2.4.4.2. China

In China, the situation is similar to Vietnam, being a mixture of formal, semi-formal, and informal activity. Most spending is done by the government as part of its poverty alleviation efforts, primarily channeled through state institutions. NGOs, working with the government and foreign donors, have also implemented many microfinance pilot projects. However, these pilots face the same problem as they do in Vietnam: how to sustain and replicate these models when donor and government funding runs out?. China has ROSCAs as well, also called *hui*, which function much like they do in other countries. However, in China, *hui* have periodically been transformed from a grassroots mechanism to provide low-income households with a community-based source of savings and credit to pyramid investment schemes. A national network of rural financial institutions provides the foundation for the large-scale, and helps in sustainable provision of microfinance: the RCCs (Rural Credit Cooperatives). Reform of the RCCs is a high government priority, as indicated by the recent USD20 billion injection of recapitalization funds, together with efforts to consolidate RCCs at the county or provincial level and strengthen their ownership and governance structures. Although RCC micro-credit delivery has had the same problem at the local level as SOCBs have had at the national level, namely policy or political based lending to TVEs (Township and Village Enterprises), the RCCs have been very successful at savings mobilization. At the end of 2001, the RCCs had USD210 billion in savings, 12 percent of all financial institution deposits in China, and 80 percent of these savings came from rural households.[64]

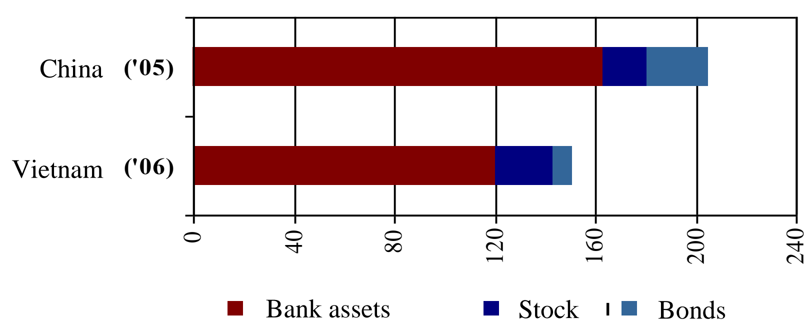
---

[62] Le Lan and Nhu-An Tran, *Towards a Viable Microfinance Sector in Viet Nam: Issues and Challenges*, ILO Viet Nam Working Paper Series No. 5 (Hanoi: ILO Office in Viet Nam, 2005), p. 1.
[63] For a nice analysis of the potential and challenges for developing microfinance in Vietnam, see: *Conference Summary Report: Making the Transition to a Regulated and Financially Sustainable Vietnamese Microfinance Industry*, CEP Vietnamese Microfinance Conference, 14-16 May 2007, HCMC.
[64] For more micro-savings data, as well as a nice summary of microfinance in China, see: Roumei Sun, *The Development of Microfinance in China*, Kennedy School of Government Financial Sector Program Working Paper No. 1, August 2003.

III.2.4.5. Bank versus Non-Bank Financial Institutions and Markets

In Vietnam, the securities market did not take off until 2006, and even then the USD14 billion total value of all listed companies plus an additional USD5 billion in government and corporate bonds accounted for only 20 percent of total financial assets and 30 percent of GDP. In China, the securities market was set up in the early 1990s, but by the end of 2005, the market value of all listed companies and outstanding bonds was only 20 percent of total financial assets and 40 percent of GDP. Moreover, the State held as much as two-thirds of total shares of listed companies, and these shares were almost never traded. [65] Banks continue to dominate the provision of financial services in both Vietnam and China, as indicated by Figure 4 below.

Figure 4: The Structure of Financial Assets in China and Vietnam (% GDP)



Source: WB and the author's calculations

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

SECTION IV: FINANCIAL SECTOR REFORM IN VIETNAM AND CHINA

IV.1. Financial Sector Liberalization

IV.1.1. Interest Rate Controls

IV.1.1.1. Vietnam

In Vietnam, banking system liberalization in the late 1980s was quite extensive, as most "economic organizations" were allowed to raise capital from the public and lend these funds at self-determined loan terms and conditions. This dramatic break with the past was too successful, highlighting the dangers of financial liberalization with inadequate regulation and supervision[66]. After a series of destabilizing disruptions, credit activities were severely tightened, and both loan and deposit rates were curbed. Since 1992, SBV has tried to tie nominal interest rates to the consumer price index in an attempt to secure positive real interest rates. Loan rate differentiation among various sectors was eliminated in 1993. Beginning in 1995, SBV allowed commercial banks to set deposit rates freely to increase competition in raising capital but the maximum loan-deposit rate spread was restricted to 0.35 percent per month, so indirectly, banks were still subject to both loan and deposit rate ceilings. When interest rate competition started increasing between banks, the restriction of 0.35 percent per month gradually became ineffective, and was finally formally removed. As banks became more commercialized in their operations, they began to focus more on meeting market demand rather than channeling directed credit. This created severe competition between banks and difficulties in finding bankable projects, putting a downward pressure on deposit and loan rates.

A new interest rate mechanism was adopted in August 2000: domestic currency loan rates were adjusted based on the prime rate announced by the SBV. Banking operations during this period were virtually unaffected by this new regulation on prime rate-based lending due to rigorous competition and the relatively large interest rate band. The ceilings on foreign currency loan rates were eliminated in November 2001, and the last restrictions on interest rates were removed in June 2002. Since then, at least according to the banking law and accompanying implementation regulations, banks have been fully free in deciding all loan and deposit rates. However, according the civil code, this is not correct, and interest rate ceilings are still in effect[67]. The situation is made even more opaque because of the difference between "base rate" as defined in Vietnam banking laws and the conventional interpretation of "base rate."

In sum, despite significant improvements in interest rate policy management over the past two decades, implementation of interest rate liberalization decisions has often fallen well short of the stated objectives of these policy reforms because of the considerable confusion surrounding interest rates and interest rate liberalization in Vietnam. SBV undercuts its own interest rate liberalization policy through a combination of promulgation of its base rate, utilization of the above-cited civil code provisions, and an

---

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

[67] Earlier, Article 473 of the 1995 Civil Code stated that lending rates should be negotiated between lender and borrower, but could be no higher than 50 percent of SBV's base rate

interest rate agreement with the Vietnam Bankers Association - an industry cartel in which the SOCBs still play a dominant role. This has been especially evident during the current surge of inflation.

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

IV.1.1.2. China

In China, interest rates have gradually but steadily been liberalized over the past twelve years, but, like Vietnam, the process is not yet complete. Interest rates were first liberalized in the money and bond markets; this was followed by liberalization of lending rates; and finally, deposit rates were liberalized. However, deposit rates are still negative in real terms, offering a disincentive to deposit money in the banking system, and the spread for lending rates is still too small to cover the transaction costs of commercially sustainable microfinance. PBOC plans to remove the interest rate ceilings on RMB (remimbi – Chinese currency) deposits and liberalize interest rates on small deposits of less than one year maturity in the future. In this context, PBOC has also introduced market-based monetary policy tools[68].

IV.1.2. Credit Lines and Directed Credit

IV.1.2.1. Vietnam

In Vietnam, extensive use was made of credit lines to manage monetary policy beginning in 1994, but the government notionally eliminated this practice in 1998. Nonetheless, SBV continues to set target credit growth rates for the banking system, of which the SOCBs comprise the largest share. In fact, directed credit and credit to SOEs have indeed been significantly reduced, falling from 90 percent[69] of total credit in the early 1990s to 31.4 percent by March 2007[70]. This suggests that commercial banks, including SOCBs, are now facing declining pressure to grant credit to the public sector. However, the story is dramatically different if the loan balances of the policy banks, especially VDB, as well as the local investment funds and VBARD loans to farmers, are taken into account[71].

"Quarantining" directed credit outside of the mainstream banks helps to improve the market orientation and commercial performance of Vietnam's banking sector, thus

---

[68] García-Herrero and Santabárbara, op.cit., p. 318; Christian Roland, "*Banking Sector Reform in India and China – A Comparative Perspective,"* 2006, p. 14 at

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

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

[71] Thành, op.cit., p. 142.

reducing its vulnerability to systemic credit risk, but it also poses considerable opportunities for misallocation of capital and institutional corruption. These institutions are off-budget mechanisms to channel resources to public enterprises, with little transparency and minimum disclosure requirements; they are essentially political institutions masquerading as banks, beyond the purvue of SBV.

IV.1.2.2. China

In China, SOCBs have had more autonomy and accountability in their lending decisions since the early 1990s. Credit quotas have been removed, and the government's intervention in credit allocation has been prohibited, at least formally[72]. However, the fact that most of bank loan balances, especially for SOCBs, are on the balance sheets of SOEs suggests that directed credit seems to be pervasive in Chinese SOCBs *de facto*, in addition to special-purpose financial institutions conducting directed lending *de jure*[73]. This remains is a big problem in reforming the banking system, especially the SOCBs in China, and can only be fully resolved as the SOEs themselves are commercialized, equitized, or liquidated. It appears that directed credit and credit to SOEs is more pervasive in China than in Vietnam.

IV.1.3. Reserve Requirements

In Vietnam, required reserves[74] have never been a source of budget revenue, because although the required reserve ratio may be as high as 35 percent[75], it has never been above 15 percent in practice. Instead, required reserves have been used solely as a tool to execute monetary policy. SBV has utilized the USD required reserve ratio in a similar manner. In China, treatment of required reserves is similar to Vietnam's, namely as a tool to execute monetary policy rather than as a way to finance budget deficits.

IV.1.4. Foreign Exchange Policy and Exchange Rate Management

IV.1.4.1. Vietnam

In Vietnam, both foreign exchange and the exchange rate are tightly controlled, although the fixed exchange rate regime has been replaced by a pegged float exchange rate regime[76]. According to current laws, "the exchange rate of the Vietnamese currency is created by the demand for and the supply of foreign currencies in the market under the government's regulation."[77] In practice, SBV announces the so-called inter-bank exchange rate of the VND against the USD every day. Based on this rate, banks decide their trading rates within a specified band around the announced rate[78]. For other foreign

[72] García-Herrero and Santabárbara, op.cit., p. 327.
[73] In late 1999, the loan balance to the private sector was only USD7 billion, accounting for 0.62% of total bank loan balances, and less than 0.5% of loan balances of SOCBs (Huang, op.cit., p. 117).
[74] The reserve requirement ratio is the percentage of customer deposits that banks must set aside as reserves.
[75] Regulation on Reserve Requirement promulgated in association with Decision 108/QĐ-NH dated 09/06/1992 of the SBV.
[76] Nguyễn Văn Tiến, "Modern International Finance: Assessing Vietnam's exchange rate policy after 20 year of reforming*,"* Statistical Publisher, 2005, p. 795; and Phí Đăng Minh, *"Current situation and Conditions to liberalize capital account in Vietnam,"* SBV, 2007, p. 23
[77] Ordinance on Foreign Exchange in 2005, Provision 1, Article 30.
[78] Decision 2554/2006/QĐ-SBV dated 31/12/2006, Article 1.

currencies, banks are fully free to decide the exchange rates. If necessary, the government can "apply the regulations on the obligation to sell foreign currencies for institutional residents," as well as some other administrative measures[79]. At present, the IMF considers that Vietnam has implemented Article 8 of IMF regulations on the capital account and exchange rate controls[80].

There have been several types of exchange rates during the reform process: the official rate announced by SBV, the rate at which commercial banks make transactions (nominal and effective), and the rate in the free market (black market). During the early years of reform the official and free market rate spread was very large, but the gap had closed significantly by the end of 2006 (see table 3 below). However, the spread has begun to widen again during the current financial crisis, as has the difference between the nominal and effective exchange rates of commercial banks when SBV's official trading band does not reflect market prices.

Table 3: The Spread between Official and Free Market Exchange Rates

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

Source: SBV; *Tiến*, op. cit.

IV.1.4.2. China

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

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

[79] Ordinance on Foreign Exchange in 2005, Article 41.
[80] See: http://www.imf.org/external/np/sec/pr/2006/pr0602.htm, 31/12/2006.

RMB remained almost fixed at 8.27 per USD until July 2005[81]. The RMB is now undergoing "managed appreciation"; it had risen 6 percent against the USD by the end of 2006, and the trend has continued through the first half of 2008, rising to 6.9 per USD.

IV.1.5. Capital Flows Policy and Capital Account Management

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

IV.2. Financial Sector Deregulation

IV.2.1. Barriers to Entry, Expansion, and Diversification

IV.2.1.1. Vietnam

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

Opening up the Vietnamese banking system was a mixed success. Competition did increase dramatically, as the number of JSCBs grew from only 4 in 1991 to 51[82] in 1997. However, this rapid growth also created a bifurcated and imbalanced market in which.
most of the assets were concentrated among the SOCBs and the rest of the market was extremely fragmented and characterized by destructive competition among the JSCBs. This led to a market consolidation via bank restructuring and mergers, particularly during 1999-2001, so that by 2006 the number of JSCBs had fallen to 37. However, SBV recently has allowed the establishment of new banks.

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

---

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

[82] Vu Viet Ngoan, *Financial Reform in Vietnam: Toward International Integration,* ABA 20th Annual Meeting and Seminars, 2003.

risk of SOE diversification into the financial sector has been compounded by the desire of many of the banks themselves to diversify their operations by becoming universal banks.

So now Vietnam is both well banked and poorly banked. In terms of number of institutions and their retail distribution networks, the growth has been encouraging: there are now 80 banks and 924 credit cooperatives in Vietnam, and the SOCBs alone have over 3,000 offices around the country. In terms of market composition, though, the figures indicate there are still significant structural weaknesses in the competitive position of JSCBs vis-à-vis SOCBs: in 2006, the market share of SOCBs was still nearly 70 percent of total deposits and 65 percent of outstanding credit, while the top 15 banks in Vietnam together had 92.4 percent of market share by assets, excluding foreign bank branches[83]. Furthermore, the majority of Vietnamese businesses and households still do not have access to formal financial services, as most of the banks in Vietnam are chasing the same small subset of formal businesses and relatively high-income urban consumers.

IV.2.1.2. China

In China, the saga of falling barriers to entry, expansion, and diversification is similar to Vietnam's story, but beginning about a decade earlier. For most of the 1980s, the most significant development of China's financial system was the growth of non-SOCB financial intermediaries: regional banks, partially owned by local governments, were formed in the coastal SEZs (Special Economic Zones); RCCs were established in rural areas and UCCs in urban areas; other non-bank institutions were also established, such as Trust and Investment Corporations; and foreign banks set up branch offices in SEZs for currency exchange operations[84]. All of these new financial intermediaries began to take deposits and make loans, which was healthy for enhancing market competition and was extremely successful in mobilizing savings. However, this also contributed to higher levels of inflation, and most of the credit was directed at either SOEs or TVEs, simply replacing financing via budget allocations with financing via the channeling of funds through the banking system[85]. This off-budget financing mechanism, while attractive politically, not only undermined the soundness of China's financial intermediaries, but was also illusionary. When many of these loans were not repaid and the lenders became insolvent, the burden reverted to the budget in the form of allocations to recapitalize these financial intermediaries.

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

[83] Thanh and Quang, op. cit., pp. 7-8.
[84] Allen, Qian, and Qian, op. cit., p. 7.
[85] For example, "the main investment channel for firms (from the government to SOEs) shifted from budget appropriation (70% in 1978) to loans from state-owned banks (80% in 1982)." (Allen, Qian, and Qian, p.7.)

IV.2.2. Privatization/Equitization

IV.2.2.1. Vietnam

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

IV.2.2.2. China

In China, as a result of IPOs in 2005 and 2006, three of the "big four" SOCBs are already listed on the Hong Kong and Shanghai Securities Exchanges (BOC, CCB, and ICBC), and an IPO is planned for ABC (Agriculture Bank of China) after it is recapitalized with a $100 billion injection of state money. The primary difference between China's three IPOs and Vietnam's IPO for VCB is that to date, China has adhered to the concept of two-stage equitization as indicated in Table 4 bellow. China's SOCBs not only raised substantial sums of capital from their strategic investors, but these strategic investors also participated in SOCB governance and management, and provided many forms of technical assistance[86].

IV.2.3. Participation of Foreign Financial Institutions

IV.2.3.1. Vietnam

Vietnam has been gradually opening its financial sector to foreign institutions in accordance with the BTA it signed with the United States in 2000 (effective in 2001), and the terms of its WTO ascension in 2007, as summarize in Figure 5 below. In response to Vietnam's opening up of its financial sector, there has been a stream of foreign investment in domestic JSCBs. Some of these have been very high-profile transactions, such as ANZ's purchase of 10 percent of Sacombank and Standard Chartered's purchase of 8.6 percent of Asia Commerce Bank – not only are these blue-chip investors, but they are buying stakes in two of Vietnam's largest and most profitable JSCBs, as summarized in Table 5 below. Recently there has been a heated debate on whether to increase the ceiling on foreign ownership in a domestic bank to 49 percent, but this issue has not yet been resolved. Given the relatively small size of Vietnamese banks and the Vietnamese economy compared to China, there is greater fear of the impact of foreign ownership on national sovereignty in Vietnam than in China.

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

Table 4: Foreign Investors in China's three Largest Banks

Bank	Profile	Total Asset (US$ billion)	MV/Asset (%)	Strategic Investor(s)	Date Complete	Deal Size (US$ million)	% of shares	Key Terms
Industrial and Commercial Bank of China	• The largest commercial bank in China with total assets of RMB5.59 trillion, end 2004	675.94	5.6%	Goldman Sachs, Allianz and America Express	Jan-06	3,800	10	• One board seat • Extensive cooperation in corporate governance, treasury operations, risk management, asset management, and human resource training etc
Bank of China	• Second largest commercial bank in China with total assets of RMB4.27 trillion, end 2004	516.32	5.9%	Royal Bank of Scotland and co-investors	Aug-05	3,048	10	• Various cooperation in credit card, corporate business, personal insurances, etc. • One board seat
				Temasek	Aug-05	1,524	5	• Committed to acquire no less than US$500 million worth of shares during IPO • One board seat
China Construction Bank	Third largest commercial bank in China with total assets of RMB3.91 trillion, end 2004	72.79	6.1%	Bank of America	Jun-05	2,500	9.1	• Cooperation includes corporate governance, risk management, information technology, finance management, etc. • Board seats • Approximately 50 BOA employees going to CCB to provide consulting services • Option to purchase additional shares in future to increase ownership up to 19.9%
				Temasek	Jul-05	1,466	5.1	• Committed to acquire no less than US$1.0 billion worth of shares during IPO • Facilitate CCB's restructuring • One board seat

Sources: Hope and Hu, and other sources.

Table 5: Foreign Investors in Vietnam's Joint Stock Commercial Banks

Bank	Total Asset (US$ billion)	Strategic Investor(s)	Date Complete	Deal Size (US$ million)	% of shares
Asia Commercial Bank	1.5	Standard Chartered	Jun-05	45	10
Sacombank	1.5	ANZ	Mar-06	27	10
Techcombank	1.1	HSBC	Dec-05	17	10
VB Bank	0.6	OCBC	Mar-06	Na	10
Orient Commercial Bank	0.4	BNP Paribas	Nov-06	Na	10
Southern Bank	0.6	UOB	Jun-07	Na	10
Habubank	0.7	Deutsche Bank	Feb-07	Na	10
Eximbank	1.5	SMBC	Mar-07	Na	10

Source: authors' collection from various sources

Figure 5: Vietnam's WTO Commitments in the Financial Sector

1. Foreign credit institutions are only permitted to establish commercial presence in Viet Nam in the following forms:
   a. With respect to foreign commercial banks: representative office, branch of foreign commercial bank, commercial joint venture bank with foreign capital contribution not exceeding 50% of chartered capital, joint venture financial leasing company, 100% foreign-invested financial leasing company, join venture finance company and 100% foreign-invested finance company, and, beginning on 1 April 2007, 100% foreign-owned banks are permitted.
   b. With respect to foreign finance companies: representative office, joint venture finance comp 100% foreign-invested finance company, joint venture financial leasing company and 100% foreign-invested financial leasing company.

2. During 5 years from the date of accession, Viet Nam may limit the right of a foreign bank branch to accept deposits in Vietnamese Dong from Vietnamese natural persons with which the bank does not have a credit relationship to a ratio of the branch's paid-in capital according to the schedule below:
   - 1 January 2007: 650% of legal paid-in capital;
   - 1 January 2008: 800% of legal paid-in capital;
   - 1 January 2009: 900% of legal paid-in capital;
   - 1 January 2010: 1,000% of legal-paid-in capital;
   - 1 January 2011: Full national treatment.

3. Equity participation:
   - Viet Nam may limit equity participation by foreign credit institutions in equitized Vietnamese state-owned banks to the same level as equity participation by Vietnamese banks.
   - For capital contribution in the form of buying shares, the total equity held by foreign institutions and individuals in each Viet Nam's joint-stock commercial bank may not exceed 30% of the bank's chartered capital, unless otherwise provided by Viet Nam's laws or authorized by a Viet Nam's competent authority.

Source: WTO, Working Party on the Accession of Viet Nam

IV.2.3.2. China

In China, an important milestone of financial sector liberalization was WTO ascension in late 2001. According to its WTO commitments, China had a five-year timetable similar to the one Vietnam is now following. China has worked steadily to meet this objective, although progress has been slow given the complexity and sensitivity of foreign participation in China's domestic banking market. The process has been incremental and actually started more than two decades ago. The number of foreign bank branches indeed increased from 157 in 2001 (WTO accession) to 192 in 2004. Most of these bank offices are from Asian economies (Taiwan, Hong Kong, and Korea)[87]. The number of representative offices also increased, from 184 to 223. Although not part of its WTO commitments, China has also increased the single foreign investor ownership ceiling in a domestic bank from 15 to 20 percent, and the total foreign investors' ownership ceiling 25 percent. This is consistent with a common perception that China's banking system is in need of capital, as well as banking governance and management expertise. By October 2005, 17 foreign banks had bought shares in domestic banks totaling USD20.88 billion[88].

IV.3. Financial Sector Stabilization

IV.3.1. Restructuring

IV.3.1.1. Vietnam

In Vietnam, the focus of most bank restructuring efforts has been on SOCBs in preparation for their IPOs. Responding to the relatively low level of SOCB efficiency and profitability, the government's efforts have focused on trying to improve governance and management systems, capital structure and asset quality, and effective application of banking technology. Significant progress has been made in reducing formal preferential lines of credit and officially directed credit as part of financial sector liberalization, but there is still considerable informal government interference in SOCB operations. There have also been some significant reforms of Vietnamese JSCBs, such as institutional consolidation and financial capacity enhancement during the late 1990s[89]. One tangible result of these efforts is that the Sacombank and ACB JSBCs are officially listed in the securities market, and have two of the highest capitalization of all listed firms. However, the process still has a long way to go, as evidenced by growing financial sector distress.

IV.3.1.2. China

China has also focused most of its attention on restructuring its SOCBs to prepare them for their IPOs. Other significant reforms in China have been launched to address structural weaknesses in the financial sector, especially regarding the credit cooperative system. Those credit cooperatives that meet a series of conditions specified by the government are entitled to receive additional capital or tax incentives from PBOC or local

---

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

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

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

governments. In addition, loss-making credit cooperatives might have to shut down. The objective is to reduce the 36,000 credit cooperatives in China in 2004 to only 10,000 credit cooperatives by 2007, mostly through consolidation at the county level. To date, the government has supported this consolidation effort by injecting USD20 billion into restructured credit cooperatives, coupled with improved ownership and governance practices. The key shortcoming of these reforms is lack of attention to the operational side of the credit cooperatives, particularly for credit services.

IV.3.2. Bad Debt Resolution

IV.3.2.1. Vietnam

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

The internal status of AMCs in Vietnam also has significant accounting ramifications. In China, although AMCs are closely related to banks, they are formally independent, so banks write off debts transferred to AMCs. In Vietnam, however, bad debts transferred to AMCs still appear on the bank's consolidated balance sheet, negatively affecting many key performance indicators related to bank solvency and profitability[90]. This, in turn, provides powerful incentives to under-report bad debts using techniques such as: rolling over non-performing loans with capitalization of unpaid interest (evergreening); restructuring non-viable loans with lower interest rates and longer repayment periods (rescheduling); and artificial inflation of loan disbursements that either never actually leave the bank but instead are transferred to the borrowers current account, or that quickly "round-trip" to the bank after the close of the reporting period (window dressing).

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

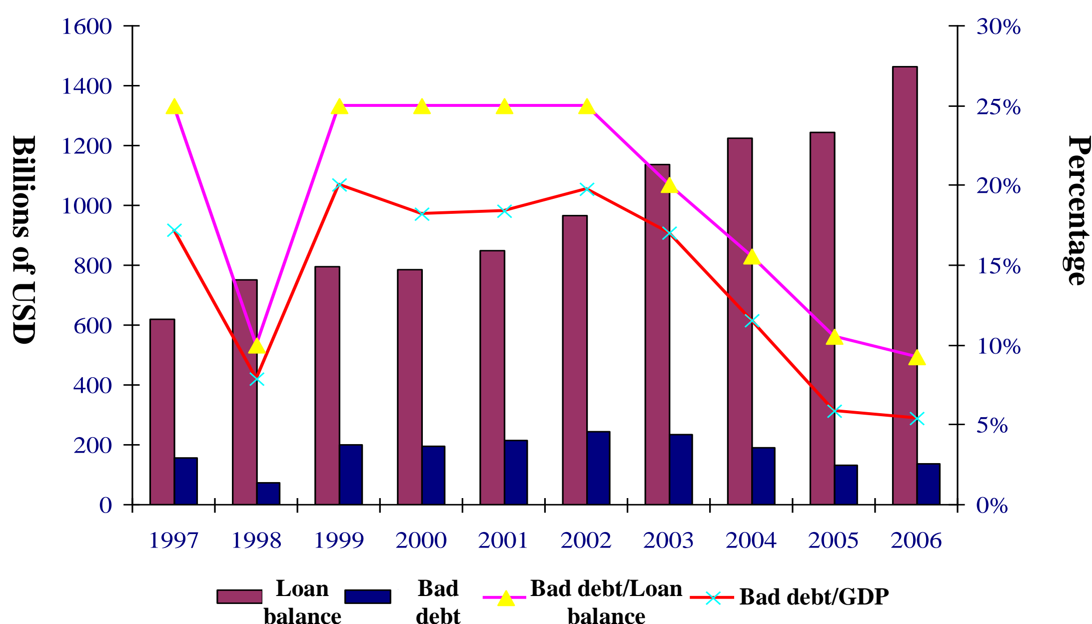
IV.3.2.2. China

In China, bad debts of banks have been resolved either by AMCs, or by the banks themselves, by liquidating collateral, converting debt into equity, and selling debt to investors, including foreign investors. Total SOCB bad debt received by AMCs was around USD323 billion. As of the end of March 2006, AMC had resolved USD111 billion in bad debt and collected USD23.1 billion; the recovery ratio was very small, only 24.2 percent. Data on resolution of USD153 billion in bad debt that was transferred

[90] VCB plans to dissolve the AMC in its equitization package.

recently is not yet available. The AMCs have been operating for almost ten years, which is their expected lifetime, but their performance has been very limited, and many have questioned the rationale and role of the Chinese AMCs[91].

Figure 6: The Bad Debt of Chinese SOCBs



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

In addition to the bad debts transferred to AMCs, Chinese SOCBs still have very large bad debts to be resolved on their own. The total bad debt of the "big four" SOCBs fell from USD232 billion in 2003 to USD140 billion in 2006, and the SOCBs themselves had resolved USD157 billion by the end of 2005[92]. Detailed data is not available, but it is likely that debts have been resolved using the bad debt provision to write them off the SOCB balance sheets, which poses other problems for banks.[93] Trends in Chinese SOCB bad debt are shown in Figure 6, although it should be noted that NPLs in China are widely believed to be significantly underreported.[94]

---

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

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

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

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

By the end of August 2004, Chinese banks and AMCs had sold debt with a face value of about USD6 billion to foreign investors, of which Citigroup took the highest proportion at a purchase price of almost USD2.2 billion.[95] This figure is a small proportion of the total bad debt of Chinese domestic banks, but it is significant for a single foreign bank, perhaps part of a strategy to increase their market share in China.

IV.3.3. Recapitalization

IV.3.3.1. Vietnam

In Vietnam, the SOCBs received almost no official capital from the government in the 1990s. The government's main SOCB activity during this period was restructuring bank operations and separating directed credit from commercial activities via establishment of VBSP and VDB. From 2001 to 2005, the government granted approximately VND15 trillion in charter capital to the SOCBs to strengthen the financial structure of these banks.[96] Most of this additional charter capital was granted in the form of non-transferable government bonds at an annual coupon rate of 3 percent. If bad debt resolution is taken into account, the amount granted to SOCBs is about USD2 billion, or 4 percent of 2005 GDP, much smaller than in China.

IV.3.3.2. China

In China, the first wave of SOCB restructuring began in 1998 when the government poured USD33 billion into the big four SOCBs in the form of non-transferable RMB-dominated bonds. One year later, USD170 billion in bad debt was transferred to four AMCs.[97]

The second wave started in 2003 as another USD45 billion was granted to BOC and CCB, the two SOCBs that had best resolved their bad debt. This amount was granted in the form of ownership transfer of US government bonds from the national foreign exchange reserves to these banks. Just like the above-mentioned non-transferable bonds, the banks were not allowed to convert these bonds into RMB for a specified time period. However, bank capitalization increased, since the bad debt provision was used to write off bad debt worth USD23.4 billion. In June 2004, BOC received USD18.1 billion and CCB received USD15.6 billion from selling to AMCs bad debt whose face value was double the proceedings.[98] In addition, BOC and CCB increased tier-2 capital through issuing subordinate debt worth USD7.8 billion and USD4.8 billion, respectively. The last steps of this second wave were the IPOs of CCB and BOC, who were listed on the Hong Kong Securities Exchange in late 2005 and June 2006, respectively.[99]

---

[95] PriceWaterHouseCooper, *"China NPL Investor Survey 2004."*
[96] SBV; Phung Khac Ke, "*WTO Accession and Banking Reform in Vietnam,"* 2006, at http://www.epic.com.vn/resources/WTO_accession_banking_sector.pdf.
[97] This issue is discussed in greater detail in the previous section on bad debt resolution.
[98] Selling the debt generates a difference of 50 percent of the debt value between the credit and debit sides of the balance sheet; this difference is offset by the capital granted by the government and bad debt provisions.
[99] García-Herrero and Santabárbara, op.cit., pp. 313-14.

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

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

IV.3.4. Regulation and Supervision

IV.3.4.1. Vietnam

In Vietnam, although promulgation and enforcement of regulations based on international standards has been very difficult to achieve and much work still remains in bringing Vietnam's regulatory and supervisory system up to international banking norms, considerable progress has been made nonetheless in construction of an effective legal framework for banking operations. At present, while the legal framework for bank operations has been considerably strengthened, two key problems remain: weak SBV technical capacity to determine the true soundness of banks, in terms of both individual bank weaknesses and vulnerabilities, as well as the systemic risk of banks collectively; and lack of SBV independence to intervene in bank operations to mitigate shortcomings that it is able to detect. To address these problems, Vietnam plans to transfer bank oversight responsibilities from SBV to a separate bank supervisory agency, similar to the model adopted by China, as the next step in improving both the legal and operational framework for Vietnam's banking system.[100]

IV.3.4.2. China

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

[100] In March 2008, the National Financial Supervisory Commission was established, but its role is still quite modest.

SECTION V: CONCLUSIONS AND RECOMMENDATIONS

V.1. Synthesis of Similarities and Differences Between Vietnam and China

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

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

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

Despite many similarities, there are also key differences between financial sector reform in Vietnam and China. Vietnam has performed relatively better than China in the

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

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

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

V.2. Policy Recommendations for Further Financial Sector Reform in Vietnam

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

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

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

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

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

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

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

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

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

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

REFERENCES

ACB. 2006. *"Prospectus."*

ACB. Annual reports *2001-2005*

Achhorner, Thomas, Johnson Chng, Holger Michaelis and Tjun Tang. 2006. "Banking on China: Successful Strategies for Foreign Entrants." The Boston Consulting Group. http://www.bcg.com/publications/files/Banking_on_China_Successful_Strategies_May06.pdf

ANZ. 2006. *"Vietnam Trip Report: Strong Growth Encouraging Foreign Investors."*

Bank for International Settlement. 1988. "International Convergence of Capital Measurement and Capital Standards." http://www.bis.org/publ/bcbs107.pdf

Bank for International Settlement. 2004. "Basel II: International Convergence of Capital Measurement and Capital Standards." http://www.bis.org/publ/bcbs107.htm

Bartel, J. and Y. Huang. 2000. "Dealing with the Bad Loans of the Chinese Banks." www.columbia.edu/cu/business/apec/publications/boninhuang.pdf , 08/2004

Barth, James R. Rob Koepp, Zhongfei Zhou. 2004. *"Banking Reform in China: Catalyzing the Nation's Financial Future."* Milken Institute Working Paper.

Beim, David O. and Charles W. Calomiris. 2001. *"Emerging Financial Markets."* McGraw-Hill Irwin.

Berger, Allen N. Iftekhar Hasan and Mingming Zhou. 2006. "Ownership, Financial Liberalization, and Efficiency of Chinese Banks." http://www.fma.org/Chicago/Papers/Chinabankeff_forown_fma2005.pdf, 26/03/2007

BIDV. 2006. *"Prospectus."*

BIDV. Annual Report 2001-2006." And information in its website www.bidv.com.vn .

Boyreau-Debray, Genevieve and Shang-Jin Wei. 2005. "Pitfalls of a State-dominated Financial System: The Case of China." http://ccfr.org.cn/cicf2005/paper/20050126013113.PDF

Brahm, Laurence. J. 2002. *"Zhu Rongji the Transformation of Modern China."* John Wiley & Son (Asia) Pte Ltd.

Caprio, Gerard, Patrick Honohan and Joseph E. Stiglitz. 2001. *"Financial Liberalization: How Far, How Fast?"* Cambridge University Press.

Claessens, Stijn & Jong-Kun Lee. 2003. *"Foreign Banks in Low-Income Countries: Recent development and Impacts."*

Darryl S.L. Jarvis. 2003. *"Vietnam's Financial Services Sector: Prospects for Reform."*

Dimien Guirud. 2005. *"Revue Elargissement Special Banking."*

Đỗ Đức Minh. 2006. *"Finance in Vietnam 2001-2010."* Finance Publisher.

Đoàn Phương Lan. 2000. "The Asian Financial Crisis and its Implication for Vietnam's Financial System." http://www.iseas.edu.sg/vr112000.pdf

Dufhues, Thomas. 2003. "Transformation of the Financial System in Vietnam and its Implications for the Rural Financial Market – an update." http://www.gov.si/zmar/apublic/jiidt/jiidt03/4dufhues.pdf

Ernst&Young. 2006. "Global Nonperforming Loan Report 2006." http://www.chinalawblog.com/chinalawblog/files/ey_rehc_nonperformingloans_may20061.pdf

Farrell, Diana, Susan Lund and Fabrice Morin, 2006. *"The Promise and Perils of China's Banking System."*

Fitch Ratings. 2006. "*Country Report: The Vietnam Banking System.*"

García-Herrero, A. and D. Santabárbara. 2004. "Where is the Chinese Banking System Going with the Ongoing Reform?" CESifo Economic Studies. http://ideas.repec.org/p/wpa/wuwpma/0408001.html

General Statistics Office. *"Statistical Year Books 1994-2006.*" Statistical Publisher

Goodfriend, Marvin and Eswar Prasad. 2006. "Monetary Policy Implementation in China." BIS Papers No 31. http://www.bis.org/publ/bppdf/bispap31c.pdf

Gordon, Jenny and Bob Warrner. 2005. *"International Integration of the banking System: Final comparative study." Prepared for SBV*

Guifen Pei and Sayuri Shirai.2004. *"The Main Problems of China's Financial Industry and Asset Management Companies,"* at http://coe21-policy.sfc.keio.ac.jp/ja/event/file/s1-7.pdf

Gup, Benton E. 2004. *"New Basel Capital Accord."* Thomson.

Hodgson, Glen. 2004. "Can China's banking system be reformed?" ECD. Economics. http://www.edc.ca/english/docs/08_04_chinese_reform_e.pdf

Hope, Nicolas and Fred Hu. (2005). "Reforming China's Banking System: How Much Can Foreign Strategic Investment Help?" Stanford Center for International Development. http://scid.stanford.edu/pdf/SCID276.pdf

HSBC. 2006a. *"Vietnamese Equities: Time to Go in."*

HSBC. 2006b. "*Vietnam: Going for the Next Level.*"

Huang, Yasheng; Tony Saich; and Edward Steinfeld. 2005. *"Financial Sector Reform."* Harvard University Asia Center 2005, Cambridge, Massachusetts.

Huỳnh Thế Du. 2004. "Dealing with Non-Performing Loans in Vietnam, Experience from China and other countries." at http://www.fetp.edu.vn/index.cfm?rframe=/research_casestudy/facresearchlist.htm

ICB. "Annual Report 2001-2006." And information in its website www.icb.com.vn.

IMF. 2003. "Vietnam: Selected Issues." Country Report No 03/381. http://www.imf.org/external/pubs/ft/scr/2003/cr03381.pdf

IMF. 2003b. "Vietnam: Statistical Appendix." http://www.imf.org/external/pubs/ft/scr/2003/cr03382.pdf

IMF. 2006a. "Vietnam: Selected Issues." Country Report No 06/422. http://www.imf.org/external/pubs/ft/scr/2006/cr06422.pdf

IMF. 2006b. "Vietnam: Statistical Appendix." http://www.imf.org/external/pubs/ft/scr/2006/cr06423.pdf

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

Lê Minh Tâm. 1999. "Reforming Vietnam's Banking System: Learning from Singapore's Model." EADN Working Papers. http://www.iseas.edu.sg/vr52000.pdf

McCarty, Adam. 2006. "Vietnam: Economic Update 2006 and Prospects to 2010." Regional Outlook Forum 2006, Singapore. http://www.iseas.edu.sg/rof06/rof06am1.pdf

McKinnon, Roland. I. 1973. *"Money and Capital in Economic Development.*" The Brookings Institution. Washington, D.C.

McKinnon, Roland. I. 1992. *"The order of Economic Liberalization: Financial Control in the Transition to a Market Economy.*" Johns Hopkins University Press.

Merrill Lynch. 2006. *"Buy Vietnam – The Emerging Frontier of ASEAN."*

Merrill Lynch. 2006. "*Vietnam: Upping the delta in the Mekong.*"

Milgrom, Paul and John Roberts .1992. *"Economics, Organization and Management.*" Prentice-Hall, Inc.

Mishkin, S. Frederic. 2004. *"The Economics of Money, Banking and Financial Markets.*" Seventh Edition, Pearson Addison Wesley.

Nguyễn Thi Hạnh. 2002. "Can the Japanese Experience of Main Bank System be a Model for Financial System Reform in Transitional Economy of Vietnam." http://www.e.u-tokyo.ac.jp/cirje/research/workshops/macro/macropaper01/hanh.pdf

Nguyễn Văn Tiến. 2005. "Modern International Finance in Open Economies*: Assessment of Exchange Rate Policy in Vietnam after 20 year of Reform."* Statistical .

Nguyễn Xuân Thành. 2003. "The Road to Interest Rate Liberalization." at: http://www.fetp.edu.vn/index.cfm?rframe=/research_casestudy/facresearchlist.htm

Oh, Soo-Nam. 2000. "Financial Deepening in the Banking Sector – Vietnam." http://www.adb.org/Documents/Books/Rising_to_the_Challenge/VietNam/2-bank.pdf

Perkins, Dwight. 2002. *"Industrial and Financial Policy in China and Vietnam: A New Model or Replay of the East Asian Experience?"* Rethinking the East Asian Miracle. A Co-publication of the World Bank and Oxford University Press.

Phí Đăng Minh. 2007. *"Current situation and condition for liberalizing capital account in Vietnam."*

Phùng Khắc Kế. "WTO Accession and Banking Reform in Vietnam." http://www.epic.com.vn/resources/WTO_accession_banking_sector.pdf

Podpiera, Richard. 2006. "Progress in China's Banking Sector Reform: Has Bank Behavior Changed?" IMF Working Paper WP/06/71. http://www.lesechos.fr/info/medias/200075345.pdf

PriceWaterHouseCooper. 2004. *"China NPL Investor Survey 2004."*

PriceWaterHouseCooper. 2006. "China NPL Investor Survey 2006." http://www.pwchk.com/webmedia/doc/633009151052592032_cn_npl_survey2006.pdf

Qian, Yingyi. 2003. "How Reform Worked in China?" In Dani Rodrik, editor, In Search of Prosperity: Analytic Narratives on Economic Growth, Princeton University Press, pp. 297-333. http://www.econ.ucsd.edu/seminars/seven_ssrc/how_reform_worked_in_china_d.pdf,

Roland, Christian. 2006. "Banking Sector Reform in India and China – A Comparative Perspective." http://unpan1.un.org/intradoc/groups/public/documents/APCITY/UNPAN024226.pdf,

Ruogu, Li. 2001. "Revisit to China's Financial Reform." http://www.emeap.org/review/0111/speach.pdf.

Sacombank. 2006. *"Prospectus."*

Sacombank. Annual Report 2001-2007." And information in its website www.sacombank.com.vn.

SBV and & Budget and Finance Committee of Vietnam Assembly. 2006. *"Seminar Document: "The role of Banking System in 20 year of Reform."*

SBV. "*Annual Report 1998-2006."*

SBV. 1996. *"State Bank of Vietnam: Establishment and Development."* National Political Publisher.

SBV. 2001. "Report in Restructure of Credit Institutions."at http://www.sbv.gov.vn/home/htcocau.asp

SBV. 2005.*"Seminar Document: Building the strategy for development of banking services to 2010 and vision to 2020."*

Seiichi, Masuyama, Donna Vandenbrink and Chia Siow Yue. 1999. *"East Asia's Financial Systems: Evolution and Crisis.*" NRI Nomura Institute.

Sikorski, M. Trevor. 1996. *"Financial Liberalization in Developing Countries.*" Edward Elgar Publishing Limited.

Soto, Hernando De. 2000. *"The Mystery of Capital."* Basic Book.

Stiglitz, Joseph E. and Shaid Yusuf .2001. *"Rethinking the East Asian Miracle.*" A Co-publication of the World Bank and Oxford University Press.

Trần Thị Nam Nguyên. 2001. "The Banking System of Vietnam: Past, Present and Future." Fulbright Research Project/ Assigned Country: Vietnam. http://www.iie.org/fulbrightweb/BankingPaper_Final.pdf

Trịnh Quang Long, Võ Trí Thành. 2006. *"Financial liberalization and risk: International Experience and a recommended routine for Vietnam."* CIEM.

Unteroberdoerster, Olaf. 2004. "Banking Reform in the Lower Mekong Countries." IMF Policy Discussion Paper No PDP/04/05. http://www.imf.org/external/pubs/ft/pdp/2004/pdp05.pdf

VBARD. Annual Report 2001-2006." And information in its website 2001-2004 www.agrb.com.vn.

VCB. "Annual Report 2001-2006." And information in its website www.vcb.com.vn.

VCB. *"Prospectus 2006 and 2007."*

VinaCapital. 2006. *"Vietnamese Banks: A Great Growth Story at Inflated Prices."*

Võ Trí Thành, Lê Xuân Sang, Đinh Hiền Minh and Trịnh Quang Long. 2004. *"Vietnam Financial Markets: Current Situation , Problems and Policies.*" Finance Publisher.

Vũ Viêt Ngoạn. 2003. *"Financial Reform in Vietnam: Toward International Integration.*" ABA 20th Annual Meeting and Seminars.

WB. 2001. *"Government Failure in Finance."* Finance for Growth, Chapter 3

WB. 2002. “Banking Sector Review: Vietnam June 2002.”
http://www.worldbank.org.vn/publication/Banking%2003.pdf

WB. 2005. *“World Development Indicator.”* *CD-Rom.*

Zhao, Min. 2005. “External Liberalization and the Evolution of China’s Exchange System: An Empirical Approach.” World Bank Research Paper No.4.
http://siteresources.worldbank.org/INTCHIINDGLOECO/Resources/external_liberalization_and_exchange_control.pdf