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A Study of Vietnamese Banking

Lisa Román

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Institutions in Transition
A Study of Vietnamese Banking

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Stockholm in November 1995.

Lisa Román

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CHAPTER I

INTRODUCTION

> "If you want to become a doctor, practice in a war; if you want to become an economist, practice in Vietnam".
>
> *Phan Van Tiem*[1]

Vietnam is one of many countries presently undergoing fundamental institutional change: the market mechanism is replacing central planning. So far, the achievements are impressive. In the mid-1980s, the country failed to feed its population, suffered from hyperinflation and faced general economic stagnation. In the early 1990s, the annual economic growth rate had accelerated to some eight to nine percent, the inflation rate had fallen to two-digit levels - sometimes even lower - and the country had become one of the world's largest rice exporters. Add some more details - the increased foreign trade, the inflow of foreign investments, the diversification of agriculture, and the various reform measures taken to alter the basic economic structure - and the success story of the Vietnamese transition is told. The country has hence followed the same path as its northern neighbor China, and provided a counterexample to much more cumbersome processes in a number of other transforming countries, notably those of the former USSR.

The transition is by no means over. Indeed, it is misleading to think of transition as a process that departs from a well-defined pre-condition and moves towards an equally well-defined end-point. Although some fundamental changes in the economic system have happened within a fairly limited time period, they originated from short-

[1]Chairman of the State Committee of Prices in Hanoi, in February, 1991.

comings in the previous system which gradually became increasingly excessive, and ultimately gave rise to change. Neither is there an obvious "after" of the transition. Vietnam is transforming in the late 20th century, in a specific historic and geographic context, and Vietnam may develop in various ways. There is, however, in the following examination of the Vietnamese transition, an implicit reference to a "before" and an "after"; the former indicating a situation characterized by administrative allocation of resources (and gross economic inefficiencies), and the latter a situation where market allocation dominates (and almost everything works much better).

Transition, which in the present context refers to the transformation from socialism to capitalism, does not necessarily bring happiness to everyone. As the ability to take advantage of the economic opportunities brought about by the market orientation varies between individuals, there is a growing potential for increased inequality and exploitation - of people and of natural resources. Nonetheless, a more efficient use of resources generates a larger surplus for a possible redistribution. The view taken here is that a system which has the potential to support its population is better than a system which is dependent on external assistance.

Vietnam has characteristics which single it out among transforming countries (in certain respects shared with China), and which may be both to the advantage and to the disadvantage of the country. Firstly, the country is a so called developing country, where the large majority of the population are poor peasants, living in rural areas. The transition in the agricultural sector has been a relatively smooth reorientation towards market incentives; briefly, the peasants have continued to farm their land, but have become better rewarded. The ailing state sector is meanwhile quite small. The problems of state sector transformation may therefore be less of a burden to Vietnam than to other reforming countries. Nevertheless, the poverty in itself, the low standard of living, the relatively low level of education (albeit high for a developing country), and the weak physical infrastructure constitute bottle-necks for a rapid change of the economic structure. A second specific characteristic is the maintenance of the political structure: the communist party continues to rule. Again, this may possibly - partly and in economic terms - be an advantage at this stage: a relatively stable and centralized power may have more strength to impose the formal legislation and the essential restructuring of the economy. Yet, there are many real and potential tensions involved in such a political set-up. A failing confidence in the commitment of the totalitarian government to pursue reforms is one problem; the actual lack of central power in the current process of decentralization is another. And the question remains whether the pluralistic system of the market economy is compatible - in the long run - with a monolithic political system.

1. A Study of the Vietnamese Banking System

Although the accomplishments are striking, the transformation of the economic system is a lengthy process. This study deals with transition, and asks, fundamentally, what it is that characterizes this process of change. What is it that takes time? An answer is searched for by exploring a case: the case of the Vietnamese financial system, with a focus primarily on the state bank complex. Obviously, only a partial answer may be expected from the findings from only one case. The study investigates how the reform of the financial system has succeeded so far, and what the main obstacles seem to be.

1.1 The Study Object

As part of the Vietnamese reforms, the banking system has undergone reorganization. Vietnam had, in its transition to socialism, developed a so called monobank system; the State Bank was, in essence, a single unit serving as an accountant for the planned economy. Reorganization of the State Bank began in the latter half of the 1980s, and gradually the market also opened up for new banks. A so called two-tier system has developed: a system with a separate central bank function and a number of independent commercial banks. The skeleton for the new formal structure is there. There are a number of new commercial banks to complement the so called state-owned commercial banks - former departments of the old State Bank. There is banking legislation which establishes the legal framework for the new banking system. In addition, there is a central bank that seeks to take on the normal tasks of central banking in the market economy: monetary policy and supervision of the commercial financial system. However, the achievements in the first half of the 1990s is only a beginning. Many problems remain, as will be highlighted in this study.

There are two separate reasons for focusing on the banking system. The first is that a banking system, or more generally a financial system, plays a key role in the development of the economy.[2] A banking system channels money from savers to investors, and thus allocates financial resources in a manner which no individual can achieve. Through the pooling of savings and the spreading of credit to different projects, the banking system also diversifies risk. In addition, a banking system provides a payment mechanism that facilitates exchange, as well as a vehicle for monetary policy.

In Vietnam, the banking system is often said to constitute a bottle-neck in the transition. The banks are weak as financial intermediaries, the payment system functions poorly and cash transactions continue to dominate economic life. The monetary policy

[2]Chapter II discusses the role of finance in development in some detail.

instruments available are few and often inadequate. The fight against inflation appears relatively successful despite the financial system, not because of it. Meanwhile, there are considerable prospects for productive investments, although a lack of capital inhibits the realization of these investment opportunities. There is also a probably substantial domestic saving potential, although not absorbed by the banks. Hence, a central question is why the Vietnamese financial system fulfils its roles so poorly. Understanding the functioning and mal-functioning of the banking system is important in order to clarify the magnitude and character of some of the problems in the further reform and development of the Vietnamese economy.

The second reason for studying the banks is that the reform of the banking system is an interesting example of organizational change in a former socialist bureaucracy.[3] The point of departure is a socialist monobank, a part of the gigantic state bureaucracy. Organizationally, transition is to a large degree a matter of bureaucratic transformation. Similar processes of bureaucratic change occur in other segments of society. The state enterprises, for example, are to become profit maximizing, and then, to a varying degree, autonomous, perhaps privately owned units. In Vietnam, state enterprises have since long, more or less successfully, adapted to market prices and profit orientation, although the privatization process is still in an embryonic and indecisive stage. Another sector which faces this bureaucratic transformation is the state administration, including the government, whose role as a central planner of most economic activities is to be replaced by that of a referee, that sets the rules for interaction between decentralized actors in the economy. Hence, a study of the state banks will hopefully provide insights not only into the characteristics of bank reorganization in Vietnam, but also into the bureaucratic transformation process in general.

1.2 The Research Approach

The study focuses on the role of institutions in determining historic and economic development. The interaction between the formal rules (laws and organizational structures), the informal rules (norms and customs), and the possibility of enforcing these different rules represent an evolutionary force in society.[4] In more concrete terms: a new banking law may determine a new role for the banks, but the success of the law is dependent on the willingness or the ability of the bankers, the bank clients and others to comply with its intention, and the possibility of enforcing the law. In a period of rapid changes in the formal rules, such as in a period of economic transition, informal

[3]Chapter III gives an account of general problems of central planning and transition processes.

[4]The approach is in the tradition of new institutional economics. My understanding of this field is briefly outlined in the first half of Chapter II. The definition of institutions follows North (1993).

rules tend to lag behind. Thus transition takes time partly because there is a tension between the formal and the informal rules. The problem is however more complex: new formal rules are as much products of changes in norms, as are changes in norms products of new rules. As we shall see below, it is not only a matter of tensions between formal and informal rules. Tensions also occur because the rules - formal *and* informal - are unclear and differently interpreted by different agents.

Each period in time is characterized by a specific set of institutions. These determine the agents' opportunities to transact, or the transaction costs. In this study, a distinction will be made between the costs of coordination and the costs of motivation.[5] The former refers to the problems that agents encounter in coordinating their interests and abilities, largely because of information difficulties. The latter refers to incentive problems: the agents may have trouble in establishing appropriate agreements and ensuring that they will be adhered to - because of problems of information and of enforcement. With the help of these cost concepts the institutional approach will be operationalized. The study analyzes how the agents in the banking system manage to coordinate their activities and interests, and how the given situation affects motivation.

In order to establish the relevant rules and how they influence coordination and motivation, a number of questions needs an answer: What are the new rules that the reforms try to establish? That is, what is a commercial banking system, the goal of the bank reforms? And what were the old rules? What function did banking have in the old monobank era? How did the old, socialist system work at large? What were the deficiencies of central planning that forced changes in the rules - in general and in Vietnam? In which institutional context was the central planning system, now abandoned, once established?

To fully answer *all* the possibly relevant questions and draw a complete picture of the entire institutional and historic context of Vietnamese banking would be a gigantic project. Some issues will therefore be dealt with only superficially and others not at all.

1.3 Two Main Themes

The institutional approach uses a wide range of information and results in a rich and complex picture of Vietnamese banking. Nevertheless, two distinct themes emerge from the analysis, which, it will be argued, are central for an understanding of the problems of transformation of the banking system. The first is the inability of the

[5]The distinction is put forth by Milgrom & Roberts (1992). The transaction cost approach, originating from Coase (1937), and its linkages to new institutionalism is another subject for Chapter II.

socialist system to handle decentralization. The second theme is the problems of opaque rules during the transition phase.

Incomplete decentralization

Centralization of most economic decisions characterized the socialist system. The transition recently experienced in Vietnam and elsewhere has implied the breakdown of centralization. At the core of market reforms is the liberalization of the price system, along with other measures of decentralization, including changes in the agricultural sector, the reorganization of state enterprises, and the liberalization of foreign trade. As noted above, the bank reforms have in a similar fashion aimed at decentralization: commercial banking means that each bank minds its own business, within a given legal framework, basing their decisions on profit criteria. However, the Vietnamese banks are far from the ideal situation of autonomy and independence.

Of course, few would claim that complete decentralization is desirable or even possible. Different types of decisions require different types of organizational structures: sometimes the benefits of coordination maintained in hierarchic structures are superior to complete decentralization; thus any society and any economic system mixes markets and hierarchies. Consequently, a "complete" decentralization of the Vietnamese banks, where every individual were his own banker or where each branch office were an autonomous profit center, would not necessarily be the most efficient type of banking. What *is* incomplete and problematic for the Vietnamese banks in a more practical sense is the maintenance of the state ownership over the dominant state banks.

The problem is the *specific* character of this state ownership in the Vietnamese situation. State ownership does not automatically create inefficiencies - but there is a great risk. The difficulties are better understood if a distinction is made between centralization of planning and of authority. Both these features characterized the original socialist system. Market reform presupposes the abandonment of central planning, but not necessarily of central authority. It is to the extent that the state maintains its authoritative control that state ownership may become problematic.

When state ownership signifies central authority, it embodies two mechanisms which may cause inefficiencies. The first is the so-called problem of selective intervention.[6] The state, the owner, may have decided to abandon its direct control over an organization, and only selectively intervene. However, situations might occur where it is in the state's interest to intervene more than originally intended in the decentralized unit's affairs. The short-run objective for the intervention may very well be commendable, but not the incentives thus created. Since the employees of the supposedly

[6]Williamson (1985), Chapter 6.

independent banks know that at times the owner will step in and overrule their decisions, their real autonomy is reduced as is their willingness to act independently for the benefit of their bank. Normally, the intervention may take the form of a transfer of profits from an "autonomous" unit that is doing very well, or by spreading the gains of an innovation made in one unit throughout the entire organization. If the individual unit cannot benefit from its performance, this reduces the incentives to keep profits high or innovate. Moreover, the awareness that the state will not keep its word and will be tempted to intervene on occasions, may create hesitancy and passivity since it is expected that the owner - the authority - will do as he pleases anyway.

The second risk with state ownership is related to the previous one. Since the employees of a semi-decentralized unit know that there is a possibility of state interference, they may be motivated to try to influence the state to act in their interest.[7] Thus resources are spent on activities which seek to exert influence, rather than on the specific activity which the unit is really supposed to concentrate on (making profits, lending money, mobilizing resources etc).

An instance of these two mechanisms is the soft budget constraint.[8] When a presumably decentralized unit cannot reach the targeted production or performance with the given funds, the owner - the state - may contribute additional funding. Through additional credit, tax reductions, state subsidies or adjustments in the administrative prices, the state thus softens the original budget limits of the unit. The underlying message from the state is that "if you can't make do with the resources you got, have some more". The incentives for the units' employees to prudently manage their business with the given funds, and cover costs with generated incomes, are thereby eroded. They will know that the state might come to the rescue, and they may use their remaining resources to try to influence the state to intervene.

Note that these problems also existed in the classic socialist system. Because the socialist system does not contain any efficient means of dealing with failure, there is no exit for inefficient firms or improper behavior - nor any real exit for obsolete political ideas or politicians - and thus no entry for better methods of production, more adequate organizations or improved thinking. The combination of state authority and an ideology that does not admit any opposition to this authority meant that the state had no mechanisms to initiate change in society's organization. The result was a deteriorating economy. Ultimately a reorganization, i.e. decentralization, of society was unavoidable. But as explained above, as long as central authority is maintained, the decentralization process is not complete and inefficiencies prevail.

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[7]Milgrom & Roberts (1990).

[8]Kornai (1986, 1992).

Decentralization problems appear in Vietnam and in the Vietnamese banks in various ways. Despite the state-owned banks' formal independence, there are close linkages between these banks, the central bank and the government authorities. The authorities at times intervene, both in central and commercial banking. The government is, for example, involved in setting the heavily regulated interest rates and in the expansion of the money supply which are elsewhere the tasks of the central bank alone. Ministries advocate advancement of credit to specific sectors or enterprises (either by ordering the central bank or by directly addressing the commercial banks), and the government also appoints directors of the banks. In turn, the central bank interferes with state-owned commercial banks in ways which limit their independence (although the close linkages are sometimes to their advantage: the new "private" banks and the foreign bank branches are often discriminated against with respect to treatment from the central bank). Moreover, the state banks are tied up with the state enterprises, which have often performed poorly, thus calling for state intervention and softening of budget constraints. The government has abandoned most of the direct transfers to the enterprises from the state budget, but has instead been soft on credit, provided by the state banks. These have in turn been provided with funds from the central bank - mostly cheaper for the banks than mobilizing funds from the public (due to the regulated interest rates).

We may think of the authority-decentralization problem as one of persisting paternalism: the government (the state) takes on the role of a father who intervenes to create justice, balance inequalities and pursue social objectives. But the market system and commercial banking does not benefit from such paternalism, as it distorts incentives. Nevertheless, the paternalism persists - for two distinct reasons. The first is ideological. Officially, a socialist orientation is also emphasized in the most recent version of the Vietnamese constitution. It would be ideologically inconsistent for the Vietnamese government to let go of all control over the state units, including the banking system. Adding to this "pure" ideological cause for preserving the basic structure for power, individuals in the government and in the state sector have reason to leave the situation intact. Like any power structure it benefits a number of influential people.

A second reason for the maintenance of central authority has less to do with a conscious strategy on the part of the authority. Old ways of thinking and old methods are not easily abandoned and replaced. There is a lack of understanding both of the market economy and of the transition. Maintaining a paternalistic attitude, thus advocating certain policies that go against smooth commercial banking, does not necessarily reflect a conscious ideological conviction - for example that the state *must* preserve its power, or that the state sector *must* be the dominant player. It may simply be a result of lingering conventional thinking. This leads us to the second major theme elaborated in this study: the difficulties of coordinating banking and the economy in general, when the basic rules are unclear.

Unclear rules and coordination

Contracting between economic agents is determined by institutions - formal and informal rules and their enforcement. The way the agents manage to interact depends on the formulation and understanding of these rules. While the system of central planning (and central authority) largely ignored motivational problems and underestimated the immense information requirements necessary to coordinate all the economic activities of the society, the system still constituted a fairly coherent set of rules for the functioning of the economy. The transition to the market economy implies a change both in the formal rules: new laws, new price mechanisms, new organizational structures, and the informal rules: how agreements should be understood, what is right and wrong in exchanges etc. When the relevant rules of the game are unclear, the agents may find it difficult to coordinate their activities.

Moreover, enforcement is poorly developed. A certain type of behavior may be punished on one occasion - or at one location - but accepted at another. The ambiguities may be due to contradictions between different sets of rules, but also to the agents' varying interpretations of the rules. Little legal practice is yet developed, and thus even consistent sets of rules may be differently interpreted by different agents, depending on their background and frame of reference.

The discussion of incomplete decentralization hinted at one basic ideological inconsistency in the Vietnamese case: there is an intention to move towards a market economy - a capitalist society. Meanwhile, the ambition remains to preserve the socialist system. Possibly, the socialist objective is largely a lip-service to the ancient ideology: the Vietnamese transformation is indeed pragmatic; old convictions are gradually adapted to the requirements of the new era. However, as long as there is a legacy of the old system, in official statements and in the way various agents and organizations perceive the functioning of the system, this affects the agents and the organizations, including the banks. As already mentioned, the inconsistency may be a prerequisite for any transition to take place at all. If reforms did not proceed gradually, carefully seeking consensus, the process would perhaps be hampered by serious instability or halted altogether.

Apart from this fundamental paradox of a market orientation within a socialist system, there are inconsistencies in the formal constraints that are of more direct relevance for the banks. Mention has been made of the dilemma of formally establishing the independence of the commercial banks, while at the same time maintaining the power of the central bank. Another contradiction is that the banks are to seek profits without being allowed to independently determine their own interest rates or to independently decide on the type of financial instruments that they can offer to their clients. Again, it is not obvious that the alternative - in this case the immediate and total

autonomy of the banks - would be advantageous for the transformation process or to the development of commercial banking. In fact, it is quite possible that a firm central control of the interest rate levels has been both necessary and beneficial for the smooth adaption of commercial banking. The problem is that the reasons for the control and the length of the period during which controls will be maintained is not clear to the agents.

Yet another example of the opaque formal rules is the poorly developed legal framework for the regulation of bank activities. There are, for example, several ordinances which regulate contracts depending on the legal status of the parties involved, and on the type of activity in which they are engaged. The priority of the two criteria is not clear, however. Further unclear regulations include those on collateral and mortgages, and of the absence, until recently, of a proper bankruptcy law. In short, important laws are missing or incomplete, ambiguous and overlapping. Poorly developed accounting and auditing standards also make it difficult to properly ascertain the financial performance of firms. Consequently, law enforcement is weak, and a lot of economic interaction - between banks and bank customers as well as between banks and the authorities - rely on bargaining and out-of-court negotiations. Obviously, such a system leaves a lot of room for discretion and arbitrary settlements.

One way of formulating the coordination problem in the transition phase is to say that the transition destroys the social capital established in the previous system, while hindering new social capital to be effectively accumulated.[9] In the centrally planned system, people had built a certain kind of social capital necessary both to comply with and circumvent the system. A market system is partly dependent on a different type of social capital. In the centrally planned system it was, for example, important to understand the underlying objective of an agreement, and quota fulfillment was more important than staying within the budget. The market system has a different construction, where it is important to honor contracts, where failure leads to bankruptcy procedures, and where more efficient competitors seek to fulfil the "quota" (i.e. the satisfaction of demand). In both systems, a certain kind of trust is necessary for the them to function. In the first, the production unit must be trusted in its ambition to reach the quotas - one way or another; in the second, the enterprise must be trusted to follow business law and honor contracts. The point is that in the phase of transition, neither kind of trust exists between the agents. They simply do not know what they can expect from each other. This complicates or impedes exchanges, and slows down the transition.

[9]Social capital is really another term for the institutions that govern people's possibilities to interact; it includes the authority relations, relations of trust and consensual allocations of rights which establish norms for people's relationships with each other (Coleman, 1990, Chapter 12).

1.4 Ambitions of the Study

How does this study contribute to our understanding of banking reforms in Vietnam or to transition in general? Does it enhance economic analysis in any way? The study focuses on one sequence of events: the transformation of the Vietnamese banking system in the early 1990s. The main purpose is to understand this particular case. Hopefully, such an in-depth study also provides some insight into transformation, not only of banks in Vietnam, but also of other institutions in other countries.

The study is *system*-specific, focusing on the mechanisms of transition from central planning to capitalism, as opposed to a *country*-specific study of Vietnamese transition. It is my belief that many of the patterns of behavior explored here, as well as their consequences for the functioning of the economy, are products of the socialist system and of the attempts to transform this system. This does not mean, however, that the transitions are similar in all the transforming countries, or that culture, history, and country-specific circumstances are not important for understanding Vietnam and Vietnamese banking.

Culture does indeed constrain action. Moreover, each country and sector is transforming in its historic context. To properly understand a specific phenomenon, it might be necessary to go back centuries ago to understand the roots of established norms and behavior.[10] Vietnamese culture and history provide numerous points of departure that provoke questions about how Vietnam may be especially alert or avert to the current processes of change.[11] But culture is not, as little as history, a static phenomenon. It is a product of time and circumstance, including the political and economic system. There is a danger in looking too deeply into the particularities of the Vietnamese situation, and thereby failing to see the patterns that a certain kind of power structure and economic system create in any country and cultural context. By reference to the uniqueness of the Vietnamese situation, fundamental mechanisms, which would help to explain the situation, may be ignored. Hence, the present analysis focuses on the system-created aspects of culture and historic development, in order to reveal certain patterns that might also be of relevance for understanding transition in other transforming sectors and countries.

Another ambition of the study is to provide an example of empirical institutional analysis. The institutional perspective is today widely acknowledged in most fields of

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[10]In the spirit of, for example, Putnam (1993), who traces differences in development between Italian regions to their differences in social capital, which in turn is a product of differences in governance structures established in the 12th century (where powerful monarchies ruled in the now more backwards regions, as opposed to a kind of communal republics in the presently more prosperous ones).

[11]A useful introduction to the Vietnamese culture is provided by Jamieson (1993). Chapter IV in the present study briefly presents the historic background to the present reform process.

economics. There is, however, a shortage of empirical studies that take the institutional framework seriously, and attempt its operationalization. The literature seems to be dominated by theoretical contributions, which advocate an institutional perspective, but remain fairly silent about how to carry out empirical studies. The empirical studies which do claim to favor the institutional perspective seem, in their actual empirical analyses, fairly traditional and neo-classically flavored.

In addition, studies of transition (and of Vietnam) often concentrate on macroeconomic conditions. Although a macroeconomic perspective is necessary to get an overview, it needs to be complemented by microanalysis, which focuses on the mechanisms behind individual agents' and organizations' behavior. This study also in this respect claims to make a contribution.

1.5 Delimitations

What does the present study leave out? Firstly, as touched upon above, the study is system-specific. I believe there is merit to an analysis, which refrains from too many country-specific considerations. Yet, this argument in favor of a system-specific focus should not conceal that my bias has to do with the limits of my experience with Vietnam, and the limits of my capacity to include *all* the possibly relevant components for understanding the Vietnamese transition.

Another limitation - which one could argue is a merit - is the lack of attention given to policy implications. The main purpose of this study is not to predict the true potential of the Vietnamese banks, nor to provide a manual for how to improve the banking system. Of course, the conclusions drawn about malfunctioning of banking lend themselves to inferences of how things could be ameliorated. If decentralization is incomplete, and rules are unclear, actions should be taken to increase the banks' autonomy, streamline the regulatory framework and increase the understanding of this framework. (These conclusions are not revolutionary - any official report on the banking system would include advise in this direction). My aspiration is, however, to furnish a more thorough understanding of why these mechanisms persist, and consequently why the adequate policies may be troublesome to implement.

There are other, more concrete limitations to the study. It focuses on the state-owned commercial banks, and treats superficially the rapidly growing private banks, and the foreign bank branches. This does not mean that these banks are unimportant for the development of banking and finance in Vietnam; indeed their strength and weaknesses may be decisive for the future. Nor will due attention be paid to the informal financial sector, which constitutes another complement to the state banks. The formalization of informal financial intermediaries has been an important ingredient in other countries, notably in some other Asian countries, like Taiwan and Korea. The manner in which

this sector operates and allocates financial resources is an important element in an overall picture of Vietnamese finance. This will be discussed, but not in any great detail.

Vietnam is a developing country. In some areas, it is difficult to determine exactly where the transition problem ends and more general problems of economic development begin. This is particularly true in relation to the question of rural development, which is largely omitted from this study. The rural population's access to credit is indeed an important prerequisite for rural development, and for an understanding of Vietnamese banking, since the large majority of the Vietnamese do live in rural areas. The agricultural bank is included in the study, and rural credit is not completely ignored, but again the issue is not treated in any detail.

Another limitation is the somewhat superficial attention paid to regional differences, particularly those between the North and the South. The analysis identifies differences in attitudes and performance between banks in the North and the South when such are observed, but tends to focus on the general patterns and the common features of the banks, regardless of location. Finally, the study traces the problems of banking largely from the perspective of the banks rather than the bank clients, who have not been approached for their views on how the banks function. The study is limited to the views of bankers and other observers on the difficulties encountered.

2. The Empirical Study

An empirical study of the economic situation in Vietnam must necessarily be explorative. Lack of information requires a broad search for relevant data. One reason for the information shortage is that the reform process is ongoing and documentation is relatively limited (although the literature is growing). Another obstacle is the socialist tradition of secrecy concerning the functioning of the economy in general, and the financial sector in particular. The study draws both on quantitative and qualitative data. Apart from secondary material such as books, articles, and official documents, it uses statistical data on banking operations and on the economy in general, particularly a large number of interviews. The quality of these different forms of data can be questioned for various reasons. I will here discuss the data quality - in particular the way the interviews were conducted - as well as the language problems associated with a study in Vietnam, and the choice of time period under study.

2.1 The Sources

As regards the *secondary material*, all the usual words of caution apply. Any report - be it a publication by a Vietnamese scholar, published in Hanoi or in Singapore, or a World Bank official document - is a subjective account from a specific point of

view. Any such statement should be handled with care. The data, analysis and conclusions presented in such material should be subjected to critical scrutiny. The dubious quality and the limited availability of *statistical data* is a well known feature of most centrally planned economies.[12] Vietnam is no exception. Regardless of whether financial statistics are particularly misleading, or only as questionable as any other figures on the Vietnamese economy, a general rule is that exact numbers should be treated with skepticism. The principle motivation for the explicit use of these dubious numbers in the text is the assumption that they at least indicate trends and proportions, and that biases are fairly systematic: i.e. when economic sectors are excluded, they are systematically excluded in all similar accounts, and exaggerations or understatements of various economic activities are systematically over- or under-reported.[13]

Regarding the *interviews*, there is first of all a problem of selection. Obtaining interviews and making contacts with people in the banking system and in other organizations is, and certainly was when I embarked on this project, harder in Vietnam than in politically more open countries. The initial phase of the study, in which I tried to find doors into the Vietnamese banks, was particularly cumbersome. The result of these initial efforts have to an extent determined the selection and numbers of interviews forming the data base of this study.

The interviews can be divided into five categories. Table 1.1 shows the number of interviews and interviewees. Firstly, I have talked to people in the *State Bank of Vietnam* (SBV), which is the Vietnamese central bank. Secondly, there are interviews with bankers in the state-owned commercial banks, and thirdly, with people in the recently established share-holding banks, as well as in some other purely Vietnamese financial organizations (credit cooperatives and gold shops). A fourth type of interview was made with people in joint-venture banks and the representative offices of foreign banks. The fifth category included a number of interviews with people who had some kind of involvement in the Vietnamese financial sector: officials with the Ministry of Finance, Vietnamese scholars at research institutes and universities, people with experience of the informal financial sector - as lenders and borrowers respectively - as well as the director of one of the banking colleges etc. Finally, needless to say, my knowledge of the Vietnamese banks have, apart from these formal interviews, gained from a large number of informal discussions with Vietnamese and foreign observers.

The interview material is limited to urban banking. The interviews were made in four distinct urban areas, two in the North, and two in the South: the capital of Hanoi, the port city of Haiphong, Danang in central Vietnam, and Ho Chi Minh City, the

[12]See Nove (1986), and de Vylder & Fforde (1988).

[13]More detailed comments on data quality will follow in the presentations of tables and figures, primarily in Chapters V and VI.

southern metropole in the Mekong delta. Table 1.1 shows the division between interviews made in North and South Vietnam. Although there are branches of the SBV all over the country, the head office in Hanoi is predominant, and this is where I met with the majority of the SBV officials. Offices of the state-owned commercial banks are found in all the major cities. In addition, there is a head office for each of these four banks situated in Hanoi. The interviews in this category are equally distributed between the two southern and the two northern cities. I interviewed bankers both at the head-office and at the local Hanoi branches of these banks, although I had problems in arranging interviews with the Haiphong branches of the state owned commercial banks, with the exception of the agricultural bank. The majority of the share-holding banks are found in the South, which partly explains the dominance of southern interviews in this category. The same holds true for the joint-ventures and the foreign banks. On the other hand, outside observers of the financial system are found (and were found by me) predominantly in Hanoi.

The interviews had two purposes. The first was to substitute for the lack of written information on the situation in Vietnam. The second was to provide material for the analysis of the transformation in the banking system. All of the interviews were, to an extent, explorative, searching to identify the respondent's particular function in the Vietnamese financial system, and his or her point of view. The interviews with the bankers in the state-owned commercial banks were, however, more structured. They were preceded by a written questionnaire with two different types of questions. The first dealt with the bankers' experiences of the transformation process: What did they perceive as the main problems and challenges of the bank? The second concentrated on

Table 1.1: Number of interviews

Discussions with:		Number of interviews:	of which in the North:	of which in the South:	of which in 1991/92	Number of interviewees:
1.	SBV	17	15	2	13	12
2.	State-owned commercial banks	22	11	11	17	21
3.	Share-holding banks, credit cooperatives and gold shops	12	5	7	10	13
4.	Joint-venture banks and foreign bank representatives	6	2	4	6	7
5.	Other formal discussions	27	22	5	27	25
Total		84	55	29	73	78

banking activities: volume of lending and deposits, type of credit advanced, repayment ratios as well as number of employees and average ratios etc.

The first type of question is given by the purpose of the study: In order to assess and explain obstacles to efficient financial intermediation, it was necessary to gather the bankers' own opinions and views on the transformation process they were experiencing. The second type of question served two purposes. Due to the lack of data (and/or difficulties in obtaining any written information about financial activities in the banks), it seemed as if the only way to obtain such information was by asking the bankers themselves about the figures. A case in point is that in the 1991-1992 period, the interviewees were restrictive in providing any written information. It was obviously less problematic to state these figures orally during the interviews. When I returned in 1993, bankers often provided me with newly printed banking brochures and photo copies of various financial data and banking legislation.

Eventually, however, access was secured to some financial data gathered in the SBV. Once again, the quality of these data was difficult to assess. A comparison has been made of the information obtained in the interviews with the SBV figures (along with other published figures) to get a feeling for the accuracy of - or at least correspondence between - the numbers. The result of these efforts has been meager. For one thing, the way bankers reported on these figures differed from bank to bank. Some gave detailed accounts, others mentioned only a rough figure, and would not dwell on the issue when asked. The correspondence between the bankers' accounts and the SBV figures was also difficult to assess. Although the exercise no doubt gave me a better feeling for the quality of the data, the tables finally compiled and presented here are largely based on the SBV figures and other published sources. The tedious reporting of figures during the interviews served, however, a second purpose: it facilitated communication as it provided a fairly concrete subject on which the discussion could focus.

The interviews with Vietnamese bankers generally lasted for about two and a half to three hours (on a couple of occasions four hours). The discussions with other Vietnamese observers of the financial system often lasted this long as well. The interviews with foreign bankers and experts were significantly shorter, most of them lasting about one hour. I made notes of the discussion during the interview. These notes, which I tried to keep as complete as possible, I later typed and mildly edited. The replies were arranged under appropriate headings, for example "On main problems", and "On interest rates", but I tried to include all the notes made, and not make any prejudgments about less relevant or irrelevant information. On occasions, the notes were not clear; then I tried to assemble the fragments into an argument that did make sense, and which corresponded to my memory of the discussion. An exception was when my notes made no sense to me at all; then I assumed that such notes reflected a moment of

absolute confusion - either because the respondent did not want to answer my question, or because it was impossible to make sense through the interpreter. On these occasions the particular argument seemed to vanish into some dark alley. This happened at times towards the end of an interview session, when at least the interviewer was quite exhausted.

What is the value of the interviews? The method of interviewing a large number of people, each of them on only one occasion, has significant drawbacks. It is clear, in particular in the Vietnamese context, that a prerequisite for acquiring reliable information in an interview situation is that confidence exists between the interviewer and the interviewee. In a formal meeting with a foreigner, a Vietnamese official might carefully state an officially sanctioned version rather than what he or she knows or feels is the reality. It is often reported by others, and indeed experienced by myself as well, that there are differences between information given formally and informal confidences. The secret, revealing stories are told over a bottle of beer.

One line of defense for the type of data that is being used here is that people are eager to make sense to each other. When what I was told did not make sense, I asked further questions, which in turn gave me more information, which allowed the discussion to continue. The interviews provide material for an interpretation of what the bankers and observers of the banking system believe are the *relevant* problems, albeit they do not necessarily reveal the *real* problems of that particular bank. A banker may tell me that capital shortage and the skills of the staff are the most urgent problems for his bank at this point. In reality, he might worry about having discovered that his deputy director has illegally advanced considerable credit to his uncle, who is unable to repay. This increases his bank branch's solvency problem, and put him in trouble for his lack of judgement. He will not reveal this to me, and I cannot know - unless I happen to drink a lot of beer with one of his staff members. What I can say, however, is that he apparently regards a lack of capital as a severe problem for a bank, something which is no longer easily resolved by additional credit transfers from the SBV. The skill of the staff is apparently experienced as a major difficulty, even though the banker might not know exactly the best way to resolve this problem.

The bankers gave me their official version, trying to make sense to me. I interpret their versions not as the absolute truth, but as indications of trends and magnitudes of problems - similar to the way I use statistical data. I have to trust my ability to interpret the situation, and sense whether there is at least some kind of mutual confidence in the interview situation or not. To an extent, I can also reverse the argument, and ask myself what it means when (on a few occasions) a respondent has clearly tried to tell lies, or argued in an incomprehensible manner. A skilful interpretation of the interview material could thereby make most statements interesting and useful. Moreoever, it has been my experience that the long duration of the interviews, despite some exhaustion, has worked

to my advantage: the longer into the interview, the more engaged and eager the respondent has been to explain and clarify. In addition, I believe that my declared purpose has been fairly well understood: to study the transformation process in general in order to understand the development of the Vietnamese economy. It is moreover possible that my status as a researcher from a Western university might influence the quality of the interviews, although in what direction is difficult to say. On some occasions I understood that the interviewees assumed that I was a representative of the Swedish government, and that such a position granted me some status. Most of the time it was, however, clear that I was not an important person. I was not in a position to offer business or aid grants. Sometimes this might have meant that I was ignored by the important persons in the bank, and deceived by those I interviewed. But sometimes my insignificance in these respects made the interviews more relaxed and open.

Interview references

Any information or statement originating from a specific interview is in the text referred to by the interviewees' organizational affiliation, and the place and the date of the interview. A statement made by a banker at the Agricultural Bank (ABV) in Danang, for example, is referred in a footnote to as "The ABV in Danang, December 3, 1991". There are several reasons why this semi-anonymous referencing has been chosen. The basic idea is that the more information provided to the reader, the better, to the point where further information hurts or embarrasses any individual. It is of interest to know the type of banker, or the type of observer who made a specific statement, and also where he made it (specifically if it was in the North or in the South of Vietnam), and on what date (since the transition progresses - a statement in 1991 may have a different meaning than a statement made in 1993). Given the difficulties of communication, however, I cannot be one hundred percent sure that what I heard and interpreted was what the interviewee was actually trying to tell me. There is in that case no reason to assign the responsibility of a statement to an individual and thus risk embarrassing or compromising him, when it was actually my fault.

As for statements made in confidence, or informally, the general rule is not to give any specific reference at all - only to state that something was told to me informally, or that several observers remarked this or that etc. Occasionally, the formal interviews may also have contained statements which were at least semi-confidential or could in other ways be embarrassing or compromising for the interviewee. Thus, there are good reasons not to publicize the name of my interviewees. In addition, I may occasionally embarrass the interviewees, by using statements to illustrate the bankers' misunderstandings, which, I argue, contribute to the banking problems. On those occasions, my purpose is definitely not to claim that the Vietnamese bankers (or

observers) are ignorant fools, but rather to reveal the mis-match between existing ideas and new requirements. Nevertheless, I realize that for the sake of argument, my quotations may at times dishonor the interviewee. Again, there is no reason to name the individual who I claim made the statement.

The semi-anonymity has the disadvantage of not giving sufficient credit to the individuals who have contributed with important and central remarks. This remains a matter of regret. Moreover, it should be noted that although I refer to the organizations rather than the individuals, the statements and views put forth are those of these individuals. Mostly they have talked as representatives of the given organization, but their accounts do not always reflect the official view of the organization.

2.2 The Language Problem

Without a command of the Vietnamese language, I have had to rely on publications in English and French (and Swedish). In addition, I have had a number of translations made of articles from Vietnamese publications on economics and banking. These articles were fairly arbitrarily selected, although I did briefly discuss the articles with my Vietnamese interpreters. One may add that in the 1991-1992 period there were not very many of these publications, so the choice was not all that difficult to make.

The interviews were predominantly conducted in English and Vietnamese through an interpreter. A few of the interviews were made in English directly between the respondent and me. An even smaller number were conducted in French. Two interviews were made in French and Vietnamese through a French speaking interpreter. The task for the interpreter was demanding. The subjects studied - finance and economics - is new to most Vietnamese English (and French) speakers. The transformation of the economy implies a transformation of language. The Vietnamese vocabulary in economics is not yet well established or standardized. Many Western terms and phenomena are still searching for a Vietnamese translation. I believe that in several situations of ambiguous terminology we - the interviewer, the interviewee and the interpreter - managed to sort things out. There must also have been occasions on which we genuinely misunderstood each other but never knew - each one happy with his and her understanding of the dialogue. During many of the interviews, I worked with an interpreter whom I got to know quite well. We discussed banking and my research problems etc on many occasions. Some of the interpreters supplied by the banks - particularly in South Vietnam - I did not get to know. They were, on the other hand, generally more familiar with the banking vocabulary than in the North.

It is my general impression that at least for the time period studied, some Vietnamese economists with a background in Marxist economic theory, albeit that they were English speakers, were fairly unsure when discussing economics and banking

issues. Meanwhile, many Vietnamese interpreters, often with a purely linguistic background, were well able to discuss modern economics with foreign scholars. I thus had quite a lot of confidence in the interpreters, even though I do not underestimate the problems of conducting interviews in this way. There is, however, one particular advantage in working through interpreter which is worth mentioning: When Vietnamese is spoken, the interviewer has time to take notes and formulate the next question. When interviews are made directly in English, there is less time to take proper notes and consider the essential questions. An ideal interview situation would be one made through an interpreter, but where the interviewer was knowledgeable in Vietnamese. Thus the interviewer would have time to think and take notes, while being able to verify the quality of the translations, and be alert to any information not transmitted by the interpreter.

There is a risk that some interpreters may censor the discussion for various reasons - because of politeness (when the interviewer poses questions which are considered too blunt), or because a question is politically too sensitive. The extent to which my material suffers from such censorship must remain uncertain. I can only say that the relatively free form of the interview enabled me to repeat questions. In addition, the interviews were predominantly made with one person, i.e. the most senior staff member present. However, there were in most (if not all) bank meetings, and in many other meetings, at least one, and often several other persons from the bank present (apart from the interpreter). Sometimes these other people also spoke English, and on those occasions, the interpreter was unable to censor the dialogue, without the mute consensus of the other English speakers present.

2.3 The Time Period

The present work constitutes a snap-shot of a process. There is thus a problem of periodization. What is the relevant period to study in order to obtain valuable insights into the transition problem? Essentially, the study discusses the state of the banking system in the 1991-1992 period, or more precisely late 1991 and early 1992. This periodization is a consequence of my research planning. During a first visit to Vietnam in February and March 1991, I met with some people who worked or had connections with the banking system. The bulk of the information was obtained from September 1991 to January 1992. Some complementary interviews were made during November and December 1992. In December 1993, I had a number of follow up discussions with some of the interviewees from the longer visit in 1991-1992. The bankers then reported that many of the problems experienced two years ago were by now at least partly resolved. It is premature to claim that the banking system went into a wholly new era

some time in 1993. My impression is however that there was a difference in attitude between the December 1993 visit and the visits one and two years earlier.

The quality of the interview material might have been improved, had I known when I started what I know today. If, when I started, I had better understood how to work my way through the bureaucracy of the banks, and if I had better understood Vietnam, I could have better designed my interview program, made more interviews with more people in more banks, and possibly also have conducted the interviews more systematically and consistently. Since the times they are a changing, this critique partly disqualifies itself. This is a study of a moment in the transition in Vietnam, a moment which constantly transforms itself into another moment with other problems and features. Despite its shortcomings, I have gathered a unique set of data from a specific time period. From this data I am seeking to trace a message, which is then being transmitted in this work.

3. The Structure of the Study

Chapters II and III establish the theoretical foundations for this study. Since the study is wide-ranging, these chapters are also quite extensive. The first half of Chapter II discusses the institutional perspective and its operationalization. The second half gives an overview of the role of finance in a market economy, aspects of banking regulation, and the role of finance in economic development.

Chapter III deals with central planning and transition to a market economy. It discusses the basic principles of the socialist system, and the role of banks and money in this system. Thereafter it examines the tensions of central planning, which leads to the eventual break-down of the system. I then discuss the ingredients of market reforms, the debate on market socialism (which is of specific relevance for Vietnam, with its objective of maintaining a basic socialist orientation), and banking reform. I also survey some of the transition literature and its attempts to explain, predict and solve the transition problems, and finally I argue for an institutional approach to transition.

Chapter IV brings us to Vietnam. This fairly short chapter describes the historical background to the current political and economic situation in Vietnam, and presents the economic reforms which have been attempted throughout the 1980s, and accelerated since 1989.

In Chapter V we turn to the Vietnamese banking system. This chapter is also partly a background chapter. It provides certain basic arguments in support of the hypothesis that the financial system act as a bottle-neck to the further development of Vietnam, and then describes the principle elements of bank reform and the basic structure of the financial system, including informal finance. In this chapter, I also

present a brief introduction to the interview material. This presentation may serve as a complement and a check-list for the discussion in the following chapters.

Chapters VI and VII, which use the interview statements extensively, constitute the core of the study. Chapter VI has the sub-title "Intermediation and Performance". It explores financial statistics as far as this is possible, as well as the qualitative statements made by the interviewees. This chapter deals with the problems of resource mobilization and credit allocation, interest rates, the payment system, debt and repayments, and profitability and competition. The sub-heading of Chapter VII is "The Institutional Environment", and it takes a broader perspective, concentrating on qualitative aspects. It discusses the organizational structure and banking skills, the legal framework and the role of the various bank authorities (including both the central bank and the various government bodies).

The final Chapter VIII is brief. It summarizes the lessons drawn from the empirical study and their relationship to the institutional theory. The chapter concludes with a few speculative remarks on the further development of Vietnamese banking and the Vietnamese transition process.

CHAPTER II

INSTITUTIONS, TRANSACTION COSTS, AND FINANCE

Three areas of inquiry relate to the transformation of the financial system in Vietnam. The first is the study object per se: a financial system. The transformation process aims at commercializing the banking system, making it similar to systems in market economies. What is, then, a financial system in a market economy? What is its role, how has it evolved? And what are the important aspects of finance in relation to the functioning of an economy at large? The second area is the transition from a centrally planned system to a market economy, the process in which the financial system receives a new function. What is transition - from what system, along which path? And what are the problems of such transition? The third area is Vietnam itself: the historic and institutional context of the current transition.

This chapter and the following address the first two issues: relevant theories and experiences of finance, central planning and transition. The common denominator for these theoretical overviews, as well as the empirical study, is the institutional perspective. The first half of this chapter introduces this perspective. The second half deals with main the features of finance in a market economy, and the specific features of finance in developing countries. Problems of central planning and transition are treated in the subsequent Chapter III. The rest of the thesis deals with the third topic: Vietnam and its banking system.

1. The Institutional Perspective

For each situation in which economic interaction is to take place, a specific set of institutions - rules or constraints - determine the agents' possibilities to transact and make agreements with each other. The transaction costs affect the efficiency of interaction and exchange, and may also induce institutional change: new rules may develop that better adapt to the given situation. Analyzing how a system undergoing economic transition induces and responds to transaction costs, is a way to better understand the problems and prospects of the transition process in the Vietnamese banking system. This section aims to briefly introduce some of the main concepts in what is often referred to as new institutionalism.[1]

The area is heterogenous and wide-ranging. The need to consider the institutional constraints for economic interaction is today widely recognized in most fields of economics - both in theoretical development and empirical studies. Consequently, there is some debate on what is the proper definition of the new institutionalism.[2] The view taken here is quite eclectic in the sense that "any economic endeavour pursuing explanations which involve institutions in the role of either *explanantia* or *explananda* or both, constitutes a case of institutional economics".[3] The study of transactions "is really a core matter and deserves renewed attention".[4]

The presentation starts with a section on transaction cost economics, which focuses on the rationale for institutional arrangements such as markets, hierarchies, and relational contracting. Closely related to transaction cost economics is contract theory, which studies generic contracting problems and their solutions. A third important line of research is the "new economic history", which focuses explicitly on institutions, i.e. formal and informal rules, in order to understand economic change. Finally, one may usefully separate transaction costs into the two broad classes of coordination and motivation costs. This approach is briefly introduced in this chapter, and will be consistently applied throughout the study.

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[1]Williamson (1975), Chapter 1, launches the concept. Langlois (1986) is an attempt to put the new institutionalism in perspective - historically and with respect to other fields of economic theories. Milgrom & Roberts (1992) is a broad overview of issues relating to transaction costs economics. An issue of the *Journal of Institutional and Theoretical Economics* (1993), especially Williamson (1993), is a valuable introduction to the new institutionalism and its various sub-fields. See also Mäki (1993).

[2]See, for example, Eggertson (1990), who distinguishes between *neo*-institutionalism and *new* institutionalism, or Posner (1993), who complains that new institutionalism is anti-theoretical. The label *new* institutionalism relates the approach to the old institutionalists (e.g. Veblen, and Commons). The latter stressed the importance of the institutional and historical contexts for economic analysis, not least power relations. But *new* also refers to its attempt "to relate itself to neo-classical economics rather than to repudiate it as did the 'old' institutionalists" (Gunnarsson, 1989, p. 45).

[3]Mäki (1993), p. 11.

[4]Williamson (1975), p. 1.

1.1 Transaction Cost Economics

Transaction cost economics broadens the traditional neo-classical market model which takes institutions as given, assuming that prices are sufficient to coordinate and motivate agents' activities.[5] Ronald Coase laid the foundation by asking a simple but path breaking question: Why do firms exist? Why is the market system and its price mechanism sometimes replaced by what Coase calls an entrepreneurial coordinator, who governs activities through centralized orders? His answer is that transactions in the market involve costs, which may be higher than the costs of transactions in hierarchical organizations. The firm economizes on these *transaction costs*.[6] Coase also shows how positive transaction costs motivate the existence of a legal system. Without these costs, actors themselves would be able to agree on efficient allocations through negotiations.[7] According to Coase, it is the very existence of transaction costs that accounts for the difference between the real world and the idealized world of modern economic theory. The legal system should be seen as an institutional response to the existence of transaction costs.[8]

Coase gained comparatively little attention when he first launched his thoughts about transaction costs. Oliver Williamson's contributions have been essential for the revival of Coase's seminal ideas. Basically, Williamson focuses on the *governance structure* of different types of organizations (in Williamson's world everything from markets to hierarchical organizations).[9] What determines whether a firm (a hierarchy) or a market evolves and solves the transaction problem? asks Williamson. The question has relevance not only for problems of firms in a narrow sense, i.e. profit maximizing corporations (such as commercial banks), but also for the problems of society's

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[5]Williamson (1985), pp. 15-16.

[6]Commons (1934) argued that *transactions* should be the basic unit of analysis. Coase (1988[1937]) put forth the idea that institutions are a response to transaction *costs*. Coase (1988) contains his main contributions from 1937, 1946 and 1960.

[7]Coase (1988 [1960]).

[8]What Stigler (1966) has labelled the *Coase theorem*, has received considerable attention as an argument for efficient resource allocation through free exchange. In a situation without transaction costs, where preferences are not effected by increases in wealth, the actors will, through negotiations, reach a solution which maximizes the total utility (see further Cooter (1987) for a brief introduction to the many interpretations of the theorem). Note, however, that Coase's ambition was not to describe any simplified version of the real world's ideal economic interaction: "The world of zero transaction costs has often been described as a Coasian world. Nothing could be further from the truth. It is the world of modern economic theory, one which I was hoping to persuade economists to leave. ... I argued that in such a world the allocation of resources would be independent of the legal position" (Coase, 1988, p. 174).

[9]Williamson (1975) and (1985) are central works. See also Williamson (1991).

organization as a whole, thus encompassing vices and virtues of central planning and market or mixed economic systems.[10]

Essentially, transaction costs are *contract costs*: all the costs involved in establishing, monitoring, and enforcing contracts. Contracts are not only those agreements which have legal status, but those which "may encompass the sort of actions each is to take, any payments that might flow from one to another, the rules and procedures they will use to decide matters in the future, and the behavior that each might expect from the others".[11] The difficulty - or impossibility - of writing complete and exhaustive contracts is a central concern of transaction cost analysis. What happens when contracts are more or less incomplete, or even implicit?

Behavioral assumptions

Transaction cost economics relies on two assumptions about economic behavior, which explain the problems of contract writing: *bounded rationality* and *opportunism*.[12] Bounded rationality implies that agents do their best with limited capabilities and information: actors are assumed to be "*intendedly* rational, but only *limitedly* so".[13] Bounded rationality is a modification of neo-classical theory's maximization idea. People "cannot solve arbitrarily complex problems exactly, costlessly, and instantaneously, and they cannot communicate with one another freely and perfectly". Instead they try to "do the best they can given the limitations under which they work. And they learn."[14]

The idea of bounded rationality is a useful metaphor for understanding how agents adjust to information imperfections in real life situations. People must make choices based on a limited knowledge; not all the possible unforseen circumstances can be considered, not all the possible, but costly, calculations will be undertaken, and language itself is imprecise and limits the information communicated. Yet, it seems like the concept is somewhat vague when we want to use it to examine what agents really do in a given situation. Hence, one may get quite far by assuming strict rationality, but with the constraint of limited information.[15] However, there is a fundamental difference between lacking information about all the payoffs of a given game, and lacking

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[10]Both Coase and Williamson are clear on this broader perspective. Williamson also points out that markets and hierarchies are extreme forms of organizations in a continuum of different mixtures of the two. Williamson (1991) explicitly discusses the features of hybrid forms of organizations.

[11]Milgrom & Roberts (1992), p. 127.

[12]Discussed by Williamson (1985) pp. 43-64 in the chapter on "Contractual Man". See also Milgrom & Roberts (1992), pp. 128-140.

[13]Simon (1961), p. xxiv.

[14]Milgrom & Roberts (1992), pp. 129-130.

[15]As mentioned by Williamson (1985) in footnote 6, p. 46.

information about the available strategies.[16] Agents in the Vietnamese financial system do move from one game (central planning) to another (the market economy), and it is far from clear that they are aware of the strategies available to them.

Opportunism refers to human actors as being "self-interest seeking with guile".[17] People will, if given the opportunity, try to improve upon their own situation, even if this implies breaking implicit or explicit contracts. Obviously, the possibility to enforce contracts influences the opportunistic behavior of agents. It is the task of transaction cost analysis to understand when an opportunity is actually given. Recognizing opportunism does not mean that people are always cheating and dishonest, only that opportunistic behavior may occur.

Bounded rationality and opportunism restrict the agents' possibilities to write complete contracts. There will always be limits to what they can know and foresee about each other, about the environment, and about the future. Transaction cost analysis is thus to a great extent concerned with problems of uncertainty, or in more modern terms, imperfect information.[18] In addition, the lack of proper enforcement mechanisms also causes high transaction costs in situations where the information problem is irrelevant: What kind of contract should you sign with a counterpart that you know will behave opportunistically and knowing that you will have no possibility of enforcing the agreement?[19]

Transaction cost economics provide a method of analysis, enabling an understanding of the rationale for the emergence of different institutions. The analysis allows us to determine the likely results of different institutional and organizational conditions. Finally, the analysis, if so desired, might be used for normative purposes, by evaluating the institutional structures that would reduce transaction costs.

1.2 Contract Theory

One sphere of theories originating from transaction cost economics is contract theory. It is the study of how different types of "generic forms of governance" economize on transaction costs.[20] Many of the models focus on the principal-agent relation, where imperfect information is central. The analysis often applies game

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[16]Nelson & Winter (1982), p. 66-67.

[17]Williamson (1985), p. 47.

[18]The problems of uncertainty (lack of information) in economic interaction was pointed out by Knight (1921).

[19]The example is extreme: in no situation is information perfect, but it illustrates that transaction costs do not only occur because of imperfect information.

[20]Williamson (1991), p. 269.

theoretic methods to understand the strategic interaction between agents in various situations.

Let us return to Coase's question about the rationale for the existence of firms, to get a notion of some basic ideas within contract theory. The firm, by vertical integration, manages to reduce the number and simplify the content of contracts, and the "essence of the contract is that it should only state the limits to the power of the entrepreneur".[21] The entrepreneur (presumably the owner) rules by order, a system agreed on in the contract between the entrepreneur and the employee. Roughly, the contract within the firm only stipulates the framework for the parties' interaction: the authorities and responsibilities involved. It is less specific about actual performance (for example exactly what and how much a worker should do). By contrast, the market contract stipulates clear objectives regarding the relationshop; it treats, for example, the type of exchange to take place and the payments involved. Normally, it leaves out how this performance is to be accomplished.

Two questions arise. The first concerns *authority*: what creates the power in a hierarchical organization that enables a coordinator (an owner or a manager) to order others to obey, so that whatever the organization aims to achieve, is actually done?[22] The second question concerns *the scope and limits* of such authoritarian (fiat or central) ordering. What makes the hierarchy a more or less efficient organizational form compared to that of a market? Both questions are strongly related to the issue of property rights.[23]

Right of property, ownership, matters because it is difficult (impossible) to write complete contracts about all the alternative uses of the assets in all the possible contingencies.[24] The owner has the residual control, and is the residual claimant for all those eventualities which the contract leaves out. The owner has the right to make decisions about the asset's use, keep the profits generated, and bear the risk of losing the asset. These qualities of ownership apply equally to an owner of a single machine

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[21]Coase (1988 [1937]), p. 39.

[22]Note that this concern with authority explains the hierarchical arrangement in a situation with agents who are able to act freely, i.e. choose to take part in a hierarchy or not. Yet, the idea is also useful for an understanding of hierarchies when their coming into existence is due to explicit decisions by certain powers in the society, not necessarily voluntary to all the participants (as, for example, the hierarchical organization of command economies).

[23]Alchian & Demsetz (1972) pointed out that a firm is a "nexus of contracts". Since the entrepreneur is the residual claimant (by owning equity) this motivates him to monitor the workers' performance; the workers, in turn, are motivated by the advantage of pooling their efforts into a team, thus being more successful in competition with other teams (other firms). It seems that Alchian & Demsetz do provide a plausible explanation for hierarchical authority - the employers' ownership of equity - although they claim that "no authoritarian control is involved" (p. 794).

[24]Milgrom & Roberts (1992), p. 288 ff.

or his personal skills, as well as to owners of large clusters of assets in a hierarchic organization.

Why, then, are hierarchies formed? How do they economize on transaction costs, and when are other forms of organization (markets) more efficient? Reference to economies of scale and scope in production are too shallow as explanations for vertical integration.[25] Assume that each individual has the control of a specific set of assets. One could then imagine that bilateral contracting replaces the hierarchies. The impossibility of complete contracting makes this solution futile. Instead, the hierarchy, for one thing, reduces the costs of contracting with respect to coordination. The bilateral contract would need to specify how the parties were to meet and exchange information and inputs throughout the production process. In the hierarchy, direct ordering and organizational routine replace these tedious specifications. One coordinator at the top has the overview to efficiently steer the production, while the ruling corporate culture or social norms (i.e. implicit contracts) further smooth coordination.

Another motive for the hierarchy relates directly to the residual power falling in the hands of the owner because of the incompleteness of contracting. An owner forms a hierarchy to maintain the residual power, and thus becomes a residual claimant of the profits generated: a boss may fire an employee but retain the assets with which he worked. If the boss instead had a market relationship to the worker, the asset would go with the worker.[26] Hierarchies are more important, the higher the degree of *asset specificity*.[27] Clearly, an investor in an asset exclusively designed for a specific use, risks considerable losses if an agreement concerning the use of the asset should fail. He thus needs a firm control of the asset by establishing hierarchical relations with the counterpart. In fact, a key assumption in Williamson's analysis is that the court system is not capable of enforcing a contract to the extent desired. An investment in a very specific asset, whose profitability depends on market contracts (for other inputs of labor and capital etc), would be lost if those other contracts were broken, since the investor would have no help from the court system to enforce the contracts. The hierarchy therefore internalizes the enforcement of contracts. The smoother coordination, and the benefits of ownership in combination with asset specificity thus provide at least partial explanations for the expansion of firms.[28]

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[25]Williamson (1985), Chapter 4.

[26]Grossman & Hart (1986).

[27]Williamson (1975) and (1985) on asset specificity.

[28]Another, somewhat different explanation behind the hierarchy are the specifics of employment relations in different types of production. The hierarchic solution is favorable in cases where transactions between employer and employees are frequent; the hierarchy reduces the costs since there are economies of scale in contracting; Wernerfelt (1992).

Still, if the hierarchy reduces transaction costs, why don't firms expand into one large unit? Coase mentions diminishing returns to management, i.e. management's difficulties in controlling a large number of employees, as a reason for the limits to firm size.[29] This hints at a more general problem, in that the benefit of hierarchic coordination eventually transforms into a disadvantage. The central coordinator is dependent on a large quantity of information in order to succeed.[30] Gathering and processing the required information is a gigantic time-consuming project, should the coordinator attempt to take advantage of local knowledge. Alternatively, if local knowledge is ignored, the coordinator will soon fail to have a complete overview and thus be unable to efficiently coordinate the activities.[31] These management problems could be overcome by delegation, however, where separate departments were run as individual firms, while maintaining the common ownership. One could even imagine a combination of benefits from a decentralized organization, economizing on transaction costs by duplicating market relations in certain ways, at the same time as the central leadership intervenes is situations where it is more efficient to use hierarchical transactions. What is the problem with this solution?[32]

Firstly, there is always the risk that owners (the central authority) will intervene even if they are not supposed to (according to original agreements). They could do so if it were beneficial to them or to the firm at large (for example by letting the whole company benefit from innovations made in one of the decentralized departments). This risk is obviously a disincentive to the different departments, which may be less ambitious in their performance. An effect of such intervention may be that the propensity to innovate and suggest new, cost reducing solutions may diminish if these innovations will be exploited by the firm at large, without giving sufficient credit to the innovative department. Secondly, there are problems of wasting the organization's resources on various "influence activities"; the different units spend time and effort to convince the central authorities to intervene in various ways that would be beneficial to that particular department.[33]

The problems of excessive intervention and resources wasted on influence activities are major reasons why this type of hierarchy has limits in efficiency terms. The problems would not occur if it was not for opportunism. Without opportunism, the

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[29]Coase (1988 [1937]), pp. 43-44, refers to Kaldor (1934), and Robinson (1934).

[30]An argument put forth by Hayek (1945), who points out the enormous information requirements in the centrally planned system. We return to this in Chapter III.

[31]See Bolton & Farrell (1990) on the trade-off between centralization and decentralization (quick decision making vs the use of local information).

[32]Williamson (1985), pp. 135-138.

[33]Milgrom & Roberts (1990) and (1992), pp. 192-194.

owner and his employees would stick to the agreements made. The owner would not intervene, but allow people to act independently although under an umbrella project (the huge hierarchy). Moreover, the departments and the employees would not opportunistically break contracts about what they were to accomplish, by wasting resources trying to influence each other.

1.3 Institutional Change

Douglass North notes that traditional economic theory cannot properly explain differences in economic development between countries and regions. Why are potentially high payoffs to various activities (such as increases in savings rates) realized in some countries but not in others?[34] The answer is that institutions determine these payoffs, and institutions differ between countries. "The major role of institutions in a society is to reduce uncertainty by establishing a stable (but not necessarily efficient) structure to human interaction."[35] These institutions "consist of formal rules, informal constraints (norms of behavior, conventions, and self-imposed codes of conduct) and the enforcement characteristics of both."[36] Formal and informal constraints as well as enforcement methods change over time. The agent of change is the entrepreneur, who responds to changes in relative prices and preferences. "Relative prices" should be understood in a broad sense, and these include costs of transaction and transformation (which together form the production costs). Relative prices change because of changes in factor price ratios, in information costs, and in technology.[37]

Institutional change is predominantly incremental, due to the interrelatedness of formal and informal constraints. A new formal law (for example, prohibiting racial discrimination) may be a response to gradual changes in informal rules of conduct (increasing acceptance of people with different ethnic background). Alternatively, the opposite may apply. Establishing respect for a new law might take time if informal values do not agree with the law (like the compulsory use of safety belts in cars). *Path dependency* is an important feature in North's model. The existing institutions define the available choices for agents and thus the degree and direction of institutional change. This has implications for efficiency. "Path dependence can produce durable differences in performance between two societies, even when the formal institutions, resources, relative prices, and individual preferences in the two are similar".[38]

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[34]North (1990a), (1990b), (1991), (1993).

[35]North (1990a), p. 6.

[36]North (1993), p. 36.

[37]North (1990a), p. 84.

[38]Putnam (1993), p. 179.

Within contract theory, the focus is on the organizational response to existing institutions (formal and informal constraints). Organizations economize on transaction costs (costs which arise because of society's institutional constraints). Since these particular organizations appear, and not others, they are viewed as relatively efficient. In North's view, the emerging institutions, and thus also the organizations appearing in response to these institutions are not necessarily efficient or socially productive. They are products of the agents' perceptions of relative prices and preferences, constrained by prevailing institutions. Institutional change might produce more or less allocatively efficient solutions.[39] Because of path dependency, institutions are even more ambiguous in efficiency terms. The established institutions create an "institutional matrix" of interdependency and "bias change in favor of the interests of the existing organizations".[40] Institutions that survive are not necessarily efficient, but they are somehow relatively stable. Hence, differences in economic performance may be explained by the complex interaction and change of institutions in various countries.[41]

Coase and Williamson have a fairly optimistic view on organizations and institutions: organizations manage to economize on transaction costs. North is more pessimistic: you might end up with very unproductive organizational solutions. Tracing the logic behind organizational behavior, ruled by institutional constraints, enable us to understand both how and why things work and do not work.

A final remark about culture: as discussed in Chapter I this study ignores, to a large extent, country specific features of transition in the Vietnamese banks. This means that the specifics of the Vietnamese culture will be largely disregarded. This is not only a limitation for the analysis, but also, it might seem, a paradox when considering the elements of the institutional perspective. Change is determined by institutions, and the institutions appearing in each instance are products of previous institutions. These institutions may be summarized as culture: Culture is the formal and informal rules determining behavior. Indeed the perspective in that sense comes very close to a sociologist's or anthropologist's view, that society's organization is a reflection of culture.[42]

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[39]North (1990a), Chapter 9.

[40]North (1993), p. 38.

[41]In *evolutionary game theory*, the analysis is brought into yet another dimension: what creates the fundamental institutions, which, in North's analysis, give rise to different constraints and different relative prices? For example: Why do we use money? Why do we have individual property rights? Why do we follow ethic norms which inhibit us to go around and kill each other? This approach is not concerned with any rationalistic behavioral assumption: people just act; groups of individuals interact and certain types of behavior survive, thus establishing institutions. See Weibull (1995) for an introduction.

[42]Greif (1994).

By the same token, culture becomes a vague concept. The definition of institutions is one way of further specifying what aspects of human interaction or culture we are talking about. Culture consists of many forms of social interaction. In this study, I concentrate on the aspects of the culture constructed by the Vietnamese economic system and its bank organizations, and in a sense I try to specify the cultural aspects, by talking about the institutions created by this system, and the path for development that this institutional context creates.

1.4 Coordination and Motivation

In a broad sense, any resource allocation involves problems of coordination and motivation.[43] From traditional economic analysis, we know that the price mechanism in many ways manages to solve problems of coordination (by its signalling features) and motivation (through profit maximization and budget constrained utility maximization). Nonetheless, in the real world we rarely have situations of pure market exchange (for example due to economies of scale, externalities and government interference). Therefore, we need to know more about coordination and motivation costs involved in exchange, and better understand how these costs relate to their institutional environment.

Sorting out the elements contained in the concepts of coordination and motivation costs is a way to operationalize the fairly vague references to transaction costs that have so far been made. Here, these components will be introduced briefly. More flesh will be put on the bones in the subsequent section and in Chapter III, where I discuss how coordination and motivation apply to finance, central planning, and transition.

Coordination

Coordination costs concern problems of *acquiring*, *processing* and *exchanging* information. If we think about the transaction problem as one of agreeing on a contract (which is more or less incomplete, and may be implicit, i.e. not explicitly discussed or written), a first requirement is that the parties involved know about each other. Resources spent on searching are thus a coordination cost. But finding each other is only a start. It is also necessary to acquire information about what the other party wants, what it is prepared to pay etc. In addition, the parties need to carry out some sort of appraisal as to whether the proposed conditions are feasible.

Simply getting the information is not enough. It has to be processed so it can be used for decision making. Such processing may simply refer to correctly interpreting the information: "So, this is what she wants!". In a large bureaucratic structure, however,

[43]Milgrom & Roberts (1992) make the distinction throughout their analysis.

processing information refers to the procedures of sending relevant information to different departments and getting the necessary decisions in order to go on with the exchange. Besides, merely interpreting information may not be that simple in itself: a main theme in the present study is that coordination costs increase when new rules and objectives are introduced in an old organizational structure, where the agents have no preconception of what these new rules imply. Understanding what you want, and deciding that it is of interest to me, does not mean that we will agree on the terms for the exchange. We need to bargain. Negotiations are a form of exchange of information, which constitute a third type of coordination costs involved in contract writing.

Institutions may reduce coordination costs. The price mechanism has already been mentioned. Advertisement in newspapers is another. There are also standardized contracts and procedures for contract writing. In a broader sense, both formal and informal constraints rule the way we manage information: where we are likely to find each other, in which ways we understand each other, how we make decisions, and how we negotiate agreements. An important informal constraint, which reduces coordination problems, are conventions.

Motivation

Motivation costs concern agents' incentives. We may distinguish between problems of *specification*, *observation*, *verification*, and *enforcement*.

If we have found our counterpart and know what we want from each other, the problem remains regarding how to specify our agreement. There are costs involved both in foreseeing events, in correctly specifying terms, and actually writing the contract. Contracts are necessarily incomplete, and different types of agreements have different *incentive effects*.

Contracts are incomplete partly because observation is costly. We may have found our counterpart, and we know what he wants and what terms he proposes, but certain information remains unknown; we cannot be totally sure of with whom we are dealing or what we will actually get from the deal. These problems can be thought of both in pre- and post-contractual terms.

There are costs involved in observing projects and actors' characteristics prior to writing the contract. If we do not know the true features of a proposed project, *adverse selection* may occur.[44] For example, sellers of high quality objects are unable to distinguish themselves from sellers of low quality objects. Thus the price reflects average quality. As a result high quality sellers withdraw from the market.

[44]Akerlof (1970) is the classic reference. In the "market for lemons" (i.e. used cars), only used cars of poor quality will be traded.

There are also costs involved in observing what is actually taking place after the contract is signed, and agents therefore have an incentive to cheat. This is the *moral hazard* problem.[45] Clearly, if you agree on deliverance of a certain type of high quality steel for a construction, but nobody is able to observe (at least for a long time) if the material supplied actually is that good (hidden in the walls, as it is), there are motives for delivering goods of poorer quality (it does not necessarily happen, but it may). Likewise, when the insurance company is unable to observe where you actually put your insured bicycle, you may be motivated to put it in obscure places where it is likely to get stolen; when your bicycle is gone, the insurance company cannot know for sure that you were careless, and cannot hold it against you when you charge your insurance.

Costly verification is a third motivation problem. It refers to the problems of proving facts to outside parties. Even though a contract is fairly complete, and both parties know when it is breached, this might be difficult to establish in a court situation. The problem may result in less complete contracts, and more complex institutional structures, where the need for outside intervention is reduced. Verification is closely linked to enforcement, the fourth motivation cost.

Enforcement is a central concept in much of what has so far been discussed. To Williamson, the shortcomings of external enforcement (the court system) motivate the particular governance structure of various organizational solutions (for example markets or hierarchies). North defines formal and informal constraints *and* their enforcement mechanisms, as the institutions which determine economic action. There are direct costs of enforcement both for the punisher and the punished. Enforcing the law by running a prison is an obvious example.[46] Direct costs of enforcement may cause *time inconsistent behavior.* A law is established, stipulating imprisonment when it is broken. As it turns out, the prison is crowded and new prisons are too expensive to build, and the law breaker is never put in jail. There are also indirect costs of enforcement, again both to the punisher and the punished. Enforcing a contract may result in outcomes which seem worse for both parties. Again, this may result in discretionary and time inconsistent behavior. An example is given by the *soft budget constraints*, i.e. the systematic surpassing of budget limits, when agents know they will always obtain additional funding.[47] The lack of enforcement mechanisms has important motivation implications. Knowing that you will not be punished for bad behavior, you may continue with your mischief. Knowing that you will not be able to enforce an agreement, you

[45]The classical example of moral hazard is that of insurance. If you are insured, you are less careful, and the risk is higher that your insured goods will be stolen. But if your insurance include self risk you are motivated to take better care. See Holmström (1979).

[46]The maintenance of the prison is costly to the state, and to the prisoner there are costs in terms of losing your personal freedom, and losing your alternative income.

[47]Kornai (1992). The soft budget constraint will be further dealt with in Chapter III.

may be reluctant to agree on anything at all. Thus, lack of enforcement may cause both fraudulent behavior and passivity.

Coordination problems, when it comes to acquiring, processing and exchanging information, and motivation problems, relating to problems of specification, observation, verification and enforcement, run as an underlying theme throughout this study. In the following section, and in Chapter III, problems of finance, central planning, and transition will be analyzed in terms of these transaction costs. When analyzing the transformation of the Vietnamese banking system, the concepts will be used as the main analytical tool.

Obviously, there is plenty of interrelatedness between coordination and motivation costs. For example, the problem of acquiring information is a problem both of coordination and motivation. If you do not know with whom you are dealing or what you are agreeing on, you are not very motivated to act at all. The coordination problems relating to a failure to understand the new rules of the game properly, also provide a basis for motivation problems. If you are given an order to deliver something, but you are unsure whether the person who gave you the order actually has authority to do so, perhaps you will settle for doing nothing at all (not deliver), since you fear you might be punished by some other authority if you do. Problems of coordination and motivation are often two sides of the same coin. It is thus unlikely that the real events can be understood by looking at only one side of it.

Any approach has its limitations. It is difficult to identify the exact coordination and motivation costs involved. There is also a risk that the present perspective ignores other important features of the Vietnamese economy which are relevant for understanding how Vietnam will manage to become a market economy. A case in point may be resource availability.[48] But an examination of resource availability is not the purpose here. This study can only claim to contribute a little piece to the puzzle of Vietnamese economic development.

2. The Financial System in a Market Economy

The Vietnamese banks are to adapt to the requirements of the market economy, transforming into a commercial banking system. What is, then, a commercial banking system in a market economy? This section sketches an answer to this question by focusing on issues which relate to banking in developing countries. First, it presents the basic role of the financial system. Second, it discusses how the banking institution is a response to transaction costs. Third, it gives two basic reasons why banks and the

[48]Nove (1986) points out that information, motivation and *means* together rule action; p. 33.

financial system are subject to special regulation and government intervention, with a specific focus on financial systems in developing countries. The final part discusses the informal financial sector, which by definition operates outside any formal banking regulation but plays an important role in most developing countries.

2.1 The Role of the Financial System

The financial system has three functions: it reallocates financial resources, by bringing together savers and borrowers, it provides a payment mechanism, and it transfers and distributes risk.[49] The financial flows match the flows of real resources; households, i.e. individuals, receive income from their work effort and from the real capital they own, making them net savers. Net saving is channelled to investments in three different ways. First, households and capital owners invest in their own projects. Both investments in housing and enterprise investments through retained earnings are examples of such self-finance. Second, through taxation, the government absorbs part of the savings for its investments and expenditures. Third, some of the net saving is reallocated through the financial system.[50]

The first banks

Historically, banks appeared along with increased monetization and specialization. Technological progress in various fields (foremost in production and transportation) made money an important means of exchange. Private bankers were employed to provide loans for commercial transactions and the service of safe deposits of coins and gold (i.e. money) in the banks. These first banks charged depositors a fee for the protection of their money in the bank vaults; the first paper money was the depositors' receipts for their cash deposited. As the receipts guaranteed the value of the deposit with the banker, it was in practice as good as any cash money. Therefore, it became easier to exchange the receipts rather than withdrawing the money from the bank whenever it was needed. Since the banker was quite sure that not everybody would fetch their money in the same time, he could safely lend from the deposit to somebody else.

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[49]See Bell (1988), Greenwald & Stiglitz (1991), Stiglitz (1991), and Mayer & Vives (1993) for overviews of the role of finance and credit markets; Fry (1988) and the World Bank (1989) survey the literature on finance specifically related to developing countries.

[50]The focus in this study is on financial organizations as intermediaries for financial resources. Channelling financial resources through a banking system is, however, only one way to achieve intermediation. Other forms of debt financing are various types of direct lending (such as company securities). In addition, equity may finance the operations of firms. Different financial structures have different incentive effects for management and owners. For such aspects of corporate control, see Harris & Raviv (1991) and Milgrom & Roberts (1992), Chapters 14 and 15.

Deposits became beneficial to the banker for another reason than the safety fee. The banker could lend the money deposited and earn the interest rate, part of which he used to pay the depositor. When the new borrowers also wanted to safely deposit part of the borrowed money in the banks, bankers could expand credit beyond the initial amount of cash kept in the safe; thus the emergence of what is today known as *credit creation* or *fractional reserve banking*.

Modern banking

The financial system in the modern economy is a distant relative to the first banks. It basically provides the same services, but within a much more sophisticated structure. Most modern banking systems consist of a *central bank* and *commercial banks* (and other financial organizations).[51]

The central bank has three main tasks. First, it controls the money supply of the economy. It does so by printing and issuing money, by controlling government lending from the central bank, and by conducting open market operations (the buying and selling of government securities in the open market). In addition, credit creation may be controlled through restrictions on interest rates, and requirements about the cash reserves held in the banks. Second, the central bank serves as a *lender of last resort* in its role as banker to the banks, and to the government. Since commercial banks can turn to the central bank to borrow funds to solve acute liquidity problems, the risk of depositors losing their money is reduced, and hence there is little need for them to panic and withdraw their deposits. The stability of the system is thus enhanced. Furthermore, for the purpose of maintaining stability, a third task for the central bank is to be in charge of a supervision function which controls the commercial banking system.[52]

Commercial banks, by providing cash and through different forms of clearing, and transfer systems, are part of the payments system. They reallocate financial resources by accepting deposits and advancing credit. They agglomerate funds, which

[51]The institutional perspective distinguishes between *institutions*, i.e. the rules regulating a certain activity, and *organizations*, i.e. the physical, organizational reflection of these rules. In the finance literature (and sometimes in other organizational contexts as well), banks and other financial organizations are often referred to as "financial institutions". The terminology becomes further confusing as the recent developments of financial intermediation theory stress a *functional* focus (i.e. the functions that banks and other intermediators perform) rather than a focus on the *institutional* structure (i.e. the kind of organizations which perform these functions, which vary from country to country due to historical reasons). In reality, the former approach is more "institutional" than the latter, as it traces the transaction costs arising in financial exchange, and the resultant institutional responses. In this study, "institutions" are referred to only as rules for interaction: the banking institution is thus the specific pattern of intermediating resources, conducting payments, and handling risk, and not necessarily a bank organization.

[52]See Downes & Vaez-Zadek (1991) for an extensive treatment of the role of central banks.

hardly any single individual could provide, by pooling savings. By spreading these funds on different projects, the banks reduce the risk that any single saver suffers considerable losses. The commercial banks have to offer interest rates which attract savers and borrowers. The bank will be profitable if it manages to lend money to successful projects. The more efficient and skilful the bank is in finding and selecting among customers, appraising and monitoring projects, and enforcing repayments, the more profitable the bank will be.

The modern financial system consists of a large number of "non-bank" financial organizations, for example, finance and insurance companies. Contrary to the traditional banks, these do not accept deposits from individuals. They are, however, important actors on the financial markets as investors in various enterprises and funds. In addition, modern finance also include a large variety of financial instruments: various types of savings accounts, various type of loans, and also different forms for lending.[53]

2.2 Banks as Financial Intermediaries

An important function of the financial system is to intermediate financial resources. But what is the reason why such an intermediating function emerges? Why do banks exist?[54]

Like other firms, banks exist because they economize on transaction costs. Picture a situation without any financial intermediary: only individuals are acting. Some have surpluses of money, others need to borrow to invest in various projects. Given that lenders can charge an interest rate from borrowers, people with money in their pockets may lend directly to those who need the money. In this situation, transaction costs are high. As an individual lender, you have difficulties in gathering adequate information and lack sufficient skills to evaluate the available projects correctly. Coordination costs are high: search costs are considerable as individual lenders and borrowers try to locate each other; it takes time and effort to process information about the agents' requirements for a deal, and to bargain in order to agree on an exchange of funds. There are also substantial motivation costs: specifying the adequate terms for the financial transaction (concerning interest rate levels and repayment periods) is an exacting task; and given such specification, there is the risk that the counterpart will fool you in some way, particularly in this world of non-standardized solutions where you might have problems in observing and verifying her actions; moreover, you may face difficulties enforcing the agreement.

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[53]See Pertington (1989) for an overview of a modern financial system.

[54]See Bhattacharya & Thakor (1993) for a survey of modern banking theory, where this and other central problems in connection with financial intermediation are discussed.

The bank is an institutional response to transaction costs. It reduces transaction costs by its informational advantages and organizational routine. The reduced transaction costs carries over to the interest rate levels. The interest rate constitutes the price of financial funds. The supplier of funds requires and the user of funds is willing to pay a certain interest rate, reflecting the expected return on the investment and the risks involved. Lower transaction and administrative costs, and the effects of risk pooling result in reduced interest rates premiums, which thus contribute to a more efficient use of funds. Let us explore in some more detail how coordination and motivation costs are affected by the existence of the bank.

Coordination cost reduction

The reduction in coordination costs appears because of the bank's informational advantages. The bank is known in society for its function as a financial intermediary. Search costs are thus reduced, since potential clients - both lenders and borrowers - turn to the bank for assistance. The bank has, moreover, the possibility of gathering information both about clients and potential projects. The depositors provide funds to the bank as a kind of liquidity insurance, since they are able to withdraw their deposits at a fixed price. Thus the bank deposit contract handles the information problem of not knowing exactly when you will be in need of your funds.[55]

An agreement about a financial transaction is a comparatively straightforward contract. It stipulates the conditions for the loan contract in terms of interest rates, repayment periods, and conditions for renegotiation, as well as penalties in case of default. The bank has an advanage compared to the individual lender, by being able to further standardize these contracts. The bank may also evaluate projects according to certain standard criteria, which facilitate the processing of information. In addition, due to its routine and experience in negotiating terms for loans, the bank is able to more quickly determine at least the boundaries for a negotiation, and thus reduce the costs of exchanging information. As for deposits, the bank is also in advantage, as its established procedures and known function as recipient of savings simplify the accumulation also of fairly small amounts of deposits.

Motivation cost reduction

A bank reduces motivation costs. Informational advantages are again important. From the bank's point of view, its accumulation of information about clients and projects, in combination with experience in specifying contracts, enables it to screen out

[55]Diamond & Dyvig (1983).

too risky projects (or borrowers). It can also, to a degree, reduce risks of moral hazard, by specifying the contract so that it reduces incentives for undesired action, and by continously monitoring borrowers' performance.[56]

Moreover, there are enforcement advantages. By the existence of the bank, both borrowers and lenders can more easily enforce contracts. In the bitter end, legal action against the bank or the client may be taken, should a contract be broken (a loan not repayed, depositors not getting their money back). Bankruptcy is a final way to sort the failure out, but one which is unsatisfactory to all parties. Enforcement mechanisms for incentive purposes thus set in at a much earlier stage of the transaction.

By institutionalizing *reputation*, banks reduce enforcement costs.[57] Borrowers need a good reputation. In a situation with only individual lenders and borrowers, each agent's information about other agents and their projects is limited. A swindling borrower may try his trick again against another lender, who has difficulties in gathering information about the client's reputation. Other, more costly enforcement systems are required for the individual lender to dare to lend his money. If there is only one single bank, this has pooled the financial resources (the deposits) from the individual lenders, and has thus become the only lender to whom a borrwer may turn. A fraudulent borrower will be known to the bank and banned from further borrowing. The borrower has a high incentive to maintain his reputation, which reduces the enforcement costs. If there are several banks in operation, it is still easier for them to gather information about borrowers' past records, than what it would be for an individual lender.

The bank also needs a good reputation. Borrowers would turn to other banks for loans, should the bank be known to suddenly charge higher interest rates, or demand repayments in advance. Likewise, depositors could withdraw their funds from the banks if the bank was known to break contracts. Its reputation would be lost if it was famous for not returning deposited money. In addition, the bank is a known organization in society. It is easily identified in the event of a conflict. Thus, the bank is a credible lender, and also a (comparatively) safe borrower of people's deposits, since it has little option to run away with the money.

Banks and efficiency

Apart from these reductions in transaction costs, there are also positive risk pooling effects of pulling together various more or less risky projects. By pooling savers together in a bank, and spreading the deposited money on a number of projects,

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[56]Diamond (1984), and Boyd & Prescott (1986).

[57]Stiglitz (1991) discusses the importance of reputation, arguing that large international banks may have more to lose, if gaining a bad reputation, and will therefore be more keen on prudent banking than domestic banks (p. 27).

depositors can share the possible losses due to a failing project, since not all projects will fail. In comparison to the bilateral lending agreement, this reduces the required interest rates, and increases the number of realized investment projects. The bank is thus a relatively efficient intermediary of financial resources.

While the bank reduces certain transaction costs, others remain. For example, the supply of credit may be different, when taking into consideration the moral hazard and adverse selection problem. Credit rationing might take place due to problems of asymmetric information.[58] In this case, lenders cannot distinguish between the risk characteristics of different borrowers. A high interest rate might attract borrowers with high-risk projects while it screens out borrowers with projects of a lower, but safer, return, or make investors deliberately choose riskier projects (i.e. adverse selection). Borrowers might need to engage in riskier projects with a higher possible return in order to pay the high interest rate (i.e. moral hazard). This changes the risk composition of the lenders' portfolio, and decreases lenders' expected return. Hence, lenders would not necessarily want to lend increasing amounts of credit if only the interest rate increases, since the borrowers' choice of projects and their own effort may change. If the lender has problems in observing this behavior, he may want to play it safe by charging a lower interest rate. Note, however, that if the borrower can provide complete collateral as a security against losses, the importance of the adverse selection and moral hazard problem more or less disappears.[59]

Another problem is the risk of time inconsistencies. Banks face the trade-off between costly enforcement and the cost of losing capital. A defaulting loan may be renegotiated for the (short-run) benefit of both parties: renegotiation increases the chances that the expected return from the investment will be materialized, or at least that part of the funds will not be lost. But if a client is aware of the possibility of such renegotiation, servicing his debt might receive low priority. He knows a repayment in delay will be accepted.

These principles of banking provide a framework for studying Vienamese banking. How and to what extent do the Vietnamese banks solve problems of coordination and motivation? Are there information problems? Are there problems of enforcement? How good is the banks' reputation, and do time inconsistencies occur? These and similar questions will guide the discussion, foremost in Chapters VI and VII.

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[58]Stiglitz and Weiss (1981).

[59]With completely collateralized lending, the function of finance as promotor of productive investments also disappears, however. We would not get what Schumpeter (1934) refers to as "abnormal" credit: credit given against future gains. This is credit not given against a tangible collateral, but rather against the banker's confidence in the entrepreneur's ability to transform the credit into production.

2.3 Regulating the Financial System

Modern banking is a product of historic processes. Banking structures vary between countries, in response to different institutional circumstances. Banking regulation and government intervention are perhaps the most important of these circumstances. Banks have almost always been subject to special regulation, over and above regular business law. Restrictions on entry into the banking market, and banks' exclusive rights to issue money are examples of this. There are two distinct reasons for this special attention. First, the banking system maintains a fundamental function in the economy by providing a payment system. Second, finance plays a key role in economic development, which motivates state intervention in financial transactions.[60] To put the current Vietnamese attempts to establish a regulatory framework for banking in perspective, we need to look a bit closer at the arguments for and against various types of banking regulation.

Banks and the payment system

Bankruptcy in banks is viewed as more problematic than other cases of bankruptcy. In essence, the problem has to do with confidence in the payment system. People deposit their money in the banks in trust that they will be able to cash them whenever desired. A prerequsite for the expansion of the credit system is, however, that everybody will not withdraw their deposits at the same time. If they did so, banks would most probably not be able to repay their depositors completely. Depositors would not only lose their money, they would also lose their confidence in the banking system, and refrain from further depositing their money in banks. Thus financial resources would not be intermediated for productive investments.[61] This argument is associated with the view that bank depositors are relatively uninformed and individually weak agents in the system. Hence, they need the assistance of a regulator to monitor the use of their funds.

For these reasons, the central bank functions as a lender of last resort, which ensures the stability of the system. In most modern banking systems there are, moreover, explicit or implicit deposit insurances which guarantees the depositors' compensation in the event of a bank going bankrupt. The necessity to guarantee the stability of banks as well as regulating the banking system relates to arguments about the distinctive features of banks compared to other firms. Similar to other firms, banks are transaction cost reducing organizations. Like other owners, bank owners engage in

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[60]Durski (1993) gives a good overview of various forms of Western bank regulation. Bhattacharya & Thakor (1993) provides more of the fundamental, theoretical aspects of regulation.

[61]See Herring & Santomero (1991) pp. 25-30 on the risk of bank runs and the saftey net of the financial system to prevent these runs.

banking business for profit motives. But as intermediaries of financial resources, banks trade in promises for the future. A contract in a "normal" business transaction, has a fairly limited time horizon; on the other hand, in a loan contract, a borrower promises to make successive payments in the future. This difference between a spot transaction and a credit transaction, is an argument that the contracting involved is more risky and therefore requires additional control and regulation.[62]

There are several economic arguments *against* specific regulation and governmental interference in banking, and in particular arguments against deposit insurances. The fundamental concern is the disincentives created when government protection replaces internal governance mechanisms.[63] If, for example, depositors know that they will be compensated if banks make losses, they have no incentive to monitor and choose between different banks' lending policies and risk taking. Banks, in addition, will be more risk-taking and increase the variance in their portfolio return in order to maximize the value of the deposit insurance.[64]

To overcome these problems, one could, instead, imagine more active and diversified contracting relations between depositors and banks. Depositors who want highly liquid deposits would use banks that keep their money in short term money market instruments. Others, who accept that their deposits are tied until a certain date, could deposit their money with other banks (or on other terms), against a higher return. This would solve the problem of different maturities between deposits and loans, and thus eliminate the risk for bank runs. In addition, if people would choose to deposit their money in banks which have acceptable margins and risk portfolios, bad banks would disappear and the confidence in the banking system would be maintained.

This highly self-regulatory banking business has still to be implemented in reality. Here there are probably several reasons to take into account. One is the problem of transition: deregulation of financial systems does not take place over night, and the process itself imposes new costs on the economy, as people learn to adapt to new rules.[65] Therefore, the given structure, in itself a product of various regulations, might justify further regulation. An example is the problem of free competition in the banking system, in a situation where there is some form of deposit insurance. In principle, free entry of firms enhances efficiency by increased competition. Nevertheless, bank competition creates a problem which other firms do not experience. Increased

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[62]Greenwald & Stiglitz (1991).

[63]Merton (1977).

[64]See further Daltung (1994), Chapter IV; see also and Milgrom & Roberts (1992), pp. 170-176 on the collapse of the Savings & Loans associations in the US, which gives ample evidence of these mechanisms.

[65]The Swedish banking crisis in the early 1990s, following fairly abrupt deregulation, is probably a good example of this.

competition forces banks to squeeze margins to attract customers. This means that banks need to engage in riskier projects and may be incurring greater losses. Given the existence of deposit insurance, depositors are not attentive to the increased risks, and the situation gives rise to poor banking and losses to society.

It is not the purpose of this chapter to stipulate the optimal degree of banking regulation. The institutional perspective indicates, however, some of the essential elements of such a regulation: an efficient financial system needs a legal environment, which supports mechanisms that reduce transaction costs. This includes clear rules of the game, in order to reduce coordination costs; establishing these rules is an important role for the central authority in a country. In addition, adequate institutions which assist in contract specification and help to enforce the contracts, will reduce motivation costs, thus increasing the efficiency of the financial system.

Finance and development

The other reason why banks are subject to special regulation, is the key function that finance plays in economic development. By regulating and intervening in financial conditions, the state could hopefully improve the development process in an economy.[66] There are many related questions in this context. One is whether "outside finance", i.e. finance intermediated through banks and other intermediaries, is more - or less - beneficial for growth and industrial development, compared to "inside finance", i.e. self-finance out of own savings.[67] Another question is whether banks develop because economic progress creates space for financial organisations and instruments, or increased access to financial services (credit and various financial savings possibilities) supports and strengthens investment levels and economic development?

The answers to these questions are not yet well established. Not least is the casual relationship between finance and development difficult to confirm. All one can safely say is that the financial system is an integral part of the economy as a whole; the evolution of finance is interlinked with general industrial development.[68] From an institutional perspective this interdependence between the two seems natural: expansion of markets motivates increased monetization; monetization gives rise to banking; access to banking services increases the possibilities for further expansion of markets, etc.

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[66]For these aspects of government intervention in banking, see, for example, World Bank (1989), Stiglitz (1991), and Greenwald & Stiglitz (1991).

[67]Hellwig (1991).

[68]Gurley & Shaw (1960), Goldsmith (1969).

Thus, the development of financial systems is central to the progress of developing countries.[69]

Expansion of financial systems was for a long time ignored in development contexts in favor of issues such as new technology, and transfers of foreign exchange. The general truth was that a low savings potential inhibits poor countries from accumulating resources and initiating economic growth.[70] Thus the poor countries could not rely on mobilizing domestic resources. Most of the domestic savings were involuntary mobilized through taxation, inflation, and overvalued exchange rates. Paradoxically, at the same time as there was a well established belief that capital accumulation was important for economic growth, and accordingly that the domestic savings rate was important (although insufficient), the capacity to mobilize this saving through the financial system was ignored.[71]

The neglect of savings mobilization was related to the generally negative view on finance; finance was believed to squeeze the real sector for resources, and accordingly had to be controlled. This resulted in policies of financial repression, including legislation on interest rate ceilings, and programs of subsidized credit to specified groups of loan takers (often poor farmers). In addition, this shortage of capital arose in an era when financial needs increased as a result of modernization of agriculture (through better inputs, fertilizers, machines etc). This gave rise to policies of credit distribution through various kinds of development banks. The basic objective was to provide cheap credit to the rural population.

This trend has been reversed. For one thing, the importance of domestically mobilized savings has been stressed: "...financial policies in developing countries have neglected the role of the financial system in mobilizing domestic resources".[72] The possibility of a fairly high savings potential in developing countries, has been recognized.[73] Also poor households manage to save. Although little in absolute terms, their saving sizeable in relation to their income, and they thus manage to smoooth their income over the life cycle.[74] Moreover, the problems of cheap credit are today fairly well documented:[75] when interest rates are low, demand for credit increases, and credit, hence, has to be rationed; the subsidized credit does not reach the target group

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[69]King & Levine (1993a) and (1993b) argue that finance does affect economic growth.

[70]Floro & Yotopoulos (1991) describe this as the traditional approach to capital markets in less developed countries.

[71]King & Levine (1994) labels the focus on capital accumulation "capital fundamentalism".

[72]Fry (1988), p. 302. See also Egger (1986).

[73]See Gersovitz (1988) and Deaton (1989).

[74]Deaton (1992).

[75]Discussed by Gonzalez-Vega (1983) and Adams (1992).

of small producers (farmers), since it is costly; small farmers without collateral are perceived as riskier loan takers, and are screened out of the credit market.[76] In addition, any rationing situation invites corruptive behavior by bank and government officials. Savings mobilization might also be further discouraged by the low interest rates.[77]

The problems of subsidized credit and savings mobilization also relate to macroeconomic questions: Which financial conditions are optimal in order to promote growth? How liberalized and deregulated should the financial sector become in relation to interest rate levels, capital movements, competitive conditions for banks etc? Repressed financial markets have since the early 1970s been seen as an important reason behind slow economic development, since they limit incentives for financial accumulation, and maintain inefficiencies in the banking sector. If financial liberalization came about, the argument goes, funds would be channelled to the most efficient uses.[78]

The umambiguous praise of financial liberalization has however been modified in the last few years.[79] Today, there is a stress on sequencing such liberalization, carefully considering the general economic conditions in the country at hand. The actual effects of financial liberalization have been very different in different regions.[80] A general lesson, however, is the necessity of achieving macroeconomic stability before interest rates can be allowed to fluctuate or competitive financial organizations are set free.[81] From another perspective, the problem of credit rationing, indicates that financial liberalization does not always mean that credit is allocated efficiently. The poorer the information systems, or the poorer the mechanisms to enforce collateral, the greater the credit rationing. Banks may thus exercise credit limits even under liberalized conditions. Once again, the institutional setting, and the prevailing transaction costs in this setting, determine the possibilities for efficient economic performance.

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[76]According to Braverman & Guasch (1986), on average, only five percent of farmers in low income countries receive 80 percent of credits distributed through low interest rate credit programs.

[77]Although the relationship between interest rates and savings potential is not so clear cut as one might imagine; see Gonzales Arrieta (1988).

[78]McKinnon (1973) and Shaw (1973) made central contributions to this theory. See Fry (1988) for an extensive overview of the financial liberalization schoool and its opponents: the neo-structuralists. Fry's support of the financial liberalization thesis is somewhat exaggerated, in my view, considering the fairly ambiguos empirical evidence of the relationship between financial conditions and growth that he presents (Román, 1991).

[79]Morisset (1993) shows that the character of financial liberalization is important. Liberalized interest rates by themselves do not guarantee economic growth. See also Park (1994).

[80]The effects of financial liberalization in Latin America has indeed been very discouraging; see Diaz-Alejandro (1985) and Dornbusch & Reynoso (1989).

[81]McKinnon (1991).

2.4 The Informal Financial Sector

The discussion so far has concerned the formal financial system; the part of the financial system which is subject to the authorities' control and legislation, i.e. to formal constraints. This discussion will shortly be linked up with the empirical experience of financial system development in some countries. Before that, it is necessary to briefly introduce some of the characteristics of the "other" part of finance in developing countries: the informal financial sector.

In developing countries, "there is a huge institutional vacuum left when it comes to the operation of the credit markets. This vacuum is filled by the informal sector".[82] The informal financial sector is beyond governmental control. Informal finance is an important feature of most developing countries' financial systems, and not least so in Vietnam.

Cost reduction in the informal sector

Fragmentation of markets is a typical feature of developing countries.[83] It coincides with large differences in income and standard of living between people in the modern sector and the people in the impoverished traditional sector of the economy. Often, these differences distinguish the urban sector from the rural.[84] Broadly speaking, markets are either informal or formal, and this also applies to the financial sector.[85] The informal - "traditional" or "unorganized" - financial market exists side by side with the formal - "modern", or "organized". Informal finance is not subject to legislation or governmental control. An important part of informal financial relations takes place within the family. In addition, the sector includes moneylenders and indigenous bankers, as well as pawnbrokers, informal insurance schemes, and credit and savings associations.[86] The notion that usurious money lenders exploit poor people by providing costly credit using unfair methods, has given the informal financial sector a

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[82]Floro & Yotopoulos (1991), p. 15.

[83]Market fragmentation is a main theme in McKinnon (1973). See also Floro & Yotopoulos (1992).

[84]The modern, large-scale enterprises are located in the urban areas, and the traditional, small-scale production (predominantly agrarian) is situated in rural regions.

[85]Jagannathan (1987) discusses features of the informal sector in general. The World Bank (1989), Floro & Yotopoulous (1991), and Adams & Fitchett (1992) treat informal finance.

[86]A so-called ROSCA (Rotating Savings and Credit Association) is a club where members make regular contributions (daily, weekly, or perhaps monthly). One member receives the total sum of contributions at each installment. The order of distribution is decided by a lottery. See Callier (1990) and Besley, Coate & Loury (1993) and (1994).

bad reputation. This reputation has been slowly replaced by a more positive view of the sector.

In several ways, the informal sector may be more efficient than formal financial institutions. This is largely explained by lower transaction costs. The informal credit relationship often reduces coordination costs: information costs are often low, since the informal institution is local, and well informed about the clients and his or her circumstances;[87] in addition, the frequent integration of other activities apart from moneylending reduces costs. Motivation costs may also be reduced in the informal sector: specification of contracts is flexible and adapted to the client's situation; the banker is well aware of the client's identity and the prospects for his proposed project. Frequently, informal finance also reduces enforcement costs: both formal and informal rules help the informal lender to enforce the loans; group pressure, and family relations are part of these enforcement mechanisms.[88] Administrative costs are thus kept low because of reduced transaction costs, but also because of low wages (if any), and by simple banking facilities.

Another argument in favor of the informal sector is that the interest rates often are related to local market conditions, and are thus not usurious. The money lender is required to maintain adequate liquidity, but may experience large slacks when the opportunity costs of his reserves are high. Moreover, informal loans are often provided without collateral, which implies considerable risk taking, reflected by the higher interest rates.[89] Informal finance has been accused of providing expensive credit for consumtion purposes. The typical example is the extensive lending for traditional ceremonies: weddings and funerals. But possibly, credit given for purely consumption purposes is not as common as often believed.[90] And whether a loan is spent on consumption or investment may be sometimes difficult to establish.[91]

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[87]See Udry (1994) for an example from Nigeria.

[88]See Pollak (1985) for a treatment of the family as a governance structure similar to that of the firm. Jagannathan (1987) also discusses the multilateral relations with groups in a village which reduce lenders' credit risks. *Trust* is the important feature of the credit relation, which informal finance manages to maintain, according to Floro & Yotopolous (1991).

[89]The World Bank (1989), p. 114.

[90]Estimations indicate that about 55-60% of demand for noninstitutional credit was made for purely productive purposes (reported in Fry, 1988).

[91]Holst (1985) gives the example of a farmer, investing in a bicycle; it may be used for marketing his crops, or for unproductive visits to friends and relatives, or both.

Costs of informal finance

It is necessary to modify some of this praise given to informal finance, however. For one thing, one may distinguish between the efficiency of the informal sector caused by relative inefficiencies in the formal sector, for example, interest rates regulations, and pure efficiencies for example caused by the sector's informational advantages.[92] To the extent that deficiencies in the formal sector cause the advantages of the informal sector, the praise should be treated with some caution.

Moreover, informal finance functions in many different ways. The sector exhibit large variations. There is "...no such thing as *the* informal credit market".[93] Differences appear not only between regions and countries, but also between forms of informal finance. Borrowing money from family members is a type of informal finance that approaches self-finance. Loans are given based on confidence and kinship. Honoring these contracts is important to the borrower. The loan relationship is often a kind of joint-venture, however, and losses are often carried symmetrically by both parties. The rotating saving club is another comparatively "friendly" form of finance. A member failing to repay loans bears the risks of social embarrassment and/or not to be able to participate in another club.

The relationship between a borrower and a money lender, however, may exhibit less attractive features. Although the market power of money lenders is generally so excessive as one have tended to believe, borrowers are certainly exploited at times.[94] The informal sector is by definition beyond legal control. This illegality often means that the dominating enforcement mechanism is based on physical violence. When the moneylender has a local monopoly in his trade, and power and influence in the community, the previously discussed symmetry in enforcement between banks and clients is gone. If the moneylender does not fulfil his commitments, the borrower has little power to punish him (either by stopping to deal with him, beating him up, or taking him to court).

A more general problem with the informal financial sector is that financial savings may not always flow to the most eligible use. Its local character, the small sizes of the loans, and the lack of proper enforcement mechanisms inhibit the advancement of funds for riskier or larger investments, with considerable potential returns. Furthermore, the

[92]Ghate (1988). See also Ahmed (1989) who shows that transaction costs for small informal loans are lower than for formal credit.

[93]Ghate (1988), p. 66.

[94]Holst (1985), Bell (1990).

existence of informal credit also dilutes the efficacy of monetary policy, and the sector certainly provides less in the way of formal deposit security.[95]

Formal and informal finance

The financial structure of developing countries is different from that of the developed economies. The formal systems may have more or less in common with developed economies' financial systems. Sometimes the structure and the available instruments are as sophisticated as in any so called developed economy; sometimes there is only a number of traditional deposit banks. In addition, these systems are complemented by informal finance to a much larger degree than in the developed world (although there is informal finance also in these countries).

The informal financial sector is important in most developing countries. Although each loan and deposit made within the sector is generally much smaller compared to the formal sector, it is important to large numbers of people. Oppressing the informal sector without a functioning formal sector to replace it does not benefit the large population in a poor country. When the formal financial system is inadquate or insufficient, informal finance takes on the financial functions required to enable to pursue transactions in the economy.[96] In many cases, informal finance have been suppliers of financial resources. Moreover, the increased modernisation of these economies has led to the growing formalization of informal financial institutions. There is no strict dichotomy between these two sectors, but rather a continuum of organizations, more or less regulated and official.[97] During the twenty years or so which have passed since the first analyses of the informal markets in developing countries appeared, the tendency has been towards an increasing awareness of the benefits of these sectors. Briefly, the informal sectors substitute *and* complement the formal sectors of an economy.

Financial organizations provide a kind of necessary institutional infrastructure in the development process. However, if formal financial organizations are suppressed or under excessive control, various forms of informal finance are there to replace them. In many ways this institutional solution is an efficient response to various transaction

[95]Ghate (1988).

[96]See Edwards (1988) for the relationship between formal and informal finance in the Korean case. Kapur (1992) discusses the specific features of formal and informal finance in general.

[97]Ghate (1988), and Chandavarkar (1992). Development organizations attempt to copy features of informal finance in order to achieve more efficient credit distribution in developing countries. Cooperative banks and group-lending, initiated by governments and aid-organizations may be seen as "semi-formal finance" (The World Bank, 1989). See also Rhyne & Otero (1992) for an argument regarding the integration of informal finance methods in financial institutions which provide credit to micro-enterprises.

costs, but informal finance often fails in the agglomeration function that formal banks perform.

This study does not deal in any depth with informal finance. Nevertheless, it is important to point out the main characteristics of the sector, since it probably plays a quite substantial role for financial intermedation in Vietnam. As long as the formal financial system is weak, informal finance will be important.

2.5 Country Experiences of Finance and Development

The presentation here has indicated a number of important issues relating to banking and finance. These ideas were not born in a vacuum, but have developed parallell to the development of banking in the real world. Vietnam stands at a crossroad. For many of the central policy issues, the country - its central government - seeks "role-models" that act as a pointer to future development. This is also true for the development of the financial system. Vietnam will hardly be able to "pick a winner" and follow in their footsteps, but at least there may be some insights gained from looking at the development of finance in more mature market economies.

There is no general success formula for finance and development. Just as the institutional perspective suggests, economic development is a consequence of an intricate interaction between various institutional arrangements. It is difficult to determine the common growth promoting features in different countries' financial systems. For example, the financial system in the United States is characterized by a large number of relatively small organizations, where the traditional banks (accepting highly liquid deposits and advancing loans) face increasing competition from so called non-bank financial intermediaries. By way of contrast, fairly large (universal) banks dominate in, for example, Germany. Economic historians have sometimes argued that the latter, bank oriented system reflects economic backwardness. Finance is a mere substitute for enterpreneurship and inside capital (own savings).[98] The possibility of obtaining outside capital may, however, just as well be viewed as an advantage, implying an increased access to capital altogether.[99] I shall not go further into this complex issue, but the point is that it seems that both types of systems have existed in economies characterized by economic growth.[100]

The financial liberalization debate has focused attention on the market structure of banking in various countries, as well as the macro-economic conditions for financial

[98]This argument obviously does not refer to contemporary Germany, but to Germany's relative late-coming in the industrialization process of the 19th century (Gershenkron, 1962).

[99]Mayer (1988).

[100]See Hellwig's (1991) discussion.

intermediation, notably the restrictions put on interest rates. The plea for liberalized conditions was motivated by empirical observations made in South East Asia. Indisputably, there are a number of examples of coexistence between financial liberalization and growth in developing countries. But there are many different types of financial liberalization, and the experiences world-wide vary.

The development in Latin America is different from that of Asia. A number of Latin American countries reformed their financial systems in the 1970s, the main ingredient being liberalization. A fundamental problem in the process was that liberalization coincided with deficit finance through the printing of money, leading to hyperinflation. The privatization of the banking sector in Chile built on the belief that banking, just like any other business, was best regulated by the free market. This brought about the emergence of a number of uncontrolled financial organizations, which eventually merged into a few groups, closely linked to industry. The oligopolistic industry thus became highly leveraged. After a devaluation in 1982, capital fled the country and the banks collapsed. Other Latin American countries had similar experiences. It seems that in these cases, the liberalized conditions enhanced the inflationary tendencies and contributed to the severe economic recessions.[101]

Financial liberalization in Japan, Korea and Taiwan came about in the 1970s and 1980s in response to changing domestic and external circumstances. Repression had become less effective.[102] Up until then, there had been advantages in the way the financial system had been fairly tightly controlled, both with respect to interest rates, but also in the pace in which financial sector development proceeded. In Japan, the focus had been on an adequate supply of industrial funds at reasonable cost. Meanwhile, financial savings rates were high - probably because of the high economic growth and low fertility rates rather than the (low) deposit interest rates.[103] In Korea, a first wave of liberalized interest rates in the mid 1960s contributed to a successful industrialization process. Yet, the banking system as such was severely regulated until the beginning of the 1980s, when a new wave of liberalization brought competition within the banking sector. The interest rates were however during this latter period heavily regulated by the central bank.[104] The Taiwanese financial system was also regulated until the 1980s. There had been a conscious policy of raising deposit interest rates already in the 1950s, in order to stop inflation, but it had been accompanied by entry restrictions and tight government control. Consequently, Taiwan also experienced a fairly backward financial

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[101]See Diaz-Alejandro (1985) on the Chilean experience, and Trebat (1991) on the crisis of the banking system in Latin America.

[102]Patrick (1994), p. 343.

[103]Vittas & Kawaura (1995).

[104]Cole (1988).

system up until the 1980s, when steps were taken to liberalize interest rates, deregulate market entry and introudce privatization.

In Indonesia, the financial system was restored in the latter part of the 1960s, while the inflation rate was successfully curbed. The State Bank was divided into a central bank and commercial banks, while the interest rates were significantly increased. These measures appear to be those of financial liberalization, but were really part of a fairly interventionistic policy that remained in force throughout the 1970s. In periods of inflationary shocks, the central bank intervened, for example by raising the interest rates. Other measures included credit restrictions and programs for special credit at low interest rates. It is only in recent years that real financial liberalization been implemented in Indonesia. Regulations on interest rates and credit advancement have been abandoned, and the directed credit programs terminated.[105]

Financial liberalization in Asia is consequently a heterogenous concept; the dominating feature up until the 1980s seems, in fact, to have been fairly severe regulation. What is of interest in all these cases, and notably in those of the Taiwan and Korea, is the room for informal finance created by the repressed formal financial systems. In Taiwan, the so called curb market (referring to uncontrolled financial intermediation, rooted in the type of arrangements discussed in the previous section, and sometimes in the form of suppliers' credit) has played an important role in providing credit to small enterprises with limited access to formal credit. An estimate suggests that some 30 percent of the total volume of loans came from the curb market during the 1970s, when interest rates had been significantly higher (some 50 to 100 percent) than in the formal sector. This curb market development emerged as a kind of residual due to the restrictions in the formal market. In Taiwan there has been a tacit acceptance of it from the authorities point of view.[106] A similar development has been observed in Korea, although perhaps less welcomed by the government.[107] What has happened (in Japan already in the early 1950s and later in Taiwan and Korea) is a gradual formalization of these curb markets: "Moneylenders established banks, money market companies and investment and trust companies, and rotating credit cooperatives became credit associations or mutual savings banks."[108]

Is there anything for Vietnam to learn from all this? One lesson could be that the dogma about financial liberalization should be carefully scrutinized, since there are so many different facets of this phenomenon. Liberalization of interest rates have often been

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[105]Bolnick (1987).

[106]Wade (1989), pp. 159-165.

[107]Park (1994).

[108]Patrick (1994), p. 329.

combined with regulation of market entry, and vice versa. But it is questionable whether Vietnam could, if so desired, imitate the development of, for example, Japan in this respect. As noted above, liberalization came about in response to changed domestic and international conditions. International financial transactions are much more liberalized - and instantaneous - today than twenty years ago, and possibly Vietnam does not have the same opportunity to choose the degree of liberalization while at the same time wanting a share in international business.

Another lesson is the role of informal finance. Although the development of this sector in Vietnam will not be explored in detail in this study, it will be shown that it exists and seems to play a similar role as that of curb markets in neighboring countries: it substitutes and complements formal banking facilities, when these do not suffice. Vietnam can learn that a gradual formalization of the sector is possible, and may contribute to the establishment of a well-spread (and well-informed) financial infrastructure. The disadvantage of such curb market development, is that a severely regulated formal sector, creates arbitrage opportunities for those in access to formal credit: they may concentrate on obtaining formal loans and relend in the curb market, where the money will not be used for (large-scale) productive investments. Hence this is a consequence of too restrictive and highly regulated formal finance, rather than the existence of the curb market itself.

A final remark about the experiences of the neighboring countries is the fundamental differences between these countries and Vietnam. Although the Japanese and Korean banking systems have been heavily regulated, they are and have been commercial banking systems operating in market economies. Vietnamese banking is only taking its first steps on the road towards commercial banking, and the ability of the banks and the bank authorities to actively promote and implement any version of gradual deregulation or any banking policy is quite different.

3. Summary

The institutional perspective is based on the notion of transaction costs, essentially understood as the costs of establishing contracts. These contracts may be more or less complete and explicit. With the behavioral assumptions of bounded rationality and opportunism, transaction cost economics focuses on the rationale for institutions arising as a result of the imperfections of contracting. Two central questions are why hierarchies emerge to replace bilateral (market) contracting, and why there are limits to the scope of these hierarchies.

Hierarchies economize on contracting costs by efficient coordination. The limits to the hierarchy arise because of the potentially huge information requirement. Authority in the hierarchy relates to property rights, as the owner of an asset has residual control

in all the contingencies which the contract leaves out. Hierarchies are more important the greater the degree of asset specificity. If the orthodox hierarchy is replaced by a combination of hierarchic and bilateral relations, the disincentives created by the selective intervention paradox and the problem of resources wasted on influence activities will still remain.

The explicit focus on institutions (formal and informal constraints and their enforcement characteristics) strives to endogenize institutional and organizational change, and thus explain economic development. Institutions change over time in response to changes in relative prices (including transaction costs) and preferences. Institutional change is incremental and path dependent, i.e. the existing institutions define the available choices. Thus the emerging institutions may be more or less efficient, which may explain differences in economic performance between countries.

The study will operationalize the institutional perspective by distinguishing between costs of coordination (i.e. the costs of acquiring, processing, and exchanging information), and motivation (i.e. the costs of specification, observation, verification and enforcement). These costs may be two sides of the same coin. In the analysis, the concepts will be used as a sorting criterion, by asking in what ways an observed phenomenon affects coordination and motivation.

The study object is the Vietnamese banking system. Banks are an institutional response to transaction costs, reducing costs through informational advantages and organizational routine. They reallocate financial resources, provide a payments mechanism, and diversify risk.

Differing banking structures between countries is a product of historic processes. Banks have always been subject to special regulation, because of the costs to the economy if confidence in the payment system is eroded, and because of the role banks may play in economic development. Expansion of finance may promote growth.

In developing countries, the informal financial sector is more important than in the so called developed world. The sector seems to provide an alternative when formal finance is unable to play its role. The experiences of certain Asian countries indicates that informal finance has substituted for repressed formal finance, and has often become increasingly formalized as the economies have grown.

Vietnam may learn from the development of finance in other emerging Asian markets, although the question is to what extent. Vietnamese banking is rooted in a fundamentally different economic system, despite common features of repression. The characteristics of the centrally planned system, and the general features of transition will be explored in the next chapter.

CHAPTER III

CENTRAL PLANNING AND TRANSITION

The point of departure for the economic reform process in Vietnam is a socialist system. The commercialization of the Vietnamese banking system is but one part of a gigantic project of institutional change in the state bureaucracy. In order to interpret what is happening in the Vietnamese banks we need to understand the original system in which these banks operated, and have some general notion about problems facing agents in the transition. This is the purpose of the present chapter.

An argument advanced in this chapter is that the costs of socialism exceed the benefits, and that this eventually gives rise to more or less comprehensive reform. Although acute crises have initiated the more radical reform processes, these crises originated in long periods of deteriorating performance in the socialist economies; many of the characteristics of the classical socialist system contained an embryo of its final destruction. Admittedly, it is difficult to measure the benefits arising from socialism, since we do not know what these countries would have accomplished given another political and economic framework. It does seem justified to grant the socialist system a certain degree of praise for initially achieving relatively high growth rates as well as a fairly equal distribution of income, and access to educational and health systems. On the other hand, equal distribution may be of little importance to most of the citizens in a society, if the cake to be shared is far too small. Market transition is largely a search for the means to produce a bigger cake.

Before proceeding to a discussion of the specific features of socialism and transition from socialism, two remarks are necessary. Firstly, talking about the transition from a planned economy to a market economy perhaps gives the impression that classical socialism was strictly and uniformly applied in the socialist countries until the inherent problems became so burdensome that the system had to be abandoned altogether. This does not correspond with historical events. The background to and the development of socialism has been very different in different socialist countries. One factor is that the reason for the transition *to* socialism varied between countries - sometimes as a result of domestic upheaval and revolution (like in the Soviet Union, China, and Vietnam), sometimes as a consequence of foreign influence or oppression (like in Eastern Europe). In addition, there is a difference between *classical socialism*, understood as a Stalinist inspired system of firm central planning and control, and *reform socialism* which allows for a certain degree of decentralized control. In most of the transforming countries, elements of reform socialism were introduced at various points in time in order to overcome some of the problems encountered in the classical socialist system. However, the objective of reform socialism has been largely to improve the basic socialist structure. The current transition in most of these countries are different. It fundamentally changes the structure of the economy and the rules for economic action.

The second remark concerns the extent to which Vietnam belongs to the category of socialist countries. In contrast to most of the former USSR and most of the Eastern European countries, Vietnam is a developing country with a large majority of the population engaged in peasant farming. The subsequent chapters will treat the distinct Vietnamese features extensively; for now it is sufficient to say that despite a much smaller and less powerful state apparatus, there is (or was) in Vietnam a system of central planning, copied from the Soviet model. This system is now subject to substantial reform including the transformation of the banking system. Although there are many differences between Vietnam and the other reforming countries - some of which are probably important in explaining the relative success of the Vietnamese transition - it is, as discussed in the introductory chapter, relevant for the purpose of this study to discuss Vietnam in the context of countries transforming from socialist to market economies.

The chapter covers several major themes. The first section presents the main features of classical socialism and socialist finance. Section two accounts for some of the main problems in this system. Section three turns to the economic reform process, by first discussing certain ideas about socialism and capitalism, and market socialism, and then presenting the basic ingredients of economic reform. Section four discusses the specifics of financial reform. Section five addresses the transition problem. It refers to some of the main questions in the presently booming transition literature. This builds

up to an argument for an institutional approach to the transition problem, which focuses on the transaction costs arising in a system characterized by constant institutional change.

1. The Socialist System

Socialism is a broad term which may refer to a large number of more or less centrally governed systems characterized by varying degrees of public enterprise. Kornai's sweeping definition of a socialist country: a country which has declared itself socialist and is ruled by a communist party,[1] suffices for a description of the system-specific phenomena and properties which at least partly have been and still are ruling the Vietnamese economy. Terms such as a *centrally planned economy*, or a *command economy* are synonyms for a socialist system. The opposite is a *capitalist system* or a *market economy*, by which I mean any kind of economy where market relations determine prices, and where at least part of the economic power does not belong to the state.[2]

Socialism is an ideology. The ideology postulates that public ownership of the means of production, and central control and planning of the economic activities overcome the deficiencies of capitalism. Marx' analysis pointed to the eventual collapse of capitalism as a consequence of inherent problems; capitalism suffers, for example, from the anarchy of the market, the inefficiency of private property (which inhibits a general use of new innovations to the benefit of the society), and the exploitaition of the working class. "The Marxist classics repeatedly underline that the market is a poorly operating coordination mechanism that must be replaced by conscious planning."[3] Socialism, which fully employs both human and material resources, is superior both in terms of efficiency and equity. It is a more just society, creating better people.[4]

1.1 The Basic Structure

In socialism, economic power is in the hands of a central authority; the state is the "manager" of society's property. Most of the power is exercised by the communist party. The party rules the state apparatus, consisting of a parliament, a state

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[1]Kornai (1992), p. 11.

[2]For comprehensive descriptions of the principles and the functions of socialist systems, see Nove (1986), and Kornai (1992); I use both extensively in this section. For more condensed overviews of different socialist countries, see Jeffries (1990), and also Vygodsky (1981).

[3]Kornai (1992), p. 475.

[4]See Kornai (1992), Chapter 4, and Nove (1986), p. 325 on ideology, and also Brus & Laski (1989) on this interpretation of Marxism.

administration and a judiciary. A key agent in the system is the bureaucracy.[5] The formal activities of the party and the bureaucracy are interwoven and the party exerts considerable influence and control over the state administration.[6] The bureaucracy is held together by the bureaucrats' ideological conviction, but also by the individual power that they may exercise over organizations and citizens. The prestige and privileges obtained, and the risk of degradation or other material punishment (for example withdrawal of priviliges, and ultimate expulsion from the party) are efficient self-disciplining mechanisms. Apart from the bureaucracy, there are mass organizations of a monopolistic character for different fields of activities, such as youth leagues, labour unions and women's organizations. In practice, these operate under the direction of the party. State-owned enterprises and cooperatives dominate the production. To the extent that there are private enterprises, these are restricted to specific segments of the economy, usually in the informal or second economy.[7]

Central planning means that the visible hand replaces the invisible; planning produces "order about just what should be produced, and orders to ensure the provision of inputs to make production possible".[8] Plans determine economic activity. Investments, resource distribution, production volumes etc are centrally determined, prices administratively set, and all the main economic activities take place within the public sector. Moreover, socialist countries have a tendency to be autarkic (or quasi-autarkic). Import requirements are planned, and export plans are adapted to the foreign currency requirements of the import plan.[9] Focus is on industrial output, through a large scale heavy industry and substantial specialization. The economic objective is to reach rapid industrial growth, a prerequisite for a communist state in which private property is abolished. The role of the agricultural sector is primarily to support the growth of the industrial sector.

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[5]The bureaucracy, according to Kornai (1992), includes the totality of the party apparatus, the state administration and other administrative bodies (p. 41).

[6]Kornai (1992), Chapter 3. The party structure is a hierarchy beginning at the bottom in party cells or branches, for specific districts or production units. A number of branches are headed by a district party committee, in turn directed by a province party committee etc. At the top is the central committee, electing the executive body of a political committee. The central leadership has a staff of officials whose activities often parallel those of the state administration in the various ministries. Nove (1986) stresses the dominance of the party over the state apparatus, but also its highly intertwined nature (p. 6).

[7]The privacy, or at least semi-privacy, of signifcant shares of agricultural plots in the USSR should, however, be noted, as discussed by Nove (1986), p. 116 ff. See also Kornai (1990) and Los (1990) on the private sector and the second economy in Marxist states.

[8]Nove (1986), p. 20.

[9]Nuti (1992), p. 49.

1.2 Socialist Finance

The original intention after the Soviet revolution in 1917 was the total abolition of money.[10] This idea was never realized; prices, money and finance are important ingredients in socialism.[11] At a superficial level, the socialist financial system resembles that of a market economy. There are prices, money, and banks; there are interest rates, credit and savings deposits. The roles that these entities play are, however, different. All monetary transactions are planned, and the financial agents are part of the state apparatus.[12]

Planned prices constitute an instrument in the planning mechanism. The physical plan is reflected in financial entities, which allow for an aggregation of the plan, and facilitate the planning procedure. In principle, prices should be based on social costs, however not including costs for land use and capital. In practice, prices are set according to a cost-plus principle, determined by bureaucratic procedures. The existence of prices allow for the planning of enterprises' revenues and expenditures, and thereby their earnings, or profits. The budgets of the enterprises are designed to match the physical plan, and enterprises are chiefly expected to cover their expenditures (by their revenues) and in addition yield profits, which are transferred to the state budget. Ideally, prices should not only facilitate the planning process, but also serve as an incentive for producers to use certain inputs (for example subsidized fertilizers or other modern technology inputs), and influence consumption demand (by a pricing policy on consumer goods in accordance with political objectives).[13]

Monetary transactions in a socialist economy are divided into two circuits: those of cash money (the household circuit) and bank money (the transfer circuit). The cash money circuit includes cash payments from the state to the population (for example wages and various transfer payments), and payments from the population to the state (such as taxes - although these are normally very low or non-existent - and payments for various consumption goods). The circuit of transfer payments, or bank money, are

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[10]Wilczynski (1982), p. 43. See also Nove (1986), p. 235, Kornai (1992), p. 131, and Peebles (1991), p. 20, on abolishment of money in early marxism-leninism.

[11]Lenin (1927) recognized the usefulness of a banking system: "Capitalism has created an accounting apparatus in the shape of the banks, syndicates, postal service, consumers' societies, and office employees' unions. Without big banks socialism would be impossible... A single State Bank, the biggest of the big, with branches in every rural district, in every factory, will constitute as much as nine-tenths of the socialist apparatus. This will be country-wide book-keeping, country-wide accounting of the production and distribution of goods, this will be so to speak, something in the nature of the skeleton of socialist society."

[12]For overviews of the socialist financial system see Grossman (1968), Peebles (1991), Kornai (1992), Chapter 8, and Montias (1994), pp. 10-15.

[13]See Kornai (1992), Chapter 8 on the role of planned prices, and Nove (1986), in particular Chapter 7, on prices in theory and practice.

book-keeping entries, which administer the majority of transactions in the state planned sector through the banking system; credit to enterprises, payments between enterprises, and transfers between enterprises and the state budget are all administered by the banks.

The main agent is the state bank, often labelled a *monobank*. This monobank incorporates both a central bank level, responsible for the issuing of currency, which cooperates closely with the state treasury, as well as various commercial credit departments. The different departments deal with separate segments of the economy; there are departments for agriculture, industry, long-term investments, and foreign trade. Sometimes, for example in Vietnam, investment banking and foreign trade transactions are dealt with by specialized banks which are separate from the state bank. There are also separate banks for savings from the population. Although formally independent, these banks are nevertheless part of the state bank apparatus. The banks usually employ large numbers of people, since the system requires a lot of manpower for all the necessary book-keeping.

The monobank is an agent of the government. The largest share of the state budget consists of direct transfers from the state sector. Since all property belongs to the state, the surpluses generated by this property (through the enterprises) also belong to the state. In return, all of the essential expenditure by enterprises will be covered by the state, and if - for some unforseeable reason - enterprises would make losses, these would also be covered by the state by adjustments in the budget, price adjustments or additional provision of credit.[14]

The banking sector is thus geared towards the enterprises (within the state sector). Enterprises receive financial resources through the bank, strictly divided into working capital (short-term credit) and fixed capital (for investments). The enterprises' working capital accounts with the banks are divided into several sub-accounts: there is money for materials, money for wages etc. The banks - the bank departments - also participate in close control of the state enterprises' activities. Banks undertake, for example, tasks foreign to a commercial bank in a market economy, such as inventory monitoring. The fixed capital largely consists of direct allocations from the state budget; long-term credit for investment is a fairly small proportion of total investment funds. Both of these types of investment funds are often advanced through the special investment banks.

To the individual citizen banks are of little importance. There are hardly any other financial organizations apart from the state bank and its special bank branches. Since the socialist system implies that the state takes on total responsbility for the citizens, there is no need for insurances or insurance companies. Since there is no private ownership, there is no trading in ownership rights, and thus no capital market. Moreover, the ideology bans profit seeking and speculation, and there should not be any

[14]See Nove (1986), Chapter 9, on public finance in a socialist system (the USSR).

attempts or opportunities to invest and enlarge one's wealth. The state pays out wages to cover consumption needs - the needs determined by the plan; wages are low and are normally in cash. Education is free, as is frequently housing. If rents are charged, they are normally very low. With most of the basic investments (such as schooling and housing) taken care of by the state, people have little need for capital or saving.

People do save - in accounts at the state bank or at the special saving banks - in order to buy some of the few capital goods available (such as a car), although household savings constitute a relatively small share of total deposits in the banking system. There are few financial instruments in which people can invest other than these savings deposits. There is no stock market and only a scarce amount of capital goods. At times, the government issues bonds, in which individuals are more or less obliged to invest. Despite the lack of savings incentives, individuals frequently keep high amounts of liquidity - in deposits or cash - because of the prevailing shortages in the economy. This constitutes another kind of forced saving.[15] Apart from formal savings, people save outside the formal financial system. They illegally invest in gold and foreign currency, or various kinds of goods - in Vietnam, for example, there has always been considerable savings in rice. In some socialist countries it is also possible for individuals to get credit from the banks. The level of this household credit, however, is very small compared to the situation in market economies.[16]

Monetary policy, strictly speaking, does not really exist in this system. In the absence of mechanisms which translate changes in the cost of money to changes in real variables, there is not need for such a policy. However, the planners control of the monetary flows also intends to control inflation. Currency flows are planned and the resultant currency holdings in the population during the planning period are calculated. Cash holdings are controlled by limiting enterprises withdrawals of currency for wage payments, and monetary expansion is checked by the way enterprise accounts are "ear-marked" for specific uses.[17]

A result of the system is the non-convertibility of the currency. Socialist currencies are non-convertible in transactions with other nations: a number of administeratively determined exchange rates differ between different types of transactions and different types of traders, thus isolating domestic firms from international prices.[18] Socialist money is also domestically non-convertible. For example, money allocated for investments cannot be used or converted to money for material purchases etc. Following the logic of the system, strict control of the monetary

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[15]Kornai (1992), p. 232. See also Peebles (1991), pp. 26-27 on savings.

[16]Kornai (1992), p. 134.

[17]Grossman (1968), pp. 9-10.

[18]Peebles (1991), p. 29.

flows is a prerequisite for successful planning. Money is therefore not a full-fledged means of exchange; the banking system is not commercial, seeking to extract profits from financial transactions. But the financial system has an important role in the administration and control of the economic activities; socialist money is an instrument in the planning procedure, and socialist banks are part of the bureaucracy.

2. The Central Planning Problem

Central planning and control may seem such a good idea. By central command, the society can decide on the optimal use of available resources, and distribute the produce to everybody, regardless of class and fortune. From everybody according to ability, to everybody according to need.

Central planning in practice is quite another thing. A basic economic problem in socialist countries has been the prevailing imbalances: for the majority of goods there has been significant excess demand.[19] Apart from chronic and frustrating shortages, excess demand also implies considerable inflationary pressure. In the ideal model, government control of prices should make the issue of inflation irrelevant, but in the socialist system inflation appears in different guises. Inflation may be hidden, for example when goods in high demand are replaced by higher priced products, which are qualitatively only marginally superior, or when free-market prices, if they exist, exceed the state controlled prices. Inflation may also be repressed; frustrated purchasing power means large quantities of involuntary savings and substantial liquidity surpluses. At times, and especially in periods of partial reform, open inflation is also significant.

The weak performance of the economy - the low productivity and the low growth rates - has resulted in poor standards of living, substantial environmental problems, and poorly developed or deteriorating infrastructure. Politically, the socialist countries have depended on totalitarian regimes, which have periodically been using various methods of coercion to secure political stability. The citizen's alienation from the political decision process, as well as spreading corruption in the bureaucracy have been other symptoms of the poorly functioning system.

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[19]The causes behind the imbalances have evoked a heated debate between two schools of thought: the "disquilibrium school" and the "shortage school". The former, with its prime proponent being Robert Portes, advocates that imbalances are largely a temporary problems due to sticky prices. The main advocate of the shortage school is János Kornai, who argues that shortages are due to systemic micro-related deficiencies in the socialist system, with origins both in the planning problem and in ideology. See van Brabant (1990b) for an overview. The following discussion is largely inspired by Kornai, because of his explicit and thorough consideration of the institutional framework which determines the constraints for individual action in the socialist system. See however Ellman (1994) p. 11 on a recent critique against the soft budget constraint as an explanation behind shortages (and footnote 44 below).

2.1 Central Planning and Transaction Costs

While socialism in a sense is the opposite of capitalism, pure central planning or completely decentralized market relations are both unrealistic economic systems. Any society (or at least any society touched by modernism) is a mixture of markets and hierarchies. Centralization facilitates coordination, and is of foremost use in situations where rapid implementation of given decisions is crucial; hierarchic organization of military operation is the typical example. If quick coordination is the most important thing, the hierarchy's opportunity to assign tasks by direct orders is superior.[20] However, when central planning becomes a general solution to society's organization, the conceptually simple task of deciding what is to be produced and by whom, is transformed into enormous problems of coordination and motivation.

Transition is better understood in the light of what was wrong with central planning in the first place. Therefore, this section will examine a number of problems appearing in classical socialism, using the framework established in Chapter II: coordination costs arise because of obstacles in acquiring, processing and exchanging information, and motivation difficulties are due to problems of specifying, observing, verifying, and enforcing agreements. These transaction costs are often two sides of the same coin. Asymmetric information, for example, have both coordination and motivation implications. The following account is by no means exhaustive, but it is problem-oriented: it focuses on the shortcomings of the central planning model. It ignores what the system manages to accomplish.

The information requirement

Central planning requires an overwhelming amount of information. It involves a complex coordination of allocation decisions in time and space, specifying quantitites and qualities of inputs and outputs. The center must determine *who* is to produce - the mines, the farms, the factories - and develop the necessary distribution channels for the products. It must also decide *what* to produce, i.e. the physical output quantities, and the quantities of all the necessary production factors. Long-term plans determine general targets for production in the different economic sectors. Short-term plans then disaggregate these targets, and assign the duties of the specific organizations involved. The short-term plans are further disaggregated by the concerned ministries, industries and other organizations.[21] The information should also be appropriately processed,

[20]Milgrom & Roberts (1992), Chapter 4.

[21]See Kornai (1992), Chapter 7, and Nove (1986), Chapter 2 on the planning process.

again a gigantic coordination task.[22] Furthermore, the final plans need to be finally negotiated. Without going into all the elements of exchanging information, there are obviously substantial coordination costs involved in agreeing on these plans, even after the *whos* and the *whats* are broadly established. Plans are expressed in physical targets, but in parallel prices and financial aggregates are used in order to control the production process and partly also to reduce the amount of information required in the planning process. Nevertheless, the coordination of a complete set of prices is a gigantic information task, and there are abundant distortions in the price planning process.[23]

There are also motivation problems connected to the huge information requirement. One problem has to do with specification. Physical plan targets expressed in physical output create an important measurement problem (which administratively determined price levels cannot solve). A classic difficulty is that of adequately specifying output whenever output consists of a product mix. Few items are as unambiguously quantifiable as, for example, electric power, measured in kilowatt hours. The central plan often relies on weight measurements, and may result in very heavy and "old fashioned" products (such as very heavy steel sheets rather than lighter and more appropriate sheets, when the production unit is rewarded for producing a certain number of kilos of steel).[24] A related problem is the specification of output targets and the necessary allocation of inputs to reach that target. Since this planning requires a large amount of information, negotiation and estimation (based on norms and coefficients in a complicated process), planners in practice often apply the so called *ratchet principle*, roughly stating that "whatever you did last year, do more or better this year."[25] Consequently, if a production unit economizes on given resources, and produces above targets, it risks being pressed to produce more next year without receiving additional resources, and without being sufficiently rewarded for this increase in productivity. The safest thing to do is thus to stick within targets.

Central planning is not the whole truth; *centralized pluralism* is part of the system. Since the assumed central planning is so complex, a large number of decisions are, in fact, informally decentralised, and this is one reason why the system can at all function (if poorly). Moreover, there is an upward pressure within the various decision

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[22]An example from the USSR: The State Planning Commission issued instructions for major 'product groups' (some 2,000), which the next level in the hierarchy, the State Material and Technical Supply Commission divided into 15,000 categories, and the various ministries in charge thereafter subdivided into 50,000 more finely detailed products, and further divided into specific products of each category. These plans were forwarded down through the hierarchy to finally reach each enterprise and plant manager, who altered and adjusted the plans, and sent them back up through the hierarchy in order to be finally settled (Heilbroner, 1990, p. 13).

[23]Kornai (1992), pp. 150-151.

[24]See Nove (1986), p. 87 ff on the success indicator problem.

[25]Nove (1986), p. 39.

bodies (ministries), where the different ministries become power centres which do "compete" for supplies and influence in the plans.[26] The actual planning of prices is also subject to substantial vertical bargaining. If "wrong" prices are assigned to input goods, and the corresponding financial flows are too low for enterprises to obtain the necessary inputs, plan targets are in trouble; thus the need to negotiate these prices. (Of course, a reason behind negotiations might also be that enterprises, by bidding up prices, want to assure themselves of sufficient financial allocations, which might possibly provide them with additional freedom to act or money to put in various pockets.) The overlapping activities of the state, the party, and the mass organizations, and the parallel control of different organizations also blurs the image of a complete top-down pyramid of control.[27]

Prices and money

To centrally compile and coordinate plans and prices is hard enough. The coordinating role that prices and money play - or do not play - is perhaps even more problematic. The allocative function of prices and other monetary entities is weak. Changes in relative costs are not reflected in price changes; changes in prices do not alter economic activities. The individual may choose whether or not to buy a product, but her choice does not directly influence the producer's quantity or quality decisions. Since planning dictates what is to be produced, prices do not contain economic information: they do not send signals about relative scarcities, or the possible profitable use of various types of resources.

The real and the financial side of the economy are largely separated from each other in the socialist system. The plan is based on physical production, and the financial flows are adapted to this plan. Enterprises have little control over their financial resources, and cannot respond to financial signals. They cannot make decisions about reallocating working capital for investment use etc. They can withdraw money from the bank only if their financial requirements corresponds to the plan. The intention behind all of this is to ensure the prudent management of enterprises. And prudent management in the socialist vocabulary means to accurately follow the plan. Financial control means planning the financial requirements, controlling the intermediate use of the money, and verifying that the economic units have stayed within budget. Financial aggregates do not function as signals for the efficient use of resources, however, and even if such signals were actually conveyed, enterprises would not be allowed to react to them. Thus

[26]See Nove (1986), Chapter 3. Van Brabant (1990b) discusses the flawed idea about planners as omnipotent decision makers with all the control in their hands.

[27]Kornai (1992), p. 98.

enterprises have little opportunity to engage in prudent management in a more market oriented sense. They cannot substitute the use of one type of resources for another, nor can they alter the product mix or the enterprise activity altogether. It is not within their mandate to do so, and they do not have any instruments to guide them on what changes would be feasible and appropriate. This reduces the "moneyness" of bank money; it is part of the administeratively determined financial transactions, and the entire system of planning. Consequently, financial control of organizations and economic activities in the Western sense does not apply. The reduced role for bank money implies that the socialist system is only semi-monetized.[28]

Another side to semi-monetization are the considerable flows in kind which occur: between enterprises, between private persons and in the uncontrolled informal sector. Reasons for this are the difficulties in using banks for transfers, and the difficulties in obtaining sufficient amounts of cash at the right moment. In addition, there are at times inflationary risks, and risks that financial assets will be confiscated. Besides, when private business is basically illegal, there is a strong incentive to keep transactions in forms which are difficult for the authorities to trace.

The idea of money as a pure administrative entity is however difficult to maintain. Cash money has a fairly high degree of "moneyness".[29] It serves as a means of exchange and its use reflects consumer choices. It can do so because even in the classic, most rigid form of socialism, a number of choices are decentralized to the individual household (concerning consumption, saving and also choice of work). These choices are limited by Western standards. Individuals are, for example, free to save their money, but the forms of savings are few. Consumption choices are also restricted due to a narrow range of products. And the freedom to choose between the available alternatives does not mean that these choices affect production or the supply of goods - at least not in any immediate and efficient way. Nevertheless, cash money gives the individual some freedom in choosing when and what to consume. This money is active - it does reflect and determine its owners' consumption choices, just like money in the market economy. Money in the enterprise (bank) circuit acts to purely accomodate target plans, while "money in the household (cash) circuit, although subject to several restrictions, always had all its usual functions."[30] The administrative role of bank money itself is also difficult to maintain. There are, for example, substantial overflows between bank and cash money through additional wage payments from the enterprises.

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[28]Kornai (1992), p. 148.

[29]Grossman (1968), p. 4.

[30]Székely (1990) p. 109.

As money is introduced into the system, it starts leading a life of its own, beyond the control of authorities: "Money does matter, of course, even in a Stalinist economy."[31] Prices and money take on functions which they according to the ideology and the principles of the system do not have. Prices and money play more active roles in the economy thus facilitating coordination. These functions are, however, arbitrary and do give rise to a large amount of distortions, which eventually undermine the system.

Ideology and failure

All societies are ruled by implicit contracts between citizens: tacit understandings of how the society is structured, and how decisions are to be made. The maintenance of this structure requires, to a degree, the agents' voluntary participation, perhaps in contradiciton to the individual's immediate self-interest. These moral incentives form a kind of informal constraints which assure the stability of society.[32]

Socialism hinges on an exaggerated belief in people's willingness to respond to moral incentives: individuals are expected to work as hard and as well as possible - they should want to serve the cause of the mission. This attitude to work has not necessarily evolved in a slow evolutionary process, and may thus not be deeply rooted in society. Socialism disregards to a large extent self-interest as a fundamental motive for individual behavior, and the ideology proposes equality between individuals, and cannot, in principle, accept too large income differentials. Nevertheless, material incentives exist to stimulate individual performance, such as promotion possibilities, income rewards etc. These incentives are often insufficient, however, thus discouraging high performance within the official system, while encouraging various activities in the informal sector and beyond official control.[33]

The ideology postulates that a socialist society creates better people who are more prone to solidarity and communal interests; it also claims that socialism is more efficient, equitable and fair than capitalism (central planning is, according to the ideology, superior to the anarchy of markets). When the system fails - when it does not function the way the ideology proposes - incentives to act contrary to rules and plan

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[31]Grossman (1989), p. 39.

[32]This volunteerism could, however, also be regarded from the individual's longer term perspective, i.e. that he realizes that his contribution to maintaining basic structures in society will benefit him and his family in the longer run.

[33]Kornai (1992) claims that the official ideology of classical socialism makes no promise of equality of incomes; the relatively smaller income differentials are more due to the lack of alternatives for people in higher positions (and thus there is little competition for good managers etc), plus the existence of compensating, non-pencuniary incentives (pp. 324 ff).

specification arise. In this sense, one could say that the "socialist contract" is misspecified. It makes an agreement about accomplishing the impossible (the prospering and superior socialist society), with inadequate incentives (the heavy reliance on moral incentives, and the limited material incentives provided). The problems become increasingly severe, the more flawed the assumptions in the contract appear.

The system lacks adequate reward mechanisms, but also mechanisms which properly penalize poor performance: the socialist contract contains little specification of how to deal with failure, both in terms of individual failure and system failure (for example failure to fulfill plan). At the individual level, the tendency to ignore (or severely underestimate) the possibility of agents pursuing their self-interest (and the lack of proper rewards) creates room for shirking and disincentives for high performance. Misconduct may have consequences - like a wage reduction, degradation or even replacement - but the ideology does not accept unemployment - it promises to take care of the citizens - and people will not be fired just because they do not work very hard. In a totalitarian regime, it is more risky to be politically active (in opposition to the ruling elite) than professionally passive.

Plan fulfillment can not be properly enforced in a system which does not accept failure. There is no "creative destruction" in the system: inefficient firms do not stop producing. Thus there are less resources for new firms to replace the inefficient production. Hence, people have more to gain than to lose from pursuing their own interests, and they pay little attention to work effort; consequently inefficiencies and low productivity prevail. In addition, the system creates room for rent seeking activities and moral hazard. Corruption appears as a consequence of indequate rewards for good performance, and weak enforcement mechanisms. It increases with the existence of tempting opportunities, not least caused by the substantial inefficiencies inherent to the system. Corruption flourishes when the moral incentives fade away, the larger the distance between ideology and reality.

Ideology and reality grow apart, the more the system fails. When failure appears - when there are shortages, when useless products are produced, or more generally, when the economic system fails to fulfil its promises of wealth and happiness to its citizens - there is no alternative but to maintain the structure regardless of its deficiencies. The phenomenon is obvious in the political sphere. In the one party system there is no political alternative. Leaders, who fail to fulfill their promises, remain in power.[34]

[34]Kornai (1992) p. 52 discusses how classical socialism ends when the unqualified faith in the system's superiority is shaken.

Public ownership

Public ownership is part of the socialist ideology, and public ownership is one reason why the system fails: it creates disincentives to adaption, productivity, and investments. Ownership implies the right to control the use of property, to sell the property, and to use the revenue generated by the property, but also the "right" to negative revenues or rather an obligation to carry any losses generated by the property.[35] Losses signal to the owner that he needs to change whatever he is doing or shut down business, and this is one of the keys to the dynamics of capitalism: individuals have a motive to act in order that their property generates profit, and react before their property incurs too heavy losses. A system of public ownership does not take advantage of the different rights and obligations to which ownership entitles. There is little incentive for the individual to strive to make assets highly profitable, and there is also little incentive for the individual to avoid losses. If you do not own the asset which you waste, you cannot lose it. Thus, the system does not provide a proper mechanism by which inefficient activities are forced to exit from the system.

Disincentives created by public ownership are obvious when it comes to capital maintainance. If a manager of production does not have the right to the future returns of an asset, he has little interest in carefully optimizing the use of the asset. If, for the purpose of high productivity, a manager is paid in relation to output, he may have an incentive to seek high productivity in the short run (by, for example, carefully monitoring the employees). This might mean, however, that proper care is not taken of the capital. He will concentrate on short-run output performance rather than long-run capital maintenance.[36]

Innovation and investments

Public ownership reduces the incentives for innovations and investments. The situation may be illustrated by a simple example. Imagine a shoe factory owned by its workers. An engineer has developed a very efficient leather processing machine, which, however, is useless if not combined with the other activities in the factory. The engineer will only receive a part of the benefits of her invention, which might not be in proportion to her very important contribution to production. She also risks that her co-managers, opportunistically, will decide to fire her, once she has constructed her

[35]Also discussed by Kornai (1992), p. 65.

[36]Holmström & Milgrom (1991). If the reward was instead related to the asset's future returns, this would probably make the manager more interested in maintaining the asset. Such an incentive scheme requires accurate and the unbiased measurement of future returns, involving measurement costs, and these could be saved by replacing such a management contract with private ownership.

machine. Chances are that the engineer will figure out these risks and will refrain from contstructing any machine at all.[37] If the engineer herself owned the machine she might receive a larger payment for her effort, and could bring the machine with her if people start causing trouble. Public ownership thus creates disincentives for innovation. Moreover, risk taking is not rewarded. A production unit may be punished for inventing efficiency enhancing production methods. When it spends resources on innovation it risks not fulfilling the current plan.[38] In many instances the rigid planning mechanism cannot allow for such departures from the plan.

Planning innovation requires an ability to process information about changes in production technology and development of new products, as well as changing consumer preferences. Through various organizations for market research, and through departments for research and development, attempts are made to capture innovative capacity. These organizations are not well suited to incorporate the unforseeable nature of technological development and consumer's preferences, however, since the incentives for innovation are inadequate. Similar problems appear also in hierarchies in market economies, but the market system seems to allow for more flexibility since it is the responsibility of individual firms to adapt to changing technical possibilities and changes in taste. Hence, a socialist system has problems in stimulating sufficient innovations and dynamics in the system.[39]

Good innovations often lead to investments. And socialist systems are in fact renowned for an excessive "investment hunger". Investments are made because socialist countries are striving to achieve rapid industrial growth and expansion. Expansion is a target, and the volume of investments made (measured in financial entities) may serve as one measurement of that target. Thus large investment volumes are in principle a good sign, but with the lack of proper incentives, it is uncertain whether the investments made are the most appropriate for the economy (i.e. likely to yield the highest return), or will be properly implemented. Investment volumes may have increased because the initial investments have failed or been wasted, thus requiring additional funding. Investment hunger is closely related to the problem of soft budget constraints.[40]

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[37]Grossman & Hart (1986); Hart & Moore (1990).

[38]Nove (1986), pp. 159-165 on problems of innovation.

[39]Hayek (1945) claims that the central economic problem is adaption to change which the market system can best handle. Oliver Williamson (1991) discusses this and Barnard's (1938) opposite position, which is that it is precisely internal organization that manages to adapt to changing circumstances. Williamson, naturally, claims that both are right. For some types of change, the price system is the sufficient statistics to which autonomous enterprises or individuals respond; other kinds of change requires coordinated adaption which is best achieved in an hierarchic organization (pp. 277-279).

[40]Kornai (1992), p. 162, discusses the system-specific features of risk-taking which create persistent investment hunger, with the absence of individual responsibility, and the possibility of additional funding because of soft budget constraint mechanisms.

Soft budget constraints

The ideology does not admit failure, but failure does occur. When the plan fails, i.e. the conditions in the contract are not fulfilled, enforcement costs are substantial. Thus, time-inconsistent behavior occurs: if you cannot fully reach the target - try at least to do a little; if you cannot do with the original funding for this project - have some more. These *soft budget constraints* create vicious circles of disincentives in the economy.[41] There are various ways to soften constraints: through lax and discrete taxation, through price adjustments, and through additional credit provisions.[42]

Softening budgets may be a rational device in various circumstances. If the original agreement has been severely misspecified, if unanticipated events cause delays etc, then it may obviously be beneficial to renegotiate the terms of the contract in order to reach the agreement's true objective.[43] The existence of soft budget constraints becomes a severe disincentive when its provision is anticipated by the agents in the system. Knowing that additional funding or prolonged deadlines will automatically be provided, there is less reason to take the budget (including both financial and time limits) seriously. This creates a pattern of systematic shortages. Production does not fulfil plan and excess demand grows. The higher the costs of enforcing the budget constraints, the less likely it is that enforcement will occur.[44]

Enforcement costs are high when there are problems in identifying who is responsible for the failure. Without individual property rights, there is a lack of individual responsibility. This could, however, be replaced by the responsibility of a collective. To punish a whole collective, for example a factory department, may be much more difficult, however, (more costly)than punishing one individual. In addition, there are still heavy short-term costs connected to hard budget constraints. If our factory from the example above makes losses, the planning agency could require it to shut down. But socialist production should not fail, according to the ideology; by protecting the factory through subsidies or soft credits, the image of a well functioning production system is at least superficially preserved. And disregarding ideology, it might still "pay" (in the short run) to protect the business. There are often substantial social costs involved in closing a work place. Since people need to be paid regardless of whether

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[41]See Kornai (1986) for a definition and discussion of the concept.

[42]Kornai (1986), pp. 5-6.

[43]Such considerations are typical in the world of Western banking, where a significant amount of loan contracts are renegotiated.

[44]For alternative views on the soft budget constraint, see Ellman (1994) who refers to Gomulka (1994): "The main factors generating shortages now appear to be state control of international and domestic trade, state price control, and macroeconomics disequilibrium"... "The soft budget constraint now appears to be a concept more relevant to help explain inflation than shortages" (p. 11).

they work or not, they might as well keep working. By bailing out the factory, we might at least get something out of the production. If it is shut down, no shoes will be produced at all.

This problem is more severe, the more of a monopoly position the factory has. If there was another shoe factory, it might be credible that this second factory would in the future get to produce more shoes if the first factory was to fail. Production targets would not be fully reached, but in the longer run the use of the more efficient factory would be advantageous to total shoe production. The first factory, realizing this, will therefore try harder, and this competitive situation could possibly, in itself, impose harder constraints on the factory. In the monopoly situation, the planning agency and its factory are stuck with each other.

The banking system

The banking system is an important agent in the mechanism of the soft budget constraints. The state bank is part of the bureaucracy, and bankers are bureaucrats. Although the focus in the socialist system is on the real side of the economy, the bank has power. It controls the financial transfers between enterprises, and may intervene if these do not conform to regulation or plan. By the division of money into two circuits, monetary planning is supposedly facilitated. If the two circuits are strictly separate, then planners can concentrate on planning the growth of cash money in accordance with the growth of the supply of retail goods, through control of wage payments, and payments for agricultural produce and so forth. Enterprises are allocated financial resources in order to fulfil their commitments according to plan. If the money allocations are not sufficient, this should indicate that the enterprise is not prudently managed, or that planned prices are not adequate. In reality, however, it is quite difficult to maintain the separation between the two circuits. Substantial overflows through, for example, excessive wage payments occur. When enterprises cannot fulfill plans with the given financial resources, banks have to supply them with additional funding. For instance, when prices are set in such a way that enterprises make losses, they still have to pay wages and meet other obligations. Credit for these expenditures has to be supplied by the banking system.

Because of the absence of a link between financial performance and economic decisions, financial transactions through the banking system - and in fact the state budget itself - play only passive roles in the resource allocation in the economy. Money allocations only determine the limits of economic activities, while money measures do not signal viable opportunies or provide an incentive to engage in these opportunities. But this does not mean that bank money is without a role in classical socialism. It is perhaps more accurate to say that banks and bank money, rather than being passive,

plays a passivizing role. Passivity "heightens the rigidity of economic activity and frequently prevents rational substitution taking place between the factors of production".[45] But then the bank also loses some of its power. The strict control exercised through the banking system also creates a tendency to keep financial transactions in cash, outside the banking system. The intermediary function of banks is impaired and banks cannot function as a coordinator of economic activities.

2.2 Failure and Search for Reform

The idea of socialism as superior to capitalism in efficiency and equity terms does not match reality: the coordination task is too great and the motivation problems too numerous. The system fails, and needs to handle these failures in various ways. The system *de facto* allows for a certain degree of decentralization and market imitating relations, outside plan and ideology (the so called centralized pluralism). Prices and money in reality take on partially allocative functions similar to those in the market economy. The chronic soft budget constraints is yet another, temporary, solution to the production problem. The system holds together by these *ad hoc* solutions, but they also contribute to increasing transaction costs and growing economic problems; eventually fundamental economic reform is necessary.

Kornai, who coined the soft budget constraint, points out that more than a strict definition of a number of activities in the socialist system, the soft budget constraint should be understood as a metaphor; it is an image of the relaxed financial discipline which appear when the state take on a paternalistic role towards economic organizations.[46] In the socialist economy, all agents and organizations are in the same boat. Any leaks and holes have to be mended by whoever sits closest - or all will sink. Transition from socialism is much about the state losing its paternalistic role. Agents and organizations put themselves in different boats; the new type of state comes to rescue only if you fall into the water. But building the boats and putting them in the water is quite a task for the nascent market economies.

3. The Reform Process

The objective of economic reform is to alleviate the problems in the socialist system that made transaction costs so high, and economic efficiency so low. Just like the idea of socialism, the transition to the market is simple enough as a thought, but demanding in practice. Many of the transforming countries are politically and

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[45]Kornai (1992), p. 133.

[46]Kornai (1986), p. 9.

economically in the midst of severe disruption; to an extent it is valid to speak of a "transformation crisis". Various indicators point to a worsened economic performance; many of the countries have suffered from a decline in GDP, in particular as a result of reduced industrial output. The countries have experienced increasing unemployment levels, in combination with more or less dramatic inflation rates (in many countries at least periodically in the three-digit region).[47]

Other signs of crisis are changes in the terms of trade, resulting from the collapse of the economic cooperation between the member countries of the Council of Mutual Economic Assistance (CMEA or *Comecon*), and a lack of fundamental reallocation of resources. Few bankruptcies or reorganizations of the inefficient state sector take place, although the enterprises have obtained increased management autonomy. The result is often the worst of both worlds: the center - the state bureaucracy - loses control but remains obliged to support the enterprises, which are still under state ownership. If the soft budget constraints were important in the more strict socialist system, the transition process does not seem to harden them - rather the reverse; the still bureaucratic banking system remains the ally of the state sector and provides it with additional credit, thus fueling inflation. Furthermore, when direct transfers from the state industry are to be replaced by tax incomes, which are difficult to collect for various reasons, fiscal deficits increase, impoverishing the state while threatening price stability.

Nevertheless, this gloomy picture should be taken with a grain of salt. For one thing, one may question the statistical data which portray the discouraging picture of economic crisis in the transforming countries. Statistical figures may be misleading because they originate in a method of evaluating economic activities belonging to the socialist system; the approach concentrates on aggregate production and output sold, and the calculated value added is purely a book-keeping category. Moreover, quantified estimates of economic activities in socialist countries largely refer to the state sector. Focus is on material production, which ignores activities in the service sector, and often excludes or underestimates the activities in the emerging private sector.[48] It can also be argued that a perceived decline in value produced in the economy - a reduction in GDP - in fact might hide an increase in production because of these statistical omissions, and because a decline in a poorly performing state industry might mean a reduced waste of resources - an unproductive industry is in reality a kind of "value subtractor" in the economy.[49] Other explanations of the downfall in output are shortages of inputs, as the production appartus falls apart, and a decline in demand, as people change their

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[47]See Schmieding (1993), pp. 216-219, and Ellman (1994) for overviews of the transition processes so far.

[48]Bratkowski (1993).

[49]Winecki (1991).

preferences. Although painful. this does push transformation of the production process towards more a more appropriate structure.[50]

Just as the general features of the socialist system vary, the transitions from these systems exhibit substantial differences between countries and regions. Not the least in the Vietnamese and Chinese cases, is it exaggerated to speak about a crisis; there are indeed transition *problems,* but overall they seem to be compensated for by the achievements made, at least in economic terms. Many of the Eastern European countries are also progressing quite rapidly.

Vietnam and China are developing countries with a relatively small state sector.[51] Moreover, these countries have not attempted any political reform or decentralization - for better or for worse.[52] Nevertheless, many features of the Vietnamese (and Chinese) reforms are similar to those in Eastern Europe and the USSR. In particular, the type of transformation that the Vietnamese banks are going through, resembles the change - and lack of change - in the other countries.

3.1 Socialism and Capitalism

The deficiencies of central planning were emphasized prior to the 1980s market reform hausse. Von Mises is an early example; he questioned how a socialist economy could make efficient use of resources in the absence of markets and private property.[53] Hayek highlighted the costs of collecting all the necessary information in order to make the centralized allocation decisions.[54] Schumpeter, likewise, analyzed socialism in economic terms. He was more optimistic about the possibilities to create an economically efficient system by a central authority; his objections had to do with the system's difficulties in utilizing the entrepreneurial talent in society.[55]

The so called Lange-Lerner solution in the 1930s was a response to von Mises' (and Hayek's) fundamental criticism. Based on Barone's theory that *ceteris paribus* the efficient allocation of resources is independent of ownership structure, and only requires

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[50]Åslund (1994), pp. 31-32.

[51]See Sachs & Wing Thye Woo (1994), and Wing Thye Woo (1994) for discussions on China in comparison to Russia and Poland.

[52]Ellman (1994) quotes Brus (1993): "contrary to the conventional wisdom"..."mono-archy [i.e. communist dictatorship] may play a positive role in this process" (p. 18).

[53]Von Mises (1920), referred to by Schumpeter (1987 [1943]), p. 172. Van Brabant (1990), p. 157 refers to the Barone-Lange-von Mises debate.

[54]Hayek (1945) is the classic. See also Hayek (1988).

[55]Schumpeter (1987 [1943]), p. 188. On the other hand, in Schumpeter's analysis of capitalism, economic organizations become increasingly large-scale and monopolistic; thus there was no reason why not a central authority could not replace such commercial organizations, and be more beneficial to society (p. 189).

an appropriate set of prices, Lange proposed a trial and error procedure for determining market clearing prices by the central authority. The socialist system could thus copy the market mechanism and establish similar economic conditions as those of a market economy. From this point of view, the choice of economic system is a political problem, a kind of political trade-off - essentially between equity and political liberty. For a long time, this view dominated the debate on socialism: emphasis on democracy and individual liberty were arguments favoring capitalism, while the importance of class conflict and workers' exploitation, and the focus on equitable distribution of wealth and income, favored socialism. For advocates of socialism, the observed economic problems in the socialist countries - for example the differences in living standard between socialist and capitalist countries - were referred to as country specific political problems, relating to historic circumstances. Problems of socialism had to do with the implementation of the system, not the basic idea.[56]

Overall, criticism of central planning gained relatively little attention until the late 1970s for several reasons, one being that marxist analysis itself focuses on the shortcomings of capitalism: when capitalism eventually would fail, something would have to replace it.[57] That something would be socialism, implying a different kind of ownership structure, a different kind of economic organization, but the detailed functioning of which was of less interest to socialism's proponents. And even if the total breakdown of capitalism has been difficult to envisage in the prospering OECD sphere in the post World-War II era, the market economic system is not, and has never been, a clear cut road to success, as little as a clear cut economic system. The role of the state and the degree of state intervention necessary (or possible) for economic growth, and for off-setting economic recessions, is a central theme in economic theory. In addition, the public sector has grown in most Western economies, and this has sometimes blurred the definition of a socialist economy. Thus, in some people's views, more state intervention, to the point of approaching a socialist system, has been a feasibile and desirable alternative.[58]

In addition, up until the 1950s (or perhaps even the 1960s) the socialist countries appeared - at least from a Western perspective - quite prospering. This validated the view that the choice of system was a political problem. Moreover, the influential leftist

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[56]See Heilbroner's (1992) self-critical reflections on the world after communism.

[57]For example, capitalist collapse would come either because of decreasing profit quotas, according to Marx, or because of its overefficiency and eventual satiation of markets, according to Schumpeter. See Nove (1985[1983]), Chapter 1, and Nove (1986), Chapter 4 on Marx and the socialist system. See also Vygodsky (1981) for a pro-marxist account which indirectly supports the notion that Marx had little to say about socialism (p. 247).

[58]A country like Sweden, with a huge public sector and an important welfare system, has been referred to as a socialist country, despite the fact that the lion's share of the means of production is privately owned.

movement of Western intellectuals also contributed to the lack of interest in socialism's inherent problems. The Western world was, in the late 1960s and in the early 1970s, busy learning lessons from the failing American military intervention in Vietnam: The final outcome of the war symbolized, to many people, the death cramps of imperialism, viewed as one of capitalism's ugly but indispensable faces. From this point of view, it was natural to seek solutions to society's organization, which evaded the drawbacks of the commercial, capitalist system. In particular, these intellectuals favored socialist solutions for others - for the poor developing countries, where people were exploited both by its domestic upper class and by imperialists, according to this view.

3.2 Market Socialism

An ingredient in the reform of former centrally planned economies has been the opening up of these countries to the outside world. The fairly sudden revelation of the actual state of affairs in these countries has perhaps helped to focus the attention on the inefficiencies of central planning per se. Reality has proven wrong the notion that the degree of centralization is neutral with regard to economic efficiency.

Reforming socialism is, however, nothing new. Various endeavors to alter shortcomings of the central planning model have appeared at different dates.[59] The very idea of using administratively determined prices in the planning process in classical socialism is in fact a first attempt of reforming "real socialism". This socialist version of the Walrasian auctioneer was never implemented in practice; instead the countries applied the cost-plus principle, as described in section two. But the use of prices and money was a step away from the original vision of "real socialism".

More market oriented reforms have been attempted in various periods and countries after the second World War. In the aftermath of the Stalin-Tito break in Yugoslavia in the 1950s, self-managed economic units began to rely on market coordination. Similar attempts followed in most of the European states, as well as in China in the late 1950s and the early 1960s. Reform measures were taken also in North Vietnam in this period, but soon the escalation of the war called for a more centralized mobilizaton of the country's resources.[60]

In economic terms, reform socialism has striven to approach market allocation, without abandoning social ownership, and macro-level planning. The "model of central planning with regulated market mechanism" has given socialized enterprises increased responsibility and provided incentives for efficiency and higher quality production, while

[59]See Grossman (1968), and Brus & Laski (1989) for the long history of socialist reforms.

[60]Fforde & Paine (1987).

keeping central control.[61] A combination of plan and market - often referred to as *market socialism* - is characteristic of the former centrally planned economies in their first steps towards more comprehensive reform. There is a persistent debate about the extent to which market socialism is - or could be - a feasible and efficient form of economic organization.

One line of argument would claim that the idea of market socialism is not in accordance with the inherent logic of the socialist system itself since socialist efficiency is dependent on the central coordination and control of economic activities. Any market allocation is, another line of argument goes, dependent on private ownership - only private owners will have the incentive to control the efficient use of resources. This incompatibility depends, however, on the definitions of markets and socialism. If socialism is defined as the abandonment of all market relations, and if a market economy exclusively defines exchanges between private owners of assets, then the combination is logically impossible. Such rigid definitions are not in accordance with the actual organization of either socialist or capitalist societies - combinations of markets and hierarchies as they all are.

Nevertheless, the concept of market socialism *is* unclear. Even Lange's idea of a planning authority which uses planned prices to clear "markets" is often referred to as market socialism, albeit in such a system, the market mechanism is imitated - not taken advantage of. Leaving that definition aside, there are still different ideas of what a combination of markets and socialism is and could be. Some would loosely define it as something which combines efficient allocation through market ruled exchanges, and an equitable distribution of the surplus.[62] To Kornai, market socialism is simply the combination of state ownership and market coordination.[63] In a similar interpretation, by Nuti, market socialism refers to the development of an economy with prevailing public ownership, a dominating communist party, generalized market exchanges - regulated by public policy - and possibly some political pluralism.[64]

If market socialism is a combination of state ownership and market coordination, there is still a question of how to define state ownership. Ownership, following the discussion in Chapter II, implies the right to make decisions about the use of property, the right to keep the profits generated, and to bear the risk of losing the property. A suggested variant of a market socialist system is one where the state ownership is combined with competitive leasing markets of property, where the leasers have a residual claim to capital gains and income - although they cannot sell or change the use

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[61]Brus (1992), p. 8.

[62]Bardhan & Roemer (1992).

[63]Kornai (1990), p. 58.

[64]Nuti (1992), p 18.

of their property.[65] But when leasers are residual claimants, they are interested in the efficient use of the asset in order that it yields high returns. In addition, since there is a second hand market for leasing contracts, leasers would also be interested in maintaining the value of the asset, and make necessary investments. Thus it is difficult to see the principle difference between these "temporary" rights obtained by the leasers and true private ownership.

In another vision of market socialism, public ownership means that the "distribution of the profits of firms is decided by the political democratic process, while the control of firms might well be in the hands of agents who do not represent the state".[66] Profit earners cannot capitalize their profit streams, and monitoring of enterprise management is taken care of by banks, which also decide on investments and make other financial decisions for the enterprise. This utopian idea of market socialism is open to criticism on several points. Perhaps most important is that the implementation of the system would be as cumbersome as any introduction of a regular capitalist system. Its inventors suggest that the model would not only guarantee a more egalitarian income distribution, but it would also be easier to introduce in East European countries, in China, or in Vietnam, than a full-fledged capitalist system which requires a well developed legal, political, and economic infrastructure.[67] The model proposes a "bank-centric organization", where banks are to play the roles that share-holders and boards of directors play in capitalism. It is very difficult to see how - all of a sudden -a sufficiently efficient and scrupulous banking system could develop in a country, for example in Vietnam, *without* the parallell development of the institutional infrastructure. It seems impractical to implement this kind of market socialism, which to a large degree mimics capitalism but isn't capitalism, when capitalism itself is round the corner.

Yet another and possibly more important problem with market socialist solutions is that when they maintain some kind of public ownership they also preserve motivational problems prevailing in classical socialism. This can be understood by distinguishing two different problems in socialism: *central planning* and *central authority*. Market socialism - defined as public ownership and market coordination - is an attempt to solve the central planning problem by increased decentralization - the system could accordingly solve many of the coordination problems. But the authority dilemma remains as long as the center has the final say in various decisions. Chapter II touched upon the problem of selective intervention, which is one way to explain why firms are limited in size. In a situation where autonomy is granted "for all practical purposes" to enterprises or departments, but the center has some kind of residual power

[65]Nuti (1992), p. 22.

[66]Bardhan & Roemer (1992), p. 101.

[67]Bardhan & Roemer (1992), p. 103.

to intervene in certain situations, the decentralized units will not have the same incentives to act for the benefit of their separate units, as if they had unreserved autonomy. For example, if their profits are too high, the center (the state) might decide to increase taxation - despite previous promises not to do so. In addition, knowing that there is a chance that the central government will interfere if the "liberalized" enterprise is doing too well - or too badly - the employees will be tempted to waste their resources on various lobbying activities, trying to obtain a particular kind of interference, which is to their (short-run) advantage. An effect of these mechanisms is the risk that budget constraints may be softened, despite the intention that decentralized units are to gain (almost) absolute independence and responsibility.

The concept of market socialism is important in Vietnam, where the economic structure partially follows the definition above: there is state ownership and there is market coordination. The Vietnamese state banks, the objects of inquiry in this study, indeed fit into this category. But the Vietnamese situation is ambiguous. While the communist party power is maintained, private ownership is at least partly allowed and sometimes even encouraged. This seems to confirm the impression that market socialism is a vague concept which is used to denote very different forms of economic organization, ranging from Lange's imitation of market coordination by a central authority, to a mixed economy situation where state ownership is reduced to mere large state holdings in share-holding companies.[68] Although inherent inefficiencies prompt the design of new organizational structures, it is in the interest of those with political power - the communist party - to maintain some basic components of the socialist ideology. Without a vision of socialism in combination with market efficiency, it is difficult to imagine that the initiations of the reform processes would have been politically possible in the now transforming countries. Forms of market socialism exists in many transforming countries, but seem to be unstable solutions to the allocation of resources, and only one step in the direction of more comprehensive reforms.

3.3 Comprehensive Economic Reform

If market socialism is a vague concept, so is the concept of market transition.[69] Roughly, the fundamental idea is to "allow prices to give the appropriate signals as to what goods should be produced", and to give firms and workers "the incentives and the

[68]Which Nuti (1992) proposes as yet one definition of market socialism.

[69]See Kornai (1992), p. 387 for a discussion of different aspects of transformation, revolution, reform etc.

means to respond to those signals".[70] Deteriorating economic performance, increasing public dissatisfaction, the loss of confidence in their duties among bureaucrats themselves, as well as the example of parallell processes in other countries, all help to push the transformation process forward.[71] The transforming economies undergo fundamental changes in the economic structure. Price liberalization is central, as well as increased decentralization of economic decisions, and liberalization of foreign trade by exposure to the outside world and world market prices. Decentralization implies that the dominating state sector (state enterprises, and state or collective farms) is granted increased autonomy, and will face competition by an expanding private sector. The transformation means that private business is tolerated and perhaps even encouraged, and that moves are made towards privatization of the state sector itself. Autonomy and privatization implies a new role for the state; it has to finance its activities by taxes rather than direct transfers. Restructuring of the economy is often combined with political pluralism, possibly combined with the abandonment of the communist party.[72] Furthermore, there is a need to establish a social safety net encompassing unemployment compensation and other financial aid to people who will no longer be automatically protected by a state employment. The state must also engage in effective stabilization policies in order to reduce the pains of the transformation which almost inevitably cause inflationary pressure and imbalances in the economy.

The market economy requires new rules for economic exchange. In central planning, the plan itself is the legal document. In a market economy new commercial laws must be established: laws which define the different economic agents (such as legal definitions and requirements for different types of firms), the framework for economic exchange (such as prudent accounting, auditing systems, bankruptcy laws etc.), and also regulate contractual relationships (such as labor contracts). Hence, previously insignificant markets must be developed; foremost, a market economy needs markets for capital and land.

The new market structure ideally overcomes (at least some of) the problems prevailing under central planning. Through price liberalization, prices and monetary aggregates retrieve their allocative function. Decentralization replaces central information with local information exchange, allowing for more accuracy and flexibility. Through commercial and bankruptcy laws, the economy has better instruments by which to ensure prudent management of economic organizations, as well as clear guidelines

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[70]Blanchard *et.al.* (1991) p. xxi. There is a substantial literature of varying quality on the transition processes. Good introductions to the main issues at stake are provided by Blanchard *et.al.* (1991), Clague & Rausser (1992), Åslund (1992), Åslund (1994), and Ellman (1994).

[71]Kornai (1992), Chapter 16.

[72]But while *doi moi* ("new road" or "renovation") is the Vietnamese equivalent of the Russian *perestroika* (restructuring), there is no similarly well known phrase in Vietnamese for *glasnost* (openness).

how to handle economic entities which fail in their mission. A similar effect is brought about by political liberalization, where the democractic system provides alternatives to a failing political leadership. To the degree that private ownership is established, the incentive problems created by public ownership are reduced. The individual's interest in enlarging his or her private wealth motivates innovation and change, and creates incentives to make productive investments.[73] Different economic units are divorced from the state. The separate firms are forced to avoid losses and manage their budgets, in order to profit maximize. It is in the state's interest to protect the vitality of the economy as a whole, rather than individual firms, and thus budget constraints will be hardened.[74]

It is all easier said than done. Crucial for the outcome of reforms is how the state manages its new role. Without a political committment to pursue the reforms they will hardly succeed, but the transformation puts heavy pressure on the government. The state apparatus is weakened by reduced control (due to decentralization) and reduced incomes (due to an eroding tax base), while in some ways it needs to be stronger than ever in order to implement and monitor the reform measures. Decentralization applies also to the state apparatus itself, and decision structures are often blurred. The problems facing countries in the process of transition will soon be discussed, but first some more details on the basic ingredients in a new and market oriented financial system.

4. Reform of the Financial System

There are good reasons why financial reform deserves special attention. Chapter II discussed the role of finance in development. The restructuring of former centrally planned economies requires large amounts of capital, but there is little private capital available. A functioning financial system could help to mobilize and reallocate resources, and thus provide the main source of outside finance. Besides, the effectiveness of all the other reform measures may be impeded by underdeveloped financial markets, and poorly functioning payment systems.[75] And in the absence of capital markets and the heritage of substantial "insider control" of enterprises (i.e. by

[73]Olson (1992) argues for the importance of establishing individual rights (and responsibilities) in order to succeed with reform.

[74]There is another way to view the motives behind the reduced subsidies from the state after privatization: if the state wants to ensure a high - but inefficient production - it has to compensate the enterprise by a subsidy. With privatization, the state can no longer order the enterprise to produce a high output. The private enterprise has stronger bargaining power: the compensating subsidy must at least be equal to the profits that a more efficient (and lower) output would yield. In this case, it is not the general interest in enhancing efficiency in the economy which is important to the bureaucracy, but rather the need to reduce costly subsidies; see further Boycko *et.al.* (1992).

[75]Calvo & Frenkel (1991).

enterprise managers), banks may be the feasible alternative for corporate governance of the enterprises.[76] A focus on banking is furthermore motivated by the so far fairly weak achievements made in this sector, compared to others in transition economies.[77] Although a key sector "the financial sector is the segment of the economy in which central planning and the planners' mentality have survived for the largest period of time".[78]

The literature on transformation of the financial system has boomed in recent years.[79] Here I will first summarize some basic features of the state of banking in transition economies to this date, and then present some of the central issues currently suggested and debated in the literature.

4.1 The State of Banking in Transition Economies

The basic structure of the financial systems in mature market economies differs between countries, largely as a result of historical circumstances. Likewise, the development of finance in the transforming countries, although subject to fairly radical organizational changes, is path dependent and varies. Most countries have attempted to establish a two-tier system, but apart from this regularity, the picture of banking reforms is scattered. In the first half of the 1990s, the most westernized commercial systems are found in Hungary, Poland, and perhaps also in the Czech Republic, where the commercial banks have full authority over their activities. A separate central bank and a number of formally independent commercial banks exist also in, for example, Rumania, Bulgaria, and Albania, but informally the intimacy seems to remain between the government, the central bank, and at least the former departments of the State Bank, now transformed into separate commercial bank units.[80] In Russia, the financial reform has so far created quite an explosion of new banks. By 1994 over 2,000 banks were registered, following legislation which permitted cooperatives and enterprises to start banking activities.[81] Consequently, most of these banks are very small, and their task is primarily to advance credit to their founders.[82]

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[76]Aoki & Kim (1995).

[77]The financial sector as a bottleneck in the transition is frequently stressed; see for example Ellman (1994), and Kornai (1994).

[78]Borish, Long & Noël (1995), p. 3.

[79]See, for example, Prindl (1992), Gowland (1992), Roe (1992), Lampe (1992), a special issue of the *Journal of Banking and Finance* (1993), Bonin & Székely (1994), Griffith-Jones & Drabek (1995), Bonin, Long & Noël (1995), Long & Rutkowska (1995), and Aoki & Kim (1995).

[80]Poenish (1992).

[81]Belyarova & Rozinsky (1995), p. 187.

[82]Johnson *et.al.* (1993).

Despite the differences, the state of finance in most of the transforming countries resembles each other: the sector is still in quite poor shape. The technical infrastructure, the skills of the banking staff, and the branch networks are underdeveloped. The inherited loan portfolios are of dubious quality, and in combination with new reserve requirements and capital adequacy ratios (to secure these bad portfolios), this has probably helped to create credit crunches, i.e. restrict potentially viable projecs' or enterprises' access to credit.[83] To cover for bad loans, the good borrowers have had to carry the burden of poor industrial policy, by compensating the banks for their losses. Consequently, good borrowers avoid banks, while banks prefer to place their assets in safe government bonds. The increased household savings are thus used to finance government deficits, and little credit is available for investments.

4.2 Financial Reform Ingredients

From a macroeconomic perspective, financial reform means remonetization. Interest rate levels and the return on assets determine the allocation of financial resources, and the currency will become a fully acceptable means of exchange. For this purpose, the currency needs to be convertible - both domestically and internationally - and price stability assured. International convertibility is essentially a policy decision, but for this policy to succeed, price stability which creates and maintains confidence in the economy and in the currency is necessary.[84] Control of inflationary tendencies during the reform process is thus critical. When prices are liberalized, a lot of the socialist deficiencies surface. The considerable monetary overhang created by the chronic shortages cause substantial price raises when prices are set freely. New relative prices, changes in income distribution, and alterations of the firms' financial positions all contribute to monetary distortions.[85]

Inflationary pressure is also caused by fiscal deficits. When enterprises are granted autonomy, taxes are to replace direct transfers, but an efficient tax system is not established over night. Moreover, the tax base might deteriorate during the restructuring period of the state industry.[86] Government expenditures may therefore be financed through the issuing of currency, i.e. the central bank provides the government with credit. In addition, there is a tendency that banks, when still playing their old roles of supporting the state sector, will finance the enterprises' increased expenditures through

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[83]Although Aoki (1995), p. 25 refers to Dittus (1994), who suggests that "the decline of lending is not a result of a credit crunch from the government deficit"..."it can be regarded as a hardening of budget constraints for the enterprises".

[84]John Williamson (1991).

[85]See Blanchard *et.al.* (1991) on price stabilization.

[86]McKinnon (1991), pp. 121-122.

soft credits. There is a substantial risk that these inflationary pressures transform into hyperinflation, in particular in the transition period when the state is weakened, and the budget deficit increases.[87] Restrictions on central bank lending and credit expansion is one way to increase stability. It is thus crucial that the state balances its budget, and prudently manages any foreign or domestic debts, in order not to fuel inflation by financing fiscal deficits through central bank lending. With little income available, a first task is to reduce expenditures by eliminating state subsidies. Although elimination of firms' subsidies leads to price rises, it might be the right time to have this happen, when many prices are rising in the economy.[88]

Financial reform implies the separation of state finance from the banking system. In the new banking system, the former monobank is replaced by a central bank and a number of commercial banks, and other financial organizations.[89] Eventually, this system may become more and more elaborate with a diversified financial structure consisting of commercial banks and other financial organizations, stock-market exchanges etc. Such elaborations advanced steps may be taken, once the basic structure and legislation are in place, and there is confidence in the currency and in the payments system.[90] Although separated from the state's finances, the banking system will continue to play an important role for stabilization and convertibility. Remonetization is dependent on a functioning payments system, and check clearing facilities and rapid transfers help to make the currency domestically convertible.[91]

Central banking

The central bank obtains a new role: it is to control monetary expansion and ensure banking stability, thus creating confidence in the currency and in the financial system. It therefore needs the support of legislation that is able to provide the framework for these functions. It is important to ensure that the central bank is independent *vis-à-vis* the government and the commercial banks.[92] This may be

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[87]See Hansson (1992) for reasons behind hyperinflation in transforming countries.

[88]Blanchard *et.al.* (1991), Chapter 1.

[89]There is no irrefutable reason why the typical two-tier system with a central bank, a number of commercial banks, and other financial organizations should serve as the blue-print for the transforming countries. For example, it is not evident that these countries should establish a traditional central bank as a dominant player. One could instead have a system with a *currency board*, which takes on the role of providing a fully convertible domestic currency against a foreign reserve currency. Such system would abandon the politically infected and unreliable central bank (as in e.g. Russia), for a transparent and relatively credible organization, able to maintain a stable currency; see Hanke *et.al.* (1993).

[90]Stiglitz (1992), p. 183.

[91]McKinnon (1992), p. 123.

[92]See Siklos (1994) for a discussion.

achieved by giving the central bank legal independence, or by prohibiting it from financing government deficits etc. Confidence is also created by making banking activities relatively transparant, for example, by publishing important bank decisions in the press etc.[93]

In the socialist system, interest rates played an insignificant role. Banking reform is largely a matter of introducing a cerain degree of financial liberalization: abolishing interest rate restrictions and directed (subsidized) credit flows, and allowing the entry of new financial agents. Much of this liberalization is governed by the central bank. In order to mobilize deposits and absorb considerable cash balances in the economy, deposit rates must be sufficiently attractive for potential depositors. A general cessation of subsidies is also part of the reform program. Moreover, the central bank has also been given the role of supervisor of the financial system, thus ensuring that the new agents fulfil necessary requirements in order to maintain stability in the system.

Many of the transforming countries have established central banks which are subject to less government influence than under central planning. Their main objective has become the maintainance of price stability.[94] There is a tendency, however, that the central banks have still kept on the old patterns of behavior, for example by refinancing state enterprise credit.[95] Central banks may also have a problem in implementing adequate interest rates reforms. Successful interest rate liberalization "requires a stable macro economic environment, adequate competition and reasonable strength in the banking sector, an active and well-functioning money market, and policy instruments that may influence the marginal cost of funds."[96] Only after all the necessary banking legislation is established, and all the retraining and reorganization of the banks and enterprise sector is accomplished, "can a market-based banking system emerge and interest rates be liberalized".[97] Apparently, the central banks still have a lot of influence over interest rates, despite general deregulation, not least because the central banks remain the largest agent in a number of markets. They maintain preferential interest rates for special segments of refinancing, for example, and this influences the market interest rate levels.[98]

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[93]Poenish (1992), p. 41. Such transparancy may be difficult to obtain since socialist banking - even more than banking in market economies - are renowned for extreme secrecy. At the same time it is vital to change the public's impression of banks as organizations which by obscure methods protect the state industry and the established but deficient structure of society.

[94]Siklos (1994).

[95]Poenisch (1992).

[96]Durski (1993), pp. 15-16.

[97]Fischer & Gelb (1991).

[98]Sándor (1994), pp. 162-163.

Commercial banking

The basic task for the commercial banks is to mobilize financial resources in the population and provide credit. The commercialization of the banks implies that they abandon their bureaucratic ways and become an efficient industry. For this purpose, the banks need proper regulation which stipulates capital requirements, accounting principles and autonomy etc. Moreover, the environment in which the banks are to operate needs to be covered by adequate regulation. The most obvious and urgent is the introduction of bankruptcy laws. In the event of enterprise failure, well-enforced bankruptcy procedures is a way to avoid softening of budget constraints, while it provides assistance in sorting out debt relationships. A more important function is perhaps that they motivate the prudent management of firms (thus making them more credible borrowers, from the banks' point of view).[99] The opening up of the financial market to competing agents is another ingredient which enhaces efficiency of the commercial banks. The banks need to face adequate competition, of which the introduction of foreign bank branches may be one part.[100]

Banking reform is furthermore a huge retraining project. The skills of bank employees are to a large degree lagging behind the changing focus and activities of the banks. Bank commercialization means that credit decisions are made on the basis of risk and the potential profitability of projects etc; banks are to become client oriented and provide proper services both to borrowers and depositors. When the monobank structure is abandoned, several banks may conduct international banking. This new field of operation requires new skills and knowledge among the people working in the banks.

One of the main tasks of a banking system is to handle and redistribute risk. With underdeveloped capital markets, banks have difficulties in diversifying risks. Banking in transition is subject both to systemic and idiosyncratic risk. In the transformation period there is substantial uncertainty as to the future development of the economy, and thus the profitability of different projects is difficult to establish. Project specific risks are also larger than in the mature market economies. Because of information problems, it is difficult to screen and monitor clients. Banks have difficulties in knowing with whom they are dealing, and clients - depositors and borrowers alike - may in turn have

[99]But, the literature points out, there are social costs of bankruptcy, especially considering the current state of the transition economies. In particular there are risks that viable enterprises may be forced into bankruptcy because of chain reactions, and the unclear definitions of property rights may also incur further costs (Aoki, 1995, p. 26).

[100]There might, however, be reasons why banking should face somewhat heavier restrictions than other industries as far as competition is concerned, as argued in Chapter II; competition may force banks to squeeze margins, and thus banks may take on too large risks. This may cause losses to society both in terms of financial expenditures (compensating depositors), and in terms of deteriorating confidence in the banks.

difficulties in judging the policies and actions of the banks. High risks tend to induce short planning horizons, which in turn favors short-term term credit rather than long-term investments. Reducing these risks is important for the purpose of an efficient and well-functioning financial system.

Project specific risks are often hard to estimate due to the abundant inter-enterprise debt - a legacy of the old system. In a situation where there were restrictions on bank credit, enterprises instead gave each other credit. Firms are thus often interlocked in debt, which in many cases will never be repayed. Obviously, banks have difficulties in evaluating the credit worthiness of different firms. It is difficult to distinguish between debt burdens associated with a genuinely inefficient production and those caused by other inefficient enterprises not being able to repay their debt. Banks' balance sheets are themselves often burdened by large proportions of bad debt.[101]

Bad debt and restructuring

In view of the heavy portfolios of bad debt, a central question is the appropriate method to clear banking debt. At least three ways of "cleaning" the balance sheets are proposed in the literature - both of banks and enterprises. The first is to simply cancel the debt once and for all. Another method is to socialize the debt, by providing the creditor government bonds and transfer the indebted enterprise's liability to the government. A third method would be to swap the debt for equity in the enterprises.

There are pros and cons of all these solutions. Debt cancellation, which would get rid of the problem once and for all, may perhaps be feasible if clearly preceived as a unique event, not to be repeated (so as not to encourage time-inconsistent behavior). But the question is whether a government in a pressing situation of transition is capable of sending such a clear signal. Debt cancellation might also be disastrous to creditor enterprises, if they are not compensated in some way. Transferring debt to the government makes explicit what is implicit: in the state-owned sector, the government is fundamentally responsible for the debt already. At the same time there would be no old debt burdens to blur evaluations of the creditworthiness of enterprises and banks.[102] On the other hand, the solution requires a tax system which can service the debt. Obviously this is a major obstacle in the transforming countries, where public debt tends to grow under all circumstances. It is also questionable whether the government

[101]Although there has been general agreement of the importance of the bad debt problem (see, for example, Griffith-Jones & FitzGerald, 1995), there seems to emerge a doubt as to whether the problem is as severe as believed (see Berglöf, 1995, p. 86, referring to Dittus, 1994). Although burdening many banks in many countries, some (in the Czech Republic, for example) have managed to (partly) resolve the problem, while in other countries high rates of inflation have reduced the value of financial claims.

[102]Calvo & Frenkel (1991).

(or the state bureacracy) has the capacity to evaluate and monitor the enterprises, in order to ensure that relatively efficient enterprises will keep up and service their debt, while the government only takes on debt of the truly inefficient or bankrupt companies. Thus, one could argue that it should rather be the banks that take on this inter-enterprise debt, and monitor companies.[103] Debt-equity is one way to achieve such monitoring, although to what extent this is a desirable alternative for the banks is not obvious. Equity in a genuinely useless enterprise is of little value to the banks. For debt-equity swaps to work, it is crucial that there is some option for the banks to choose between swapping the debt against government securities or equity.[104]

Debt-equity swaps relate to another central issue of concern in the ongoing debate: the question of how to restructure both enterprises and banks, i.e. how to recapitalize them and possibly privatize. As for privatizing banks, there are two central arguments: the first is the benefits of cutting off the government's incentives to intervene in commercial banking, for example by forcing credit advancement to government favored sectors or enterprises.[105] The second argument is the idea that privatization would be a way to break old patterns of behavior (including influence activities from the government) by establishing a new organizational structure.[106] Privatization is an important issue in the transition literature. Here is is only given a brief mention, since the Vietnamese situation is far removed from any serious privatization programme, in particular not of the state banks.

Another issue currently debated, related to banks holding equity in enterprises, is the type of commercial banking system to be developed. Developed market economies portray both systems of universal banks (for example in Germany and Japan) and specialized banks (for example in the United States). The former kind do not only provide loans to enterprises, but may have large share-holdings in the same enterprises, and also exert a general influence in the enterprises' activities. One of the advantages of universal banks is their more pronounced role in monitoring companies (corporate control). On the other hand, universal banks may hold an excessively dominant owner position and may have split interests when being both lenders, share-holders, and advisors to investors. Given the lack of alternative capital sources, and the much less developed information channels and business skills, universal banks, it is often argued, may still be a good option for the transforming countries. In the context of state enterprises, banks may, for example, replace government agencies in governing the

[103]Mates (1992).

[104]Roland (1995).

[105]Roland (1995).

[106]Montias (1994).

managers of these firms.[107] Even this method's proponents do question, however, the transforming banks' capacity to conduct this corporate control.[108] A related counter-argument is whether the banks should devote their scarce human resources on enterprise management, instead of learning and implementing appropriate banking skills.[109]

There seem to be two themes in the literature on financial and banking reforms. Firstly, there is a policy oriented, normative discussion on the reform objectives, and the necessary (desired) ingredients in order to reach these objectives (where the views differ somewhat on what is indeed the best methods to apply). Reform of the banking system is a target for renovation in itself, but also an instrument for further development of the economy. Secondly, there are discussions on the observed achievements in the transforming countries (generally concluding that the achievements are not yet particularly impressive).

There is a gap between what one wishes to achieve, and what has actually happened. When banking is seen as an instrument for the economy in general (as in its role in monetary stability, as a provider of a payments system, or a tool for corporate control), the possibility for banks to actually take on these roles is fairly superficially treated. The very crucial questions, regarding whether the banks have the capacity or could become capable of taking on these roles, are largely ignored. When the focus is on the problems of financial reform, there is a tendency to summarize the achievements (or lack of achievements), and their effect on the economy, while the reasons behind the situation is less explored. This is understandable: it is important to establish the state of the art, before discussing the underlying causes. It leaves us, however, with little insights as to why things are the way they are. This lack of knowledge motivates a more in-depth study of the mechanisms within the banking systems which determine their present performance in transition economies in general, and in Vietnam in particular.

5. Approaches to the Transition Problem

Fundamental changes in an economic system takes time. There are problems in the transition, and there are various ways to understand these problems. Just as in the case of the financial reform debate, the now booming transition literature is dominated by two themes: The first policy oriented theme deals with how countries best succeed in transforming their economies. This kind of approach often contains various pedagogic overviews of economic organization and policies in mature and relatively efficient

[107]Nuti (1992), p. 52, Buch (1993), pp. 78-80, and a volume edited by Aoki & Kim (1995).

[108]Berglöf (1995), pp. 84-85.

[109]Long & Rutkowska (1995).

market economies, whereafter it advises on the path and pace in order to establish the desired structure. Chronologically, this theme largely precedes the second, which is concerned with the observed difficulties experienced in pursuing reform, and discussions on the diverse performances of different countries. The latter type of studies also seeks to explain the observations, and often add some ingenious solution to the problems. A third theme is emerging, fairly closely related to the second one: an institutional perspective on transition processes. It is more explicit about the institutional context in which the transition process takes place, and focuses on slow institutional change as an explanation to why economic reorganization - structural adjustment if you like - takes time. This approach asks why the reform programs do not lead to immediate and unambiguously positive change. This section begins by highlighting some aspects of the two first themes. The institutional approach is given some more substance in the last part of this section.

5.1 The Path and Pace of Economic Reform

While basic ingredients of reform are quite well-established, the ideal path and pace of reform are more controversial.[110] One group of observers advocates the necessity of rapid and fundamental reform of all the key variables in the economy. The basic idea is that by immediate and comprehensive change, the rules of the game are clearly and irrevocably altered, so that agents will be able to react to the new signals sent, and fundamental restructuring of the economy will come about as rapidly as possible. Given the speed of events in the transforming countries they "now have little choice but to move on all fronts at once - or not move at all".[111]

This so called shock-therapy meets with the opposition of those who argue for a slower and more gradual pace of economic reform: one step at a time. The main concern is the increasing unemployment, resulting from too many too quick changes; unemployment which is not only painful for the individual and a waste of human resources, but also contributes to increasing social unrest, eventually threatening the stability of the reforming country and the whole reform process. Advocates of more sequential reform are concerned with the costs to society of destroying an old structure, before the new is in place.[112] In particular, opening up for foreign trade at the instance when exporting companies are allowed to set prices and wages freely, might kill these enterprises when they are - too hastily - exposed to foreign competition: "to curb monopoly power in highly concentrated manufacturing industries, these enterprises

[110]See Åslund (1992), Chapter 2, for an introduction.

[111]Blanchard *et.al* (1991), p. xi.

[112]Dewatripont & Roland (1992).

might well continue under centralized wage and price controls until an effective degree of foreign competition is established".[113]

These two schools are seen as representing the opposite corners in this debate. Gradualists, say the shock-therapists, advance a policy which leads to ambiguous signals and slow and disruptive alterations of the institutions. Although unemployment figures are less dramatic in the shorter run, the continuous support to a poorly performing state industry will tend to lead to increased unemployment levels in the longer run. Society's resources are wasted, while new and productive investments are never given proper backing. Shock-therapists, say the gradualists, do not understand how complicated the transformation process is. It is impossible to just climb in and change all the rules over night and think that it will work out. People cannot adapt that quickly, and new organizations will not appear out of nowhere.

The dichotomy between the two schools seems, however, often artificial. Many proponents of comprehensive reform packages are aware of what a time-consuming process it is to implement a radical and comprehensive reform program. "Restructuring is a long-term process that will last many years."[114] Moreover, it is recognized that the degree to which shock-therapy is necessary also depends on the country in question.[115] And some of those who may be labelled gradualists are merely concerned with the long implementation process and the complications involved. They are not necessarily opposed to comprehensive reform measures as such, they only say that because of the time-consuming implementation, sequencing will be important to consider.[116]

The debate has already become somewhat obsolete. Rapid change in the formal rules does not mean rapid change in the economy. Change is gradual, whether this was planned or not. Transition takes time.[117]

5.2 Explaining the Transition Problem

If transition takes time, how can we know whether countries are succeeding with reform, and if not - why? Roughly three different approaches address this issue: One focuses on factor immobilities and price rigidities, another adresses problems of

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[113]McKinnon (1991), p. 162.

[114]Åslund (1992c), p. 39. Åslund is a clear proponent of swift reform.

[115]See Fischer & Frenkel (1992), who argues for shock treatment in Russia, but accepts more gradual measures in, for example, China (p. 38).

[116]Svejnar (1991).

[117]This insight is gaining recognition as the experiences of reform accumulate; see, for example, Ellman (1994).

aggregate demand, while a third concentrates on the institutional framework and the adjustment problems appearing when institutions change.[118]

The first view produces various explanations of the observed decline in GDP as a result of new prices. When prices are liberalized and relative prices change, this alters the nominal value of the production; measured with new and more accurate prices there is a decline in GDP, but this does not necessarily imply that production is actually falling in the transition period - the new prices only reveal the inefficient production system as such. Other similar explanations focus on how restructuring takes time, since new relative prices do not immediately influence the use of resources in the economy. Although the new prices send signals to the industry about how production should change, change does not happen over night. Resources are thus wasted in the period awaiting the structural adjustment and GDP fall. Rigid factor prices - predominantly wages - are another cause behind a temporary production decline. Likewise, there might be a kind of overshooting of real wages following liberalization. When the prices of consumer goods suddenly rise, workers are paid higher wages as well. The new wages may be too high in comparison to the price rise, and cause a kind of shock effect, which lowers the value of production - but only until prices and wages are adequately adjusted.

As for the second type of explanation, there are several ways to understand a fall in aggregate demand (for example in Poland - a country where there has clearly been a decline in aggregate demand, and also a country which in this respect has been thoroughly studied). The price liberalization brings about a decline in real wages.[119] Moreover, demand falls when income is reallocated from wages to profits by the emergence of a private sector, since the receivers of profits have a higher propensity to save. In addition, high rates of inflation reduce the monetary surpluses in the economy, which also reduces demand. Another way in which purchasing power is depressed is through a credit squeeze in the state sector. If enterprises are to pay higher input prices while receiving unchanged or even limited levels of credit from the banks, there will be a lack of liquidity, and demand for input goods must consequently fall.

The relevance of these different explanations may be questioned on theoretical and empirical grounds. One can, for example, argue that the credit squeeze diagnosis ignores the time dimension: As input prices rise, so do output prices, and enterprises should be able to finance inputs by earnings from the sales of the output they have in stock. Besides, enterprises' complaints about credit squeezes might merely be an attempt to conceal their true problems, which have to do with producing virtually unsellable

[118]Here I follow Schmieding (1993) in the division of these three types of approaches.

[119]Perhaps a reason why real wages may increase too much, i.e. overshoot as described above: since workers experience a real wage reduction at first, they will - perhaps - be overcompensated by a substantial wage increase.

products - a production which survived only because of the artificially low input prices.[120]

My view is that most of these ideas are probably partially valid, but that most of them seem fairly narrow in how they view the economic problems facing the transforming countries. Many of the explanations appear, for example, vague in their definition of the transition problem: a GDP decline due to price liberalization is merely a disclosure of an inefficient production apparatus, not the transition problem in itself. And if one can show that a credit squeeze causes the decline in GDP, this may be correct - at least for a particular country and context - but it should not be confused with the transition problem itself. Rather, the transition problem is the effect that the reform program has on the structural change of the economy: i.e. how structural change succeed, is slowed down or impaired.

Several of the above mentioned approaches are close to this view since they point to the effects of slow structural adjustment. For example, if new relative prices do not immediately lead to a reallocation of resources and if GDP consequently declines, this implies that there is a problem in the process of reallocating resources. The credit squeeze hypothesis indicates that there is something strange in the way credit is advanced in the economy since it allegedly kills off potentially profitable enterprises. But the analysis often stops at the reference to the problems of restructuring the economy, and thus somehow regards the underlying mechanism as a black box: because fundamental change of the economic structure takes time, transition problems appear. But we want to know why transition takes time. What, precisely, are the problems?

5.3 Transaction Costs and Transition

The institutional approach opens the black box and examines the transition process. Transition implies change in the organization of the economy. Such change necessarily involves institutional change. Institutions give rise to certain kinds of transaction costs, which determine the kind of economic interaction to take place in that particular context. Although the formal constraints can rapidly be changed through political decisions and by the establishment of new laws and regulations, these changes may not immediately be perceived, accepted or understood by individual agents. The informal constraints take much longer to change, and may also change in manners which are not fully in line with the initial objectives.

Hence, the existence of a new formal legal framework does not necessarily mean that these new rules govern action. In countries where law and order has been maintained through discretion rather than by following the legal provisions, there is

[120]Schmieding (1993).

often a weak "legal culture". Consequently, the new laws may not be fully understood or respected. One could talk about a kind of "cultural lag" existing in the transforming countries. Moreover, when it takes time for new formal rules to be fully accepted because of these cultural lags (or, if you like, because of the discrepency between formal and informal constraints), there is a risk that those who have learnt the new rules or methods (like new accounting principles or criteria for credit evaluation etc), will experience some kind of "cognitive dissonance" between what they have learnt and what it is possible to do. The reform will thus lose some of its credibility. The difference between what should and what could be done may also cause moral hazard problems, when agents view enforcement of the new rules as uncertain.[121] Another way of expressing this is to talk about the need to establish legality in the reform process, i.e. "(1) a mutually consistent set of laws; and (2) a belief by the population in the stability and enforcement of these laws".[122]

The third theme in the transition literature makes this institutional framework more or less explicit. It focuses on the time lag between changes in formal rules and informal constraints: "the adjustment of behavioural patterns, including the accumulation of new institution-specific human capital is necessarily a time-consuming process".[123] If there is a strong discrepancy between formal and informal rules, the reform process is likely to be slow, or even "counter-productive" (causing political instability).[124] Sometimes this type of analysis leads to strong policy implications: for example that "the evolutionary approach suggests that the most successful reforms will occur in those countries that effect change consistently over an extended time period".[125] One could, however, argue that because change takes time, the starting point for reform should be clear and unambiguous, without any possibility of return.[126] Perhaps more importantly, an institutional approach is a golden opportunity to abandon the strong policy orientation which is almost mandatory in the more "traditional" transition literature. The approach furnishes a framework by which the actual events in the transition process can be reasonably systematized and interpreted. To the lag between formal and informal constraints, one may add that the formulation and implementation of formal constraints may be inadequate. Formal rules may be changed only partially, and perhaps contrary to the purpose of reform.

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[121]Poenish (1992), pp. 42-44.

[122]Litwack (1991), p. 78.

[123]Schmieding (1993), p. 236.

[124]North (1990a), p. 140.

[125]Murrell (1992), p. 92.

[126]As also argued by Montias (1994).

The institutions in the transition period give rise to a certain behavior, which in turn contributes to the continuous revision of the instiotutions. During the transition period, agents may have a very confused picture of the institutions in which they are to act. They face neither the rules of the socialist game, nor distinct maket economic rules, but something in between. Transition is not about awaiting the time "when new institutions are in place"[127] - institutions are always in place, but in a period of rapid transformation the institutions keep changing; this is the transition problem.

Several of the coordination and motivation costs prevailing in the socialist system remain in the transforming economy. "The ability to conduct successful reforms is constrained by the initial environment in which the economy is embedded".[128] Economic reform reduces some of them, alters others, and causes new problems of coordination and motivation. These costs determine the kind of contracting possible in the economy, and this affects the organizational structure and the efficiency of economic exchange. I will here sketch the character of the transition induced transaction costs. The discussion is by no means exhaustive - how these costs change and affect the transition process will be elaborated in Chapters VI and VII, when analysing the Vietnamese case.

Coordination

Transition is a matter of sending new signals and establishing new channels for information. Liberalized prices ideally reflect scarcities and allocate resources to their most efficient use. When money is fully convertible - domestically and internationally - it serves as a coordination mechanism for economic exchange. When companies rely on market exchanges the information requirements are reduced and simplified. But in the transition period this stage is not yet reached.

Basically, coordination problems remain and increase because the *rules of the game* are unclear. Reorganization of the economy is in motion, and this creates confused decision structures. Enterprises are granted autonomy, although the planning departments, which were previously in charge of major decisions for these enterprises, may still exist. Who, then, has the final say in decisions about new investments or changes in production mixes, etc? This ambiguity affect outside parties - potential investors or others - as well as the enterprise and the planning departments themselves. Another related facor is the large bureaucratic change that the reforms imply. When planning is no longer central, the role of the bureaucracy changes, while the organizational structure of the bureacracy may remain intact.

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[127]Schmieding (1993), p 235.

[128]Montias (1994), p. 10.

Many practical problems appear because of the *new informational requirements* in the emerging markets. A market economy relies on bilateral contracting between agents. These agents need to find each other, they need to find out about each other, and they need methods and systems which assist them in establishing accurate and reliable contracts between each other. During the transition there is a lack of organizations which can assist in information processing. Moreover, there is limited business news, inadequate accounting systems, hardly any auditing firms, or any commercial laws which can give guidance in negotiations etc.

Establishing new organizations takes time, and the less clear is their purpose, the longer it takes. Difficulties in understanding the purpose of the market economy further increase coordination costs during the transition period. A foreign observer might take the objectives of the reforms for granted, and understand the purpose of increased privatization, profit motives, and abolishment of the one-party state. This view might not be understood (nor shared) by many domestic participants in the transition process. This creates an ambiguous ideology which is problematical for motivation (which I will soon discuss), but also complicates coordination. When agents do not fully understand a reorganization scheme, or see the point of the new structure, they have difficulties in acting in a way which promotes the (unknown) final goal.

Motivation

The reform measures aim at improving incentives. Enterprises' increased autonomy and their ability to make profits, encourage them to take consumer demand seriously. Thus shortages may be reduced. However, in the transition process many motivation costs increase.

Ideologically, transition brings a period of confusion. I argued above that the way the "socialist contract" was specified created disincentives for economically sound behavior. But during the reform process the "transition contract" is perhaps not specified at all. This creates disincentives since it is not clear what will happen in case people fail in their projects etc. What is the state? How much power does it have? What will it do for me? If I put my money in a bank and this bank loses it all - will the state help me out? Less metaphorically, the transition period requires a more careful specification of contracts: since there is a lack of coordination mechanisms, contracting parties must be more meticulous when establishing an exchange, and take care to foresee all the possible contingencies that might appear. Unfortunately, this specification is also more problematical in the transition period, because conditions are very uncertain - rules may change, and the economic situation might be very different even in the near future.

There are also observation problems in an economy where there are difficulties in obtaining adequate information. As for pre-contractual observation, it is less clear

with whom you deal when circumstances change. You do not have the adequate information about your counterpart, and in addition you are less certain about how your counterpart perceives the new situation and understands the new - or emerging - rules. Hence the problem of adverse selection is present. And after the contract is signed, monitoring is also difficult. Weak information channels cause difficulties in observing behavior, and with blurred institutions, the conditions of the contract might be less clear: because the rules keep changing, there will be less mutual agreement on how to interpret the contract. In the transforming system, it might be difficult to define a failure since the new rules of the game are not coordinated. Moral hazard problems will appear because it is more difficult to determine whether contracts have actually been broken, and of course because of the lack of adequate enforcement mechanisms.

Transition alters the organizational structure. However, it takes time to establish a matching legal structure. There is, for example, a lack of bankruptcy laws. In addition, there is a lack of assigned responsibility which comes out of well defined property rights. For example, before banking legislation is in place and understood, banks have not got clear obligations towards depositors or borrowers. As a result, banks are not trusted, and banks cannot operate as the financial intermediaries that they are supposed to be if we take the establishment of a market economy seriously.

In a socialist system, the plan documents provided the law for economic activities. In the transition process, the plans are abandoned and the state is losing power. While proper enforcement mechanisms are lacking, moral incentives are also weakened, and people will sign contracts, which they are less prone to follow. They are less motivated to obey rules produced by a weak and ideologically dubious authority. Obviously, there is more room for corruption. Therefore, it might be pointless to write complete contracts, or any explicit contracts at all. Instead informal relations, reputation and trust become even more important than before.

6. Summary

The classic socialist system is characterized by central authority and central planning; the communist party rules and public ownership of the means of production dominates. Planned financial transactions serve to smooth the coordination of the real side of the economy. Monetary transactions are divided into a cash circuit and a bank money circuit, and the monobank is the single administer of the financial transactions. Banking is of little importance to the individual.

The inherent problems of central planning contain an embryo of its eventual breakdown, and the consequent reorientation to a market system. The huge information requirement is one problem. The difficulty of planning prices and monetary flows to convey accurate signals for production and consumption is another. Moreover, the

system lacks efficient mechanisms to deal with failure. Poor performance does not mean that individuals are fired, enterprises are shut down, or that the political leadership is replaced. The ideology postulates the superiority of the system while the system ignores efficiency enhancing incentive mechanisms. The public ownership creates disincentives for adaption, productivity, and innovation.

Failure is met with temporary solutions. One example is the systematic softening of budget constrains, where the banking system, by providing additional credit to failing enterprises plays a central role. Another example is the existence of centralized pluralism: contrary to the official version of firm central planning, there are considerable vertical and horizontal bargaining, and informal decentralizaion of decisions.

The socialist system has almost from its birth been accompanied by various attempts at reform. The very existence of (planned) prices and money is one step away from the orthodox idea of socialism. The concept of market socialism includes various combinations of market coordination and public ownership, which appear, however, to be fairly unstable solutions to the problem of efficiently allocating resources.

The transition in focus in this study concerns comprehensive economic reform, including price liberalization, decentralization of economic decisions, and liberalization of foreign trade. The state sector is exposed to competition from an emerging private sector, and privatization might be on the agenda. Reform of the financial system is central in the process. The monobank is divided into a central bank and commercial banks. More competition in the financial market is invited. State finance is moreover separated from the banking system. However, financial reform appears often to remain a bottleneck in the transforming countries. Time-consuming changes include the reorientation of monetary policy, and the implementation of a legal framework. Furthermore, the banks are often burdened with bad debt, which requrires restructuring of some kind.

The general debate on transition was to begin with dominated by normative advice on the appropriate policies. The controversy between shock-therapists and gradualists has been central, but now seems fairly obsolete in view of the differing experiences in the transforming countries, and the lengthy character of the transition - even if a number of policies have been introduced at a stroke. Attempts to evaluate and explain the performance of transforming countries highlights the GDP decline and the fall in aggregate demand. The explanations focuses on price rigidities, factor immobilities, wage developments and credit crunches among other things. These analyses pay attention to the results of cumbersome transition without attempting to properly understand the transition problem itself: the effect the reform programs has on the structural change of the economy.

The institutional approach opens this black box and examines how institutions change in the process of transformation. New formal rules are introduced while the informal rules may lag behind. In the period of transition the formal rules may themselves be inconsistent and contradict the purpose of reform. Because the rules of the game may be unclear and because there are new information requirements, there may be problems of coordination. The new situation also alters the incentive structure in the system, while appropriate enforcement mechanisms are not yet in place, and this may cause high motivation costs.

All this will effect the agents' behavior and their possibilities of reaching agreements. How this happens in the real case of Vietnamese banking will be explored in Chapters VI and VII. First, however, we need to put the Vietnamese banking reform into its historic and economic context.

CHAPTER IV

VIETNAM: HISTORIC BACKGROUND AND ECONOMIC CONTEXT

Transition takes place in a historic and economic context. This chapter provides a brief background to the ongoing reforms in the Vietnamese banking sector.[1] The first section sketches the history of Vietnam, some characteristics of the Vietnamese culture, and the origins of finance in pre-colonial and colonial Vietnam. Section two discusses socialist Vietnam, the resulting socialist financial system, and the initial economic reform attempts. Section three gives an account of *doi moi* - the reform process initiated in 1986, and then examines the state of the Vietnamese economy in the early 1990s. Section four, finally, discusses the present state of the Vietnamese transition, the apparent socio-economic problems, and the character and continuation of economic reforms today.

1. A Brief Geography and History

Vietnam stretches some 1,600 kilometers from the northern border of China to the very southern tip, where the South China Sea meets the Gulf of Siam. Between the central coast line and the mountain chain of Truong Son, on the border to Laos and

[1]An extensive bibliography of Vietnam related literature in all fields is Marr (1992). For an introduction to Vietnam, see Ruscio (1989).

Cambodia, the country is sometimes as narrow as some 100 kilometers. Although Vietnam has large mountainous areas, the two delta regions of the Red River in the north and the Mekong in the south dominate. These are the regions suitable for agricultural production, and consequently the most densely populated. Most of the approximately 70 million inhabitants live in the rural regions (some 80 percent), where rice is the foremost important crop. Large variations in temperature, erratic rainfalls, and frequent typhoons characterize the northern climate, while the temperature in the south is less varied, and the weather is generally more predictable. The southern delta is the most fertile in the country. The important urban areas are the capital Hanoi in the north, its port city of Haiphong, Danang in central Vietnam (close to the ancient capital of Hue), and the huge Ho Chi Minh City in the south.[2]

As a people of a common heritage, the Vietnamese may trace their history several thousand years back.[3] The currently dominating ethnic group, the Viets (or *Kinh*), probably originate from southern China, from where they once migrated south to the northern mountain regions of present Vietnam. A kingdom of *Nam Viet* was founded in northern Vietnam around two centuries B.C. Some hundred years later this area became a Chinese province. The ethnic identity of the Viets survived a millennium of Chinese rule. In the late 900s the Vietnamese resistance led to a recovery of independence (although with periods of turbulent Sino-Vietnamese relations). A long dynastic period followed, when the Viets also expanded their territory southward. In the 15th century, the Champa kingdom in central Vietnam was crushed, and the Cham driven out or assimilated. A similar destiny met the Khmer in the south, who were pushed towards the land of the Thai. The following centuries were colored by internal conflicts, also among the Viets themselves, which in the 16th century led to the partitioning of the country with a north and a south center (both, however, under the formal authority of the Emperor). The two centers were reunited at the turn of the 18th century. At the same time the very south of the Mekong delta was finally colonized by the Viets. Unification was soon followed by French intervention, beginning in the mid-1850s.

1.1 Colonization and War

The division of three distinct regions of Vietnam: Tonkin (*Bac Bo* or North Vietnam), Annam (*Trung Bo* or Central Vietnam), and Cochinchina (*Nam Bo* or South Vietnam) in the 1880s, completed the French colonization of Indochina. The two former regions were labelled French protectorates, officially maintaining the Vietnamese

[2]Vu Tu Lap & Taillard (1993) present a socio-economic atlas of Vietnam.

[3]For this introduction to the Vietnamese history I have mainly consulted Nguyen Khac Vien (1987), Beresford (1988), Chapters 1-4, Karnow (1991), Chapter 3, Tønnesson (1991), Chapter 2, and Jamieson (1993), Chapter 1.

monarchy and mandarin government, while Cochinchina became a regular French colony. The Indochinese Union, created in 1887, included Vietnam, Cambodia and Laos. Regardless of formal government structure in the different *pays* of the Union, real power remained in the hand of the French governor-general in Hanoi.

Three main driving forces drove the French colonization: first, access to raw materials such as rice, rubber, coal and minerals; second, expansion of markets for the increasingly industrialized Europe; third, the strategic position of the Indochinese peninsula - for military and economic reasons. Colonization, however, proved costly. Infrastructural investments, administration and military control of the colony required huge financial contributions from the French state. To cover these expenses, the Vietnamese villagers were heavily taxed, large customs were imposed on traded goods, and the Vietnamese were forced to contribute labor (*corvée*) to plantations and mines. Although individual business concerns indeed made profits out of trade in Vietnamese products, financial transfers from France to Indochina were still large. It seems that France benefitted from Indochina in the beginning of the colonization period, but that the colony later became more of an economic burden.[4]

During the 1930s, the Vietnamese nationalist movement grew strong. The fall of France to Germany in 1940 weakened the French colonial power, and Indochina was occupied by Japan in 1940, while the French still retained administrative control. The *Viet Minh*, a front organisation formed by Ho Chi Minh, and its army came to dominate the independence struggle.[5] Meanwhile, the United States was eager to put an end to the domination of France in East Asia, and supported the nationalist movement in Indochina. Several external and domestic factors contributed to the dominance of the Indochinese Communist Party in this movement, which eventually led to the Vietnamese revolution in August 1945. Towards the end of the world war, a famine in North Viettnam spurred the opposition against foreign exploitation. The Japanese surrender was also important. The international turbulence led to a power vacuum, which helped to set the stage for revolution.[6]

Nine years of warfare followed. The Geneva Accords in 1954 temporarily settled the conflict. The agreement included the momentary separation of Vietnam at the 17th parallel (through central Vietnam), and established that general elections of a government for the united country were to be held within two years. Meanwhile, the United States feared expanding communism in East Asia. The anti-revolutionary movement in South Vietnam, and notably the appointment of prime minister Ngo Dinh

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[4]Tønnesson, (1991), p. 44, refers to Marseille (1984).

[5]Viet Minh is short for *Viet Nam Doc Lap Dong Minh*, or the League for Independence of Vietnam. Duiker (1981), p. 68.

[6]Tønnesson (1991).

Diem recieved American support. The announced elections were never held. The South Vietnamese government considered The Republic of Vietnam as an independent state, but the government in North Vietnam did not agree. From the mid 1950s, South Vietnam obtained considerable financial aid and military assistance from the United States, while American military intervention accelerated during the 1960s in order to prevent a North Vietnamese takeover. Despite these massive efforts, the United States and the South Vietnamese army eventually lost the war in 1975, and the country was finally reunited in 1976.[7] South Vietnam was, at least partly, integrated into the North Vietnamese socialist planning system, and the united country was named the Socialist Republic of Vietnam. In late 1978 Vietnam invaded Cambodia, threw out the Pol Pot regime, and replaced it with a Vietnamese friendly government. As a reaction, China invaded Vietnam in early 1979 and a brief border conflict followed, while the United States proclaimed its embargo on Vietnam, causing the cessation of almost all Western aid. Vietnam became an ally of the USSR.

With the introduction of *doi moi* in the mid-1980s, Vietnam began to open up towards the rest of the world, and the pattern was accentuated by the break-up of the USSR in the early 1990s. Eastern capitalist neighbours such as Japan, Singapore and Australia have continuously developed their commercial and diplomatic ties with Vietnam since the late 1980s. The relations to Western Europe and the United States reached a turning point in 1994 with the official lifting of the United States embargo, and the opening of full diplomatic relationships between the United States and Vietnam in 1995.

1.2 Vietnamese Culture

Three features of Vietnamese life and culture seem to dominate and persist over the centuries. The first is the economic structure. The large majority of the population lives in the rural regions and works in agriculture, mostly as small peasant farmers. Despite changes imposed by the French, and despite other substantial political and economic disruptions all through the late 19th and the 20th century, this ancient structure has largely remained. The second feature is the relationship to China. A thousand years of Chinese occupation has had a fundamental impact on the Vietnamese culture, but also on its relationship to the outside world. In spite of the long-lasting French liaison, and the costly experiences of the American intervention, it is China that matters - both as a potential enemy and a brother. Culturally, Vietnam is strongly influenced by China, while at the same time Vietnam is keen on maintaining its independence in relation to the northern neighbor. The long history of complicated Sino-

[7]See Karnow (1991) for a historic overview of the so called Vietnam War.

Vietnamese relations is reflected by contemporary events, such as the 1979 border conflict, and the current parallel transformations of the two economies, which have opened for renewed diplomatic relationships - and trade.[8]

The third feature is perhaps the most important for the present study - and the most difficult to grasp. It is the dualistic element in the Vietnamese culture: on the one hand, the Confucian heritage, once imported from China, of strongly hierarchic relationships, and, on the other hand, the horizontal, egalitarian traditions, which originate from Buddhist traditions and Vietnamese village life. Briefly, difficult climatic conditions, in combination with rice cultivation requirements, have motivated cooperation and a communal spirit among the villagers in traditional Vietnam - of the North.[9]

With this combination of hierarchic and egalitarian traditions, one may claim that Vietnam would be especially susceptible to the economic and political organization of the marxist-leninst system (with a central authority, and a collective or public ownership of the means of production). But the current transformation of the economy has obviously also roused strong individualistic aspirations among many Vietnamese, not really explained by the hierarchy-collective dichotomy. A third element may, however, be such an individual or at least family oriented sub-system, now encouraged by the new economic opportunities.[10]

For the purpose of this study it is important to keep these aspects of the Vietnamese heritage and culture in mind. Yet, as argued elsewhere, there is a danger in a too strong emphasis on the country-specific characteristics of the Vietnamese transition. Moreover, the idea of two (or three) cultural sub-systems is probably relevant and true for northern Vietnam, but the situation in southern Vietnam may be quite different for historic and geographic reasons (the Confucian traditions were established more recently, the land cultivation has been less demanding and required less of cooperation etc). It is also tempting - but questionable - to conclude that the Vietnamese mentality, because of these cultural features, would be particularly prone to more totalitarian regimes; an argument which may be used both to explain and motivate the present political structure, and predict the future development of the country (advocating

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[8]See Amer (1991), and Hood (1992) on Sino-Vietnamese relationships.

[9]Jamieson (1993) develops this theme; he metaphorically characterizes the Vietnamese culture as an interaction of the systems of *yang* ("male dominated, culturally prescribed, hierarchical, formal, and often competitive") and *yin* ("a high level of female activity"..."culturally optional, more egalitarian, more informal, more cooperative, and much less competitive", p. 36).

[10]de Vylder & Fforde (1988) distinguish between three sub-systems of traditional (North-) Vietnamese life: the neo-Confucian state, the system of local collectives, and the family and the individual (pp. 20-21).

that Vietnam should follow the path of some of its neighboring countries with strong, authoritarian leadership). This is a conclusion I would certainly like to avoid.

1.3 Finance in Colonial and South Vietnam

The traditional pre-colonial Vietnam was to a large degree a subsistence and barter economy, with limited inter-regional trade. Colonial ruling introduced new phenomena, such as ownership of large estates and taxation of small farmers (predominantly in rice), foreign to pre-colonial Vietnam.[11] Nevertheless, differences between the village life and that of the urban centers have, in Vietnam as in so many other developing countries, prevailed all through the 20th century. The modern industrialized sector is concentrated in the fairly few important cities, while in the rural areas the traditional agricultural way of life continues. Hence, most of the following overview of the financial system, concerns the urban and relatively modern Vietnam.

Currency and formal finance

Over the centuries, money in Vietnam has been equal to cash, and cash has been equal to silver. The various dynasties issued currencies in zink and silver, both as a means of exchange and for award purposes.[12] After the conquest of Indochina in 1884, the French government introduced a new currency, the *piastre*, as a specific Indochinese monetary unit. Since it followed fluctuations in the world silver price, it caused monetary disturbances and a rising cost of living in Vietnam. In 1936, it was directly attached to the French franc, and thereby became essentially a French currency. However, the World War II led to disrupted communications and diverging price developments, and the French currencies became increasingly differentiated from each other. The *piastre* was from 1954 tied to the US dollar. It remained the currency in the Republic of Vietnam (RVN, i.e. South Vietnam) up until reunification in 1975, and was not finally abandoned until 1978.[13]

During the 1945-54 period, the financial situation in the whole of Vietnam was confused and indeterminate. The new revolutionary government attempted to seize the Bank of Indochina in 1945 but failed. For a short period, the transactions of the revolutionary government went through the private *Bank of Indochina*, but the bank

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[11]Beresford (1989), pp. 20-22.

[12]The first official monetary unit was a silver coin minted in 1835 by emperor Ming Manh, acccording to Nguyen Tien Hung (1965), p. 2. A beautiful edition from the State Bank of Vietnam (1991) shows Vietnamese currencies from the bronze age up until today (although the 1835 coin is curiously missing).

[13]Spoor (1987/88), p. 105.

soon ceased payments attempting to cause a financial crisis.[14] Until 1951, the Bank of Indochina had had the right to issue currency, a privilige that was then taken over an *Institute of Issue* for the three states of (South) Vietnam, Cambodia, and Laos. The Institute operated until the surrender of the French army in 1954 and the final partitioning of Vietnam. This broke up the monetary union of the three states.[15]

After the French withdrawal in late 1954, the *National Bank of Vietnam* was founded in the new (South) Republic of Vietnam. The National Bank was indeed a central bank, albeit at a rudimentary stage. It conducted credit operations with other banks, controlled the gold and foreign exchange reserves, supervised the banks, and made advances to the state against treasury bills.[16] The characteristics of the financial system narrowed the scope for monetary control, however. The lack of a functioning capital market was one problem, the domination of cash transactions another. In addition, foreign bank branches predominantly turned to their foreign headquarters for additional funding. In the late 1960s and the early 1970s, deficit financing was again used, despite the still large American aid inflows.[17] Inflationary pressure increased as the Vietnam War accelerated.

The commercial banks were located in the few larger cities, primarily in the region of Saigon-Cholon (i.e. Ho Chi Minh City), and concentrated on trade finance. The dominant commercial bank during the colonial period was the Bank of Indochina. It was, in a sense, the very center of financial activities in Indochina as it controlled a large number or enterprises.[18] While the true costs and benefits to France of the colonisation may be indeterminate, the Bank of Indochina was certainly one benefactor, making huge profits out of trade in coal, rubber, and rice.[19] By the 1930s, apart from the Bank of Indochina, there were only three banks in Vietnam and some financial houses, like the *Société Financière de Caouchoucs*. The smallest bank was Vietnamese, founded in 1927. Banking policies were conservative, loan interest rates were high and banks were expansionary only in times of relative economic prosperity. After 1954, the commercial banking system continued to be limited in scope and scale. It consisted of

[14]Post (1989), p. 138.

[15]Nguyen Tien Hung (1965), pp. 58-59.

[16]Schiff (1959).

[17]Beresford (1989), p. 56.

[18]See Gonjo (1993 [1985]) and Meuleau (1990) for extensive accounts and analyses of the Bank of Indochina.

[19]Tønnesson (1991), p. 40.

twelve banks, of which eight were branches of foreign banks and one was the government owned *Crédit Commercial.*[20]

Informal finance

Throughout Vietnamese history, formal finance has been the concern of a small segment of the Vietnamese society: the urban elite working in enterprises and the administration. For the majority of the population, financial transactions - i.e. access to credit and saving - have taken place in the informal financial sector. Moneylenders, saving clubs, and informal lending and borrowing among family and relatives have always been part of the Vietnamese society. The informal sector has been important not the least among the large Chinese community of South Vietnam, where: "the informal strategies and methods of organizing trust and credit...play a major role in perpetuating an ethnic division of labour, in which control of commercial activities is in the hands of Chinese merchants."[21]

The informal financial system was to a large extent traditional, with customs and habits dating far back in history. The practices developed in the Vietnamese villages were linked to informal customs in urban settlements. In essence, there were four different ways to save, borrow and insure in the traditional Vietnamese village. First, the Vietnamese villager often engaged in so called *huis*, rotating savings and credit associations. Second, various village funds existed (primarily in North Vietnam), which were a kind of insurance or welfare system for the villagers.[22] Third, indebted villagers could turn to local moneylenders, often a well-off farmer or a local merchant, who would provide loans for shorter or longer terms. Finally, an important store of value, and hence a means of transaction, was (and still is) rice. Hence, in the off-harvest season, poor farmers often turned to the rich to lend rice rations, to be repayed in

[20]Schiff (1959), pp. 60-63, Nguyen Tien Hung (1965), pp. 70 and 91-92, and Post (1989), p. 27 and p. 58.

[21]Barton (1977), p. 362. The numbers of Vietnamese of a Chinese decent ranged from 800,000 to 1,500,000 around 1960, according to Barton, out of a total population of South Vietnam of about 20 millions.

[22]There were four forms of traditional credit funds: 1) *credit associations* for emergency events, happy events, *tet* (the lunar new year), or as purchasing associations; 2) *village funds*, which took care of the harvest from the some 20 percent of the public land in North Vietnamese villages, and lended this at comparatively low rates (perhaps some 20 percent, compared to money lenders' rate of some 150 percent per year). Rice from these plots were sometimes given to soldiers, and this system expanded eventually into a kind of tax system. Funds were also created for widows and orphans, or for education purposes, or generally for helping the poor; 3) from the 1920s there were *state organized funds*, with public credit offices; these were intended to provide loans to poor farmers, but in practice the credit predominantly reached the rich; 4) the *rotating savings funds* - for money or rice - the so called *huis*.

harvest time, not rarely at a considerable rate of interest.[23] Chapter V will give some further evidence of informal finance such as it appears in Vietnam today.

2. Socialist Vietnam

The ambition of the Democratic Republic of Vietnam (the DRV, i.e. North Vietnam) was to build a socialist state. The construction of a Soviet type of economy has guided Vietnam politically and economically up until recently. A prime goal for the new government was to nationalize private industry and collectivize agriculture. In principle, the state was to provide all necessary goods and services. This strategy required the existence of industry. The official Vietnamese strategy has therefore been to industrialise the country primarily through heavy industry.[24]

2.1 The New Financial System

Between 1945 and the separation of the country in 1954, Vietnam was scattered into liberated zones and areas controlled by the French. After the revolutionary government's failure to seize the Bank of Indochina in 1945, bank deposits from the liberated areas were instead transferred to the National Bank in the South.[25] To finance the expenditures of the revolutionary government, people were encouraged to provide holdings of precious metals and jewellery.[26] Financial independence was seen as a necessity: creating a new currency meant getting away from French domination, and was in line with the new economic system which the revolutionary leadership had in mind. The *National Bank of North Vietnam* was founded in 1951 and a new Vietnamese currency, the *dong*, was introduced.[27]

The revolution and the independence in 1954 of the DRV led to a restructuring of the financial system. As in other centrally planned economies, the financial system in North Vietnam became an accommodating institution, serving the state sector by

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[23]The information on traditional informal finance was provided by the Institute of Economics in Hanoi, November 16, 1991.

[24]The literature on the economy of the DRV, of the reunited nation, and on the initial economic reforms include Vo Nhan Tri (1967) and (1990), Nguyen Tien Hung (1977), Nguyen Van Canh (1982), Fforde & Paine (1987), Marr & White (1988), Beresford (1988) and (1989), Kimura (1989), and de Vylder & Fforde (1988) and (1995).

[25]Nguyen Tien Hung (1965), p. 48.

[26]According to Nguyen Khac Vien (1987): "Right from the beginning, the government had launched among the population a vast collection of valuables, gold and silver, to pay the most urgent expenses. All social strata responded with enthusiasm and officials worked without pay several months" (p. 260).

[27]Post (1989), p. 180.

providing centrally planned credit to enterprises. In 1957 what remained of the private commercial credit system was banned, and private credit was severely limited.[28]

The banking system emerging in the DRV consisted of the National Bank (from 1960 called the *Vietnam State Bank*), which was responsible for most of the functions of the banking system. Eventually, two specialised banks were established: the *Bank for Investment and Construction* (founded in 1957) and the *Bank for Foreign Trade* (founded in 1963). In addition, there was a *Socialist Savings Bank*, which served to mobilize savings from the population, but was of minor importance.[29] Finally, a number of rural credit cooperatives were directly associated with agricultural cooperatives.[30]

The main management task of the monobank system in the DRV was to execute the centrally planned allocation of financial resources. Either "working capital" (capital for input material, wages and other short-term expenditures) or "fixed capital" (long-term credit for investments) were supplied to various public sectors of the economy. The allocation of the capital was determined by a credit plan, decided by the public authorities (the ministries). In addition, there was a plan for cash management, specifying receipts and payments in the banking system.[31] The normal types of management competence in a profit oriented banking system, such as project appraisal as well as bank supervision, were of little importance.

In DRV, during the first years of independence, the limited credit from the banks was predominantly directed to facilitate domestic trade. In 1959, the norm was established that 30 percent of the working capital for industrial enterprises, until then almost entirely budget financed, should be given as short-term credit from the bank.[32] This system expanded in 1960, as the fifth five year plan introduced an economic accounting system to replace the totally administered system of budget governed enterprises. Hence this was an attempt to create a financial awareness and to change the incentive structure in the state-owned enterprises, in line with the moderate attempts of certain reforms, typical of this period.[33] The new accounting system and the emphasis on credit funding implied a different and more important role for the banks. The main source of bank credit was, however, the issuing of new notes. The money supply grew as did inflationary pressure. The intimate relationship between state banks and state

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[28]Spoor (1987), p. 350.

[29]de Vylder & Fforde (1988), p. 137.

[30]*Area Handbook of Vietnam* (1967), pp. 370-74, and Nguyen Duc Thao & Pham Dinh Thuong (1994), Chapter 1, describe the financial system of the DRV.

[31]de Vylder & Fforde (1988), p. 138.

[32]Spoor (1987), p. 350.

[33]In this period (i.e. the early 1960s) the government was relatively open towards reform to improve production capacity, but the problems were partly "replaced" by the escalating war (see Fforde & Paine, 1987).

enterprises, implied the absence of proper control of the use of funds. Another feature of the financial system was the increasing use of cash in enterprises' transactions with each other. Payments between enterprises had to take place through the State Bank, although the administration of transfer payments was slow. Enterprises tended to keep cash and use them directly for the purchase of material supplies, for example, to make business activities more efficient and flexible (or at least possible).[34]

Between 1975 and 1977, the country functioned as two separate units with a divided state budget, and the central bank of the South still in operation. In 1976 the Vietnam State Bank merged with the National Bank of South Vietnam, forming the *State Bank of Vietnam*. The bank became the sole provider of formal financial intermediation throughout the entire Vietnam. The state budgets were unified in 1977, and the monetary reform of May 1979 made the *dong* the nationwide currency.[35]

2.2 The Initial Attempts at Reform

As early as the late 1950s, the Vietnamese economy experienced problems producing and allocating goods. The DRV difficulties were strongly related to problems of shortage, typical of the centrally planned economy. In Vietnam, these shortages were largely due to problems in the agricultural sector, where the collective farms lacked resources and proper incentives. Priority was given to the industrial sector, which implied transfers of surpluses from the agricultural sector to the infant industry.[36] The measures taken by the second five year plan in 1960, aimed to give the free market an increased role. The reform process was however hampered by the Vietnam War, and the US acceleration of military intervention overshadowed the short-comings of the socialist model.[37]

At the time of reunification in 1975-76,[38] Vietnam was a weak state, dependent on external assistance. The agricultural sector was worn down, the export industry undeveloped and the industrial sector small and in poor shape. The Vietnamese authorities tended to identify the short-comings of the economy as war sacrifices. As the country now had relative peace, renewed efforts could be devoted to finalize the building of the socialist state in North Vietnam and implement the North Vietnamese

[34]Fforde & Paine (1987), p. 67, and Spoor (1987) pp. 347-351.

[35]Spoor (1987/88), p. 105.

[36]de Vylder & Fforde (1995), Chapter 2.

[37]Fforde & Paine (1987).

[38]The war ended on April 30, 1975, when the last Americans left from the American embassy roof in Saigon, but formal reunification of the country did not take place until July 1976 (Beresford, 1988, pp. 49-50).

system in the south. In order to operationalize this strategy, industry was nationalized agriculture collectivized in the Mekong delta, and restrictions placed on trade.[39]

Vietnam joined the CMEA (the *Council of Mutual Economic Assistance*) in 1977 while relations to China deteriorated.[40] The Cambodian conflict immediately isolated Vietnam internationally. Only the relationship with the USSR remained in good order. A large part of the industrialization process became financially and technically supported by the members of the CMEA, who also were Vietnam's main trading partners.[41] But severe economic problems faced the newly reunited Vietnam: falling food production, inflation in the parallel, informal market, inefficiencies in the state-industry and an increased deficit in the trade balance. In addition, the incorporation of the South was costly.[42] As a result of these difficulties, social sectors received declining amounts of resources which exerted pressure on the government to seek reform.[43]

The initial steps toward reform of the economy in Vietnam were taken already in the late 1970s. The origin of these changes is interesting. Vietnam has, like most centrally planned (and developing) economies depended on the existence of a parallel or second economy. This has also been the case through the era of strict socialist planning, when officially the existence of the parallel market had been suppressed. The government's inability to maintain central control made way for a spontanous reform from below, so called *fence-breaking*.[44] As the central allocation mechanism ceased to function, cooperatives and industries were obliged to obtain inputs and perform distribution on its own. A free market began to develop.[45]

The call for change came from above as well, as the economic problems continued. The wars against Cambodia and China strained the state budget, and the cessation of Western and Chinese development aid meant that the government faced severe difficulties. A first official sign of reform was the legalisation of the fence-

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[39]de Vylder & Fforde (1988), p. 61.

[40]Kimura (1989) discusses the causes and the implications of the Vietnamese shift of allies in this period. See also Petrasovits (1988).

[41]Englund (1988). See also Buu Hoan (1991).

[42]There is a debate on the costs of reunification. Vo Nhan Tri (1990) voices the opinion that the flow of resources to the North from the South were important - i.e. the South was depleted of resources due to reunification. A more "traditional" view (e.g. Spoor, 1987, and Beresford, 1989), is that reunification was mainly disfavoring the North which had to support the war-impoverished South.

[43]de Vylder (1990) highlights six major characteristics of the DRV model: the exaggerated optimism about the development possibilities of the country, an exaggerated belief in modern, large-scale technology, a lack of monetary discipline, the soft-budget constraint, the inward-oriented development strategy, and the discrimination of agriculture (pp. 4-9).

[44]de Vylder & Fforde (1988) introduce this English translation of the Vietnamese concept *pha rao* (p. 68).

[45]Ronnås & Sjöberg (1991a) stress the Vietnamese economy's dependence on the parallel economy.

breaking behavior. Already in 1981, the government awarded enterprises the right to do business with each other in the so called "Three Plan System". The "Output Contract System" improved incentives in the agricultural sector, where the farmer could sell some of his surplus on the market (after compulsory distribution to the state had been accomplished).

Reforms during the 1979-1985 period entailed a certain amount of autonomy to farms and enterprises as well as a price and cost sensitivity at the margin among farmers and industrial managers. But the period failed to bring about any major change of the system. The reforms could be interpreted as either preparing the ground for further reform, or striving to maintain the system.[46] Nevertheless, important problems in the economy remained, above all a stagnating agricultural production. Inflation persisted since the important rice subsidies to state employees caused an increasing state budget deficit, largely financed by money printing. In 1985, the government introduced a price-wage-currency reform package in an attempt to alter the high prices in the free market, and absorb excess liquidity in the economy. The reforms were however ill-conceived and largely failed. They resulted in increased the money supply since the state enterprise needed new credit.[47] Hyperinflation was a fact in the mid 1980s, with the CPI reaching an annual 775 percent in 1986.[48] More fundamental reform was necessary.

3. *Doi Moi* - Economic Reforms after 1986

The positive economic development observable in Vietnam in the early 1990s has its roots in the new turn of economic reforms, initiated in 1986.[49] Although previous reforms had already introduced many of the recommended policies, the 1986 package was the so far most wide-ranging, including explicit and detailed statements concerning a new direction of the Vietnamese economy. While the implementation of the reforms was slow and uncertain, *doi moi* (new road or renovation) importantly recognized the market mechanism as a more efficient allocator of resources.[50]

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[46]de Vylder (1990) p. 12.

[47]de Vylder & Fforde (1988), p. 71, Kimura (1989), pp. 54-8, and McCarty (1993), pp. 99-100.

[48]Andersen (1994), p. 23.

[49]The literature on the post-1986 transition process in Vietnam is growing. Useful texts include Van Brabant (1990), Vo Nhan Tri (1990), Forbes *et.al.* (1991), Williams, (1992), Ljunggren (1993), Riedel (1993), Than & Tan (1993), Van Arkadie (1993), IBRD (1993), Dollar (1994), Vu Tuan Anh (1994), Beresford (1995), and de Vylder & Fforde (1995). See also two edited volymes by Ronnås & Sjöberg (1990) and (1991b), for examples of the *doi moi* debate in the 1989-1991 period.

[50]Beresford (1992), p. 244, and Williams (1992), p. 48. Vo Nhan Tri (1990), Chapter 4, warns against interpreting *doi moi* as an intended fundamental change of the Vietnamese economy and system. Porter (1990) gives an interesting account of the political process at the top leadership initiating and

3.1 The 6th Party Congress in 1986

The Politburo meeting in August 1986 and the following 6th Party Congress (in December the same year) voiced criticism of Vietnamese policies in the post-war era: the continued reliance on a subsidy system dependent on foreign aid had caused severe imbalances in the economy. The Party Congress formulated the objectives for the future development, which included increased consumption and accumulation, readjustment of the economic structure, the development of all economic sectors (socialist and non-socialist), and significant social changes (in employment and income distribution).[51]

During 1987 a number of policies and decrees were carried out in accordance with the general direction outlined in 1986. In late 1987, deputy prime minister Vo Van Kiet, in an economic report to the National Assembly, laid out the tasks for the five year plan of 1986-1990. The prime objective was to satisfy the needs of food staples, consumption goods and exports. Moreover, the report envisaged a switch to "socialist economic accounting", in order to increase production efficiency, and improve distribution of goods and income and... "ensure that all imperative needs of the working people in their daily life are met; and limit inflation".[52] In agriculture, taxation was to completely replace compulsory deliveries to the state, while land was allotted to land users on short- and long-term. In the industrial sector, state-enterprises received increased autonomy and the reform program encouraged alternative forms of ownership (joint-ventures and cooperatives). The design of a foreign investment law began, in order to strengthen the Vietnamese foreign sector and increase export volumes.

But the reform program initially failed its objective of improving economic growth. The inflation rate increased, and the balance of payments deteriorated. Inflation, in early 1988, reached monthly rates of 20-30 per cent. In addition, agricultural output was still low, and total food production even fell from 1985 to 1987.[53] The largely inefficient industrial sector was dependent on imported raw material, which left foreign trade in chronic deficit. Economic assistance from the USSR financed most of the foreign deficit, but arrears on foreign debt were increasing.[54]

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following reform.

[51]Vo Nhan Tri (1990), pp. 180-85, Beresford (1988), p. 171 ff.

[52]Vo Nhan Tri (1990) p 184, quoting Vo Van Kiet's report in *Nhan Dan*, December 28, 1987 and *Tap Chi Cong San*, no 2, 1988, pp. 1-7. In addition, the report stresses the determination to strengthen state and collective sectors, as well as other economic sectors, to address the problem of unemployment, ensure national security, and make preparations for the 1991-95 socio-economic development plan (Vo Nhan Tri, 1990, p. 185, and de Vylder & Fforde, 1988, pp. 77-78).

[53]UNDP (1990), p. 46, p. 59, and p. 81.

[54]de Vylder & Fforde (1988), p. 128.

The critique against the initial *doi moi* process, can be summarized in three points:[55] Firstly, reform measures were incomplete. There was, for example, a focus on radical changes at the micro-level, while neglecting fundamental macro-mechanisms in the society. The government needed to finance the stabilization measures, but failed to mobilize domestic resources while external funding was severely constrained. Exports had to increase to pay for necessary imports, but this increased inflationary pressure through supply shortages for the export industry. Moreover, the alterations in the micro-mechanisms were also incomplete. The liberalization of prices, exchanges rates, and interest rates distorted incentives, since many prices remained determined according to plan. This created a two-price system which encouraged substantial rent-seeking behavior. The low agricultural output persisted since agriculture continued to be discriminated against; the reforms did not introduce necessary institutions, such as rural credit, distribution channels etc. Disincentives for the agricultural cooperatives continued to operate.

A second problem was the poor sequencing of reforms. For example, restructuring of the state sector was not in phase with the reform in the financial system, which was still of a monobank type. The official rhetoric claimed that the state sector had to become independent and profitable, and some enterprises had their subsidies cut, but most low-performing state enterprises still received subsidized credit. The escalating costs of living raised state expenditures on wages, and the state largely financed its growing deficits by printing money. Meanwhile, the more profitable enterprises were denied subsidized credit and had to drastically increase output prices. In addition, the increased production incentives in the state sector and the larger room for private enterprising expanded markets and led to increased incomes which raised demand and thereby prices as well. This led to a monetary expansion which, due to lack of financial markets, had to be financed by printing money, and the result was the high rate of inflation.

Thirdly, there was uncertainty regarding the political commitment the pursuit of the reforms. Although the targets were firmly stated, the new rules of the game were less clear. For example, the proposed institutional change had little if any support in legislation. In addition, it was uncertain to what degree privatization would be allowed. The reform program, on the one hand, encouraged "all economic sectors" (i.e. all kinds of ownership), but private enterprises could not employ people besides family members. However, emphasizing the family as the basic economic unit temporarily resolved the delicate problem of privatization.

[55]Drabek (1990), pp. 33-36, and de Vylder (1990), pp. 13-15 asses most of these difficulties.

These three aspects are interrelated: ambiguity in the political commitment made reform incomplete and left important implementation issues, such as sequencing, in the air.

3.2 The 1988-1989 Reforms

The economic situation towards the end of 1988, with threatening hyperinflation and stagnation in agricultural output, called for action. In the spring of 1989 a new set of reforms were launched. The 1986 package marked a change of attitude towards economics: the old economic mechanism was admitted to be ineffective; Vietnam should rely on markets and open up towards the outside world. The 1989 reforms implemented these policy changes.[56] Most importantly, the 1989 reform replaced the two-price system with market prices throughout almost the whole economy.[57] Only a few commodity prices were still determined by the state. Other prices were also liberalized: interest rates increased substantially and became positive in real terms, while the domestic currency depreciated, as the official exchange rate was readjusted towards the parallel or free interest rate. This implied a dramatic reduction in the difference between official and black market exchange rates. The reforms also brought about more fundamental changes in agriculture, foremost by fully encouraging household farming. In addition, the 1989 reforms encouraged an expansion of commercial transactions, by including measures which granted state enterprises increased autonomy, and announced that virtually all direct subsidies would be abolished. Simultaneously, tax reforms were introduced and the state budget was tightened. The reforms provided better conditions for private enterprises, and softened restrictions on foreign trade and investments (importantly by the promulgation of the new investment law).[58]

Apart from the domestic problems, the new reform package was motivated by the announced cessation of Soviet assistance. During the 1980s, this aid, primarily in the form of subsidized imports, had been a corner stone in the economy. The break-down of the Soviet Union, meant that Soviet aid had dried up completely by 1991. Although the cessation of Soviet aid and of other preferential arrangements with the CMEA area meant a worsening budget deficit, the effects were less severe than expected for two reasons. First, Soviet aid never really aided, but was rather a form of artificial breathing for the inefficient state industry. The abandonment by the USSR revealed the state

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[56]Van Brabant (1990) discusses the prerequisites, content, achievements and short-comings of the 1989 reforms.

[57]Note that the co-existence of a parallel economy where higher prices prevailed, made Vietnamese consumers fairly tolerant to the subsequent price increases. The high inflation rate seems also to have contributed to facilitate the price reform, for the same reason (Wood, 1989).

[58]IBRD (1993), pp. 3-4.

sector's low productivity and thus initiated a process of restructuring: enterprises had either to shut down business or change. Second, the cessation of Soviet aid came when agricultural output had started to increase, even allowing for rice export, and when oil exploration projects, initiated in the early 1980s, started to pay off. Thus rice and oil exports after 1989 dampened the effects of the USSR aid drought.[59]

3.3 The Vietnamese Economy after 1989

Although "bumpy recovery" seems like an appropriate epithet for the Vietnamese reform process in the early 1990s,[60] it is clear that Vietnam by the time of the 1989 reforms had entered a new era of economic transformation. The macro-economic indicators of Table 4.1 denotes the general pattern of the economic achievements. Growth in GDP accelerated with the reform measures already in 1988 and surged in 1989. In 1990 and 1991 GDP growth fell back, but recovered in 1992, and averaged

Table 4.1: Selected macro-economic indicators, 1987-1995

	1987	1988	1989	1990	1991	1992	1993	1994	1995
				(percentage change from previous year:)					
GDP	4.0	5.1	8.0	5.0	6.0	8.6	8.1	8.5	[2]9-10
- agriculture	-0.6	4.0	6.9	1.5	2.2	7.2	3.8	5.5	-
- industry	11.0	3.3	-4.0	3.0	8.6	13.3	12.9	12.6	-
- services	5.5	8.9	17.7	10.8	8.6	7.2	9.4	9.3	-
Exports	6.8	24.4	112.6	21.4	13.8	26.2	16.7	-	-
Imports	10.6	24.3	-19.2	22.4	13.3	16.0	31.6	-	-
CPI	223.1	393.8	34.7	67.4	67.6	17.6	5.3	14.4	[2]19
				(percentage of GDP:)					
Budget deficit	-5.4	-8.2	-11.4	-8.0	-2.9	-4.3	[1]-6.3	[2]-5.9	-
				(million tonnes:)					
Rice output	15.1	17.0	19.0	19.2	19.6	23.5	25.0	23.0	[2]23.5

Notes:
[1]estimate; [2]projected

Sources: Andersen (1994), Tables 4, 11, 12, 15; IBRD (1995b), Table 2.1; Far Eastern Economic Review, 4 December, 1994, 15 June 1995, 13 July 1995.

[59]Buu Hoan (1991) presents Soviet and Vietnamese official accounts of the USSR aid, and concludes that much had been inefficient for various reasons and that both Vietnam and USSR officials have been aware of that.

[60]*Far Eastern Economic Review*, September 18, 1992

some 6.7 percent over the 1987-1994 period. The table also reveals some of the underlying components behind the GDP growth. Improved incentives in the agricultural sector meant that agriculture led the expansion. Rising incomes also led to an increase in the service sector. This area, in which private enterprises are especially active and dynamic, had been severely repressed prior to 1989. The expansion in the industry sector came later than in agriculture and services. Industry, which has been (and remains) largely publicly owned, was hit by the Soviet aid cessation, the cut in state subsidies, and the rise in interest rates to positive real levels. The recovery of growth in industry in 1990 and 1991 is partly explained by resumed negative real lending rates, which eased the burden of the state enterprises, but also by the expansion in the oil secor, in the light manufacturing sector, and in agro-processing.[61]

Foreign trade and investments

Overall, Vietnamese trade has since 1989 experienced a positive development. The growing export earnings from oil, rice, and marine products, have helped to earn important foreign exchange. Given that Vietnam in 1988 imported rice, primarily from the USSR, this change in the trade pattern is remarkable and an indication that reforms succeeded in changing incentives and production volumes in the agricultural sector. In addition, Vietnam in the late 1980s began to exploit considerable oil reserves. Export earnings have expanded, and in 1992 trade was roughly balanced.[62] In 1993, however, imports increased more than exports and caused a trade deficit. Nevertheless, Vietnam has obviously managed to transform its former CMEA dominated trade into trade with convertible currency markets, and thus open up its economy towards the rest of the world. Another feature of that process is the inflow of foreign direct investments (FDI), which since 1988 has continuously expanded. By 1993, the registered stock of FDI amounted to some 7.5 billion US dollars, although only some 30 percent of these have actually been implemented.[63]

Monetary development

Table 4.1 also shows the dramatic changes in price development following the 1989 reforms. By May 1989 the monthly inflation rate was negative, and the annual average inflation rate at the end of the year a mere 35 percent, i.e. a considerable drop

[61]See IBRD (1993), p. 6 for an overview of growth up until 1992.

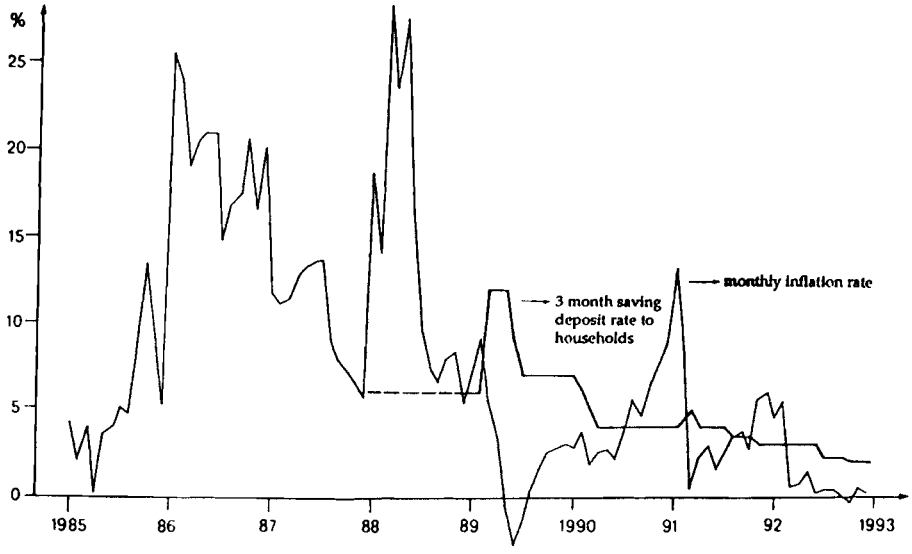
[62]The trade surplus in 1992 was 70 million US dollars, according to *Far Eastern Economic Review*, 28 January, 1993.

[63]Andersen (1994), p. 14. On foreign direct investments, see Freeman (1994), Dollar & Ljunggren (1995), Nestor (1995), and Kokko & Zejan (1995).

compared to the previous year's rate of close to 400 percent. A radical shift in interest rates, which in 1989 suddenly rose to positive real rates led to a a considerable increase of deposit volumes in the banks, apparently reflecting a growing confidence in the domestic currency and in the prospects for the economy.[64] Figure 4.1 shows the parallel development of the monthly inflation rate and the interest rate on three months saving deposits between 1985 and 1993.[65]

In 1990, the inflation rate again accelerated, reaching an annual 68 percent at the end of the year, and 1991 ended with the same high rate of inflation. The main source of problems in this phase of reforms seems to have been a growing deficit, caused by the decline of Soviet aid, poor agricultural output, and growing problems in the public sector, financed by central bank credit.[66] As shown in Table 4.1, the budget deficit dramatically diminished in 1991, and remained relatively (to the 1989 level) low in the following years. Increased tax revenues and reductions in current expenditures explains most of this. Thus in 1992, the inflation rate fell again. By 1993 it had reached the attractive one-figure level. However, this achievement did not last, and by 1994 the rate

Figure 4.1: Monthly inflation rate and monthly saving deposit interest rate to households, 1985-1993;



[64]Dollar (1993), p. 213.

[65]Chapters V and VI will look further into various aspects of interest rates policies.

[66]Lipworth & Spitäller (1993), p. 16.

was again rising. Increases in bank credit to state enterprises, and once again a growing budget deficit may partly explain this recent and worrying increase in the inflation rate.[67]

Economic structure

Table 4.2 gives an overview of the economic structure of the economy, by showing various sectors' shares of GDP in 1989 to 1994. Although agricultural output grew considerably as a result of the 1989 reforms, its relative importance for total production has diminished since then, from some 42 percent in 1989 to an estimated 36 percent in 1994. The agrarian character of Vietnam is, however, obvious from the large share of the total labor force employed in this sector: some 74 percent were in 1989 employed in agriculture and forestry (of which the latter sector only employed some 0.5 percent).[68] Industry, meanwhile, contributed around 19 per cent of GDP in 1989, while employing some ten percent. Excluding the fall in 1990, the share of the industrial sector in GDP has since then largely grown. Its employment share has however somewhat diminished. Employment in the agricultural sector, on the other hand, has not declined as a share of the total labor force, at least not up until 1992.[69] The other

Table 4.2: Economic Structure 1989-1994;

	share of total labor force in 1989:	share of economic sector as percent of GDP: 1989	1990	1991	1992	1993	1994 (est)
Agriculture and Forestry	74.2	41.7	40.8	39.3	38.8	37.2	36.1
Industry	10.4	19.2	15.4	19.8	21.7	21.5	}26.6
Construction	1.9	3.8	3.8	3.8	3.9	4.2	
Trade	5.7	11.9	11.9	12.7	13.8	12.8	}37.3
Finance, Insurance and Banking	0.3	-	1.6	1.4	1.4	1.7	
State Sector	4.3	-	13.0	8.9	8.8	10.5	
Others	3.2	23.5	13.5	14.1	11.6	12.1	

Sources: Vietnam Population Census, 1989, table 5.5; IBRD (1995b), Table 2.2.

[67]IBRD (1995b) discusses the increase in bank lending to state enterprises, as a cause for a loosening monetary policy. Their estimate of the budget deficit for 1994 (1.9 percent of GDP) is however considerably lower than reported in Table 4.1 (where the projected 5.9 percent of GDP emanates from Andersen, 1994, Table 15).

[68]The total labor force in 1989 was 28.7 million, according to *Vietnam Population Census* (1990), Table 5.5.

[69]IBRD (1993), p. 234. The IBRD figures for the development of the labor structure betwen 1988 and 1992 are however not compatible with Table 4.2 for other sectors than industry and agriculture.

sectors also listed in Table 4.2 contributes to GDP more than to employment. Of particular interest for this study is the constant growth in the finance, insurance and banking sector, although its share of GDP remains small, and it employs an even smaller fraction of the labor force.[70]

Measurement problems

This brief overview quite bluntly takes the available macro-economic indicators at face-value. Vietnamese economic statistics are in many ways incomplete and unreliable. With the transformation of the economy comes a transformation of measurement methods. In the previous system, with the absence of a market related price system, most monetary estimates were in one way or another misleading or uninformative. Some sectors' contribution to the economy (i.e. industry) was overvalued at the expense of others (i.e. agriculture). Moreover, important sectors of the economy were simply ignored (like informal and free market activities, since these were not supposed to exist). For various reasons (a lack of resources as well as a lack of motivation to establish an accurate picture of economic performance), data collection has also often been poor.[71] Some of these problems remain today: most of the important informal activities in the Vietnamese economy are omitted in the official statistics, while, for example, private sector contributions may be underestimated due to problems of data collection. Vietnam is currently engaged in ambitious projects to transform its statistical system, for example by replacing the previous Material Productive System (MPS) with that of the System of National Accounts (SNA). Old data are constantly revised according to the new system, and the SNA is alone applied from 1993.[72]

The problem of statistics is not only a problem of different accounting systems and of data collection, however. Inconsistency and secrecy is also part of the measurement problem in Vietnam, although there has been much improvement in recent years, not least in the availability of statistics.[73] Chapters V and VI, which make use of financial data, discuss the short-comings and contradictions contained in the various financial indicators. The main message is that the numbers could hardly be used as exact

[70]It is unlikely that the number of employees has increased significantly since 1989. 0.3 percent of the total labor force corresponds to some 86,000 employees. While the number of financial intermediaries and other agents in the sector constantly increases, the state bank complex - by far the largest employer of them all - employed in 1989 some 50,000 people but has in the first years of the 1990s considerably reduced the number of employees.

[71]See de Vylder & Fforde (1988), pp. 14-15 on data quality in Vietnam prior to reform.

[72]Andersen (1994), p. 20. See Le Van Toan (1992) for a description of the differences between the two systems.

[73]This is reflected in a quite substantial publication of statistics, often translated into English.

measures, but rather as indicators of trends and magnitudes. Here I settle for a general warning that numbers should be treated with some skepticism. However, the difficulties with the GDP measure deserves special mentioning.

Official figures report a GDP per capita of some 130 to 140 US dollars in 1992. This number is probably far too low. While formal private sector activities may be underestimated, the whole of the informal sector is omitted. A figure in the region of 220 US dollar per capita has been mentioned as more accurate for 1992, although this number still ignores the informal sector.[74] In addition, GDP would be higher if the purchasing power of the Vietnamese currency was reflected. The conclusion is that the GDP statistics presented here may indicate the trends of growth in the sectors included, although they underestimate the level. A misleading level of GDP also affects the significance of other entities (such as the budget deficit) which are related to GDP.

4. The Present State of the Vietnamese Transition

Two pictures emerge when trying to evaluate the progress of the Vietnamese economy. The dominant image is that of a dynamic country, outmatching itself in economic prosperity and growth. Another is that of a poor but struggling developing country, with an ambitious but equally poor government, trying to overcome severe economic problems caused by lack of resources and institutional constraints. How do these two images relate to each other?

4.1 Socio-Economic Problems

Although the real rate of growth is probably underestimated in official figures, the dependency on only a few export products (rice and oil) makes growth vulnerable. The vulnerability of economic performance is further enhanced by the increasing impoverishment of the Vietnamese state. The transition to a liberalized price system, making prices and money matter, means that the state has turned to tax revenues as a major source of income. Implementation of tax reform is cumbersome, while state borrowing from abroad and from domestic sources is limited. The government has, in order to prevent an expansion of the budget deficit, strived to tighten budget expenditures in the last few years. State financial resources are limited and social sectors suffer. Social services are increasingly dependent on self-finance; fees are charged for health care and schools. As a result, children drop out of school, particularly in rural areas, where they are needed on the family farm, which is now more profitable than before.

[74]Andersen (1994), p. 20.

While labor is in demand on the family farms, unemployment is constantly referred to as a major worry. Unemployment grows for three main reasons. Firstly, the state sector has cut down its labor force. Although a whole set of ideological, institutional and social considerations make restructuring of the state sector delicate and slow, enterprises have been closed, and people fired (not receiving salaries). Secondly, since Vietnamese foreign relations, particulary with China, have improved, and soldiers from Cambodia have been demobilized, the Vietnamese military complex has reduced the number of soldiers. Finally, large numbers of workers from Eastern Europe and the Gulf states have returned to Vietnam. The size of unemployment is however difficult to measure. Figures mentioned are unemployment of 29 percent of the rural work force, and 22 per cent in urban areas.[75] These figures most probably refer to underemployment or seasonal unemployment. It is not evident that people, officially unemployed, go without a job or an income. Regardless whether you have a job or not, you have to and can make extra money. Given the official wage levels (for example, in 1991 the average monthly income for a state employee in North Vietnam was 100-150,000 Vietnamese dong or, roughly, some 10-15 US dollars), few employees in the state sector can manage normal every-day expenditures on these salaries. State employees and unemployed alike have to find secondary occupations, and most people find their extra income within the informal sector. Petty trade, small restaurants and other services make up part of this sector, and people with all kinds of education and positions make their living this way.

Despite growing income opportunities, the country is poor. A recent World Bank survey classifies 51 percent of the Vietnamese population as poor, i.e. they cannot reach the daily calorie requirement of 2,100 calories per day.[76] The GDP per capita, whether 130 or 220 US dollars, resembles those of the world's poorest, like Bangladesh or Nepal. Income grows for some, while others, for various reasons are left behind. There are also differences in economic development between the North and the South. While the political power remains in the North, the economic power rests in the South. An indication of this is that the annual national income per capita in South Vietnam may in 1992 have been around 300 US dollars, as compared to the overall GDP per capita of below 200.[77] The South has an advantage in its resource endowments: the fertility of rice fields in the Mekong delta is sometimes twice as high as in the Red River delta in the North. In addition, the historic circumstances are to the advantage of the South. A market economy existed in the South until reunification in 1976. Southern agriculture was never really collectivized. Small trade and semi-private enterprises were allowed

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[75]*Far Eastern Economic Review*, 28 January 1993.

[76]IBRD (1995a), p. ii.

[77]Hoang Ngoc Nguyen (1992), p. 36.

in the South as experiments in the early 1980s. Today, it is to the Southern capital of Ho Chi Minh City that foreign investors and businessmen primarily turn in order to take advantage of the opening up of the economy.

Increasing income differentials and socio-economic problems connected to poor state finances, have to be evaluated against the longer term prospects of successfully reforming the economy. New income opportunities have created new dynamics in the society. Moreover, a tight state budget is a prerequisite for the reform process. In addition, it is not necessarily the case that the poorest are worse off today than prior to reforms. The reforms were motivated by the weak economy, where the state could not fulfill its promise to take care of even the most basic needs of the population. Although there is much concern today about the weak state which does not manage to finance necessary infrastructure and a social safety net, this weakness was a feature of the state also prior to fundamental reforms. Deterioration in, for example, the health sector, took place already in the mid 1980s.[78] The World Bank poverty survey in fact reports that 95 percent of 120 communes surveyed replied that life in the commune had improved in the last five years.[79] The overall impression of Vietnam in the early 1990s is that, despite all the lingering problems, there have been major improvements in the economy, constituting a necessary although not sufficient condition for a general rise in the Vietnamese people's living standard. The pie has grown. It remains to be seen if and how the pie will continue to grow, and how it will be shared in the future.

4.2 The Continuation of Reform

Vietnam has come a long way from a situation of severe food shortages and general macroeconomic instability. The country continues along the reform path, heading towards a market economy, albeit in the Vietnamese understanding of the word. The 7th Party Congress in June 1991 confirmed the government's intention to continue the reform process.[80] Vietnam's gradual transformation by and large seems irreversible, although the accompanying political process takes ambiguous turns. The new constitution in 1992 marked the irreversibility of reform, although the communist party continues to rule.[81] The official version is nevertheless that the market mechanism will be used in the construction of a special kind of Vietnamese socialism, and the poverty of the state and the increasing social problems is a headache for the

[78]Allen (1993), p. 44.

[79]IBRD (1995a), p. 9; the respondendents in this case were groups of community officials (p. 132).

[80]*Vietnam, one year after the 7th National Party Congress* (1992).

[81]*Socialist Republic of Vietnam, Constitution, 1992.*

Communist Party, striving to keep both the people's confidence and the power.[82] On the other hand, there is an increasingly open discussion about such crucial issues as ownership.[83] There are even people who openly address the delicate subject of the future political system, and the prerequisites for democracy.[84]

Yet, there is a fundamental contradiction embodied in the dominance of the communist, the socialist ambitions, and the requirements of the market economy. What, then, ensures the continuation of the reforms? One guarantee is undoubtedly the progress that has been made so far: it seems highly unlikely that the political leadership would abandon a formula which has proved to be so superior to the previous development strategy. The 1980s experience shows that the Vietnamese government is pragmatic. Another factor is that the government may not be fully in charge of the reforms. As was the case with the fence-breaking of the initial reform, many changes seem to occur prior to any political decisions. The government in these cases are expected to - and may have no alternative but to - adapt to realities.[85]

Before closing this chapter, let us return to a couple of issues raised in Chapter III, and try to briefly put the Vietnamese transition in perspective. The first question concerns the character of the Vietnamese reforms, the second whether the transition process is, by now, over.

Shock-therapy or gradualism?

The essence of the above discussion is that the Vietnamese reforms have been relatively successful. In many respects, there have been fundamental changes in the economic structure and economic mechanisms, accompanied by relative macroeconomic stability and considerable growth. This has altered the 1980s' gloomy picture of a suffering economy. Vietnam is flooded with consumer goods, food markets are prospering, the country is opening up towards other countries, and foreign investors are turning to Vietnam to exploit natural resources and make use of a cheap but well-educated labor force. Does this experience shed light on the question of the pace and path of reform? Has Vietnam gone through shock-therapy or a gradual transition?

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[82]See *Far Eastern Economic Review*, February 4, 1993

[83]Discussions with Vietnamese observers in Hanoi in November 1992; see also Luu Bich Ho & Le Anh Son (1992). Vo Dai (1992), p. 3, writes on ownership that... "there exist two kinds of basic viewpoints. The first one holds that ownership may have diversified forms on the basis of public ownership... The soundness of this viewpoint is not fully backed by facts. The second viewpoint holds that the various forms ownership - state, collective and private ownership - should be allowed to freely develop on an equal basis, to compete with one another and, on that basis, to be evaluated in terms of efficiency and progressiveness..."

[84]See for example an interview in *NIAS Nytt*, April, 1993.

[85]Beresford (1995) discusses certain aspects of this in terms of changes in the state enterprise sector.

The 1988-1989 reforms were in many ways a shock-type stabilization program.[86] In one stroke there were fundamental changes in the economy's *modus operandi*, particularly in relation to the almost complete price liberalization, the end of state subsidies, and the changes in the agricultural sector. This big bang, followed by consistent and credible policies, could largely explain why Vietnam has succeeded as well as it has.[87] From the above account of the various phases of reform, it is nonetheless clear that this big bang did not itself come suddenly. There had been several reform steps prior to 1989, gradually altering the economic mechanisms. Changes in the state enterprises is one example. Although the closing and restructuring of many state enterprises remains a head-ache for the Vietnamese government, a larger number of the major (and centrally controlled) enterprises have been transformed surprisingly smoothly. There are state enterprises behind the lion's share of the growing exports (excluding rice).

There are many reasons why these enterprises have succeeded. For example, at times they have received preferential treatment from the banks and the government. Part of the explanation is, however, that these enterprises had already prior to reform been forced to adapt to more market oriented mechanisms. The "three-plan-system" allowed the enterprises to do business with each other and sell their products beyond compulsory deliverences to the state. Another example is agriculture, where the "output contract system" acted as an incentive for farmers to increase production at the margin. At the time, these measures did not aim at a complete transformation of the economic system, but nonetheless they initiated a change in the rules of the game. It seems undeniable that these and other movements in the pre-1989 period contributed to the successful reform and stabilization programme.[88] Hence, Vietnam, it appears, is an example of the joint virtues of gradualism and big bang. A big bang only works if the conditions are right.

As already hinted in Chapter I, there are other fundamental features of Vietnam that have contributed to their relative success. Foremost, there is the basic economic structure: agriculture was easily transformed from collective to family farming (since the collectives had not become large-scale *sovkhozy* farms). The state sector is small and relatively inexpensive to transform. Moreover, there has been a considerable degree of flexibility in the economy, which has allowed for the expansion of the service sector, and thereby cushioned the effects of the decline of industry following the shock-therapy. The ability of the informal sector to absorb a growing labor supply seems also to be important for the relatively smooth transformation. Finally, the political stability associated with the maintenance of the communist party has so far, from an economic

[86]Van Brabant (1990).

[87]Diehl (1995).

[88]de Vylder & Fforde (1988), pp. 67-71, and de Vylder (1993), pp. 10-12.

perspective, been beneficial to Vietnam. Although there have been ambiguities and uncertainty about the continuation of the reforms, a relatively homogenous political leadership has been able to pursue reforms in a fairly consistent manner.

Is the transition over?

One cannot claim that just because most transactions are based on voluntary exchange and mutual interest, the transition is over.[89] Not if by transition we mean a fundamental systemic change. Poorly developed or non-existent markets for capital, land and labor indicate that there is more to a change in the system than merely "making prices matter", distinguishing transition from more standard structural adjustment programs.[90] As argued in Chapter III, transition is about institutional change - changes in the formal and informal rules of economic action. There are many signs that these rules in many cases have not yet been transformed into the rules of the market economy. One example is the character of the state sector. Despite many smooth changes, state enterprises also maintain behavioral patterns typical of the old regime. The state (the responsible ministries) directly intervenes in state enterprise affairs, and the enterprises' understanding of competition may be poorly developed, while the issue of privatization is clearly not yet settled.[91] Another example of incomplete transition is the financial sector, the central topic of this study.

In which direction Vietnam will develop in the future is, of course, impossible to forecast. Although there have been a number of praiseworthy accomplishments, Vietnam, as has been previously emphasized, is a poor country. It is possible that it is a country which may very well fall into typical developing country patterns, as growing income differentials create new tensions in society. People may abandon the rural areas for higher income opportunities in the cities. As an attractive low-wage country for labor intensive production, the workers may become trapped in demanding factory work, with meager prospects. Alternatively, the country may not manage to establish itself as an attractive low-wage country (because of unrealistic minimum wages, excessive costs for factory premises, or too much bureaucracy) and thereby fail to obtain these employment opportunities. The government may settle for a minimum effort strategy, content with the foreign assistence now flowing into the country, and allow (and benefit from) an increasing waste of resources, and corruption.

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[89]Or that the transition was over by 1990, as is the position taken by de Vylder & Fforde (1995), p. 22.

[90]de Vylder & Fforde (1995), p. 20.

[91]Beresford (1995).

5. Summary

After years of colonization and war, North and South Vietnam were finally reunited in 1975. Both regions of the country have been characterized by dual economies. In the South, the traditional life in the rural areas was in contrast to the Western influenced, urban sector. In the North, the central planning system controlled the relatively small urban industrial sector from the 1950s, while the rural areas, despite the collectivization of agriculture, remained largely traditional. In both regions, formal finance has played a fairly subordinate role. The overwhelming majority of the population (living in rural regions) have mostly relied on informal finance.

Reform attempts were made in North Vietnam prior to reunification, but the war partly over-shadowed the malfunctioning of the system. The current reform process, *doi moi*, originates in the alterations made in the incentive mechanisms as early as 1979, and were initiated both from above and below. A more fundamental reorientation towards market mechanisms was announced in 1986, and the 1989 program brought about its actual implementation. Agriculture was decollectivized, prices were liberalized, interest rates rose to positive real levels, state enterprises gained increased autonomy, and the country opened up to foreign investments and trade.

In spite of worrying social tensions and weak state finances, the result of reforms has been largely impressive. GDP growth has been substantial, the inflation rate fairly low, export volumes have increased, and the general standard of living has improved.

Probably, Vietnam will continue along the reform path, despite the fundamental contradiction embedded in the market reform requirements and the continued communist party dominance. The pragmatism of the Vietnamese government, and the spontanous character of many changes (beyond state control) support this notion. The transition is not over, since transition refers to the fundamental structural change which the reform measures set in motion. This will now be illustrated by the events in the Vietnamese banking system.

CHAPTER V

REFORM OF THE FINANCIAL SYSTEM

The previous chapter put the Vietnamese transition into its historic context, and presented the major components of economic reform. The present chapter and the two following address the core matter of the study: the development of the financial system. Until 1988 the socialist monobank structure remained. Since then the banking system has undergone several phases of reorganization aiming to create a central bank, a number of commercial banks, and other financial organizations. In the first half of the 1990s, Vietnamese banking is still in an embryonic state. The system is dominated by the four so called state-owned commercial banks (of which two are former departments of the State Bank), and are mainly the concern for the relatively small state sector. Bank services are associated with a tedious bureaucratic hassle, the general confidence in banks is low, and banks are of little importance to the ordinary citizen.[1]

The main objective of this chapter is to identify the banking problems of the early 1990s, and provide a background for the analysis of the subsequent chapters. The first section takes a macro perspective of the situation: it discusses capital shortage and the savings potential, evaluates the degree of financial depth and width, and outlines the

[1]IBRD (1995b) reports on financial sector development in the 1989-1994 period. This strongly policy oriented evaluation provides useful information on the organizational structure, techniques and performance of the banking system.

general functioning (or malfunctioning) of the Vietnamese market for savings and credit. Section two introduces the financial reform measures taken since the late 1980s, and gives a basic overview of the financial system. Section three, finally, summarizes the main points presented in a number of interviews with Vietnamese bankers and other agents made in 1991, 1992, and 1993.

1. Finance and Development in Vietnam

The Vietnamese economic reforms have brought about an impressive growth performance, with abundant investment opportunities. Investments require capital, but capital is in short supply. The main argument in this section is that there *are* important domestic resources in Vietnam, but that the absence of a well functioning financial system inhibits these resources to be efficiently reallocated.

1.1 Capital Shortage and Saving

Capital shortages are important bottlenecks in most economic sectors in Vietnam. The state needs capital for infrastructure investments, the public and the emerging private industry needs capital for production investments, and modernization of the agricultural sector depends on access to capital. "Lack of capital threatening production in Vietnam" claimed a Vietnam based investment review in October 1991: "Almost all industrial firms lack capital and most, especially in local industry, are in a dire situation' said the official mouthpiece of the ruling communist party [Nhan Dan]".[2] In a survey of small scale private enterprises in 1991, lack of capital was reported to be one of the major obstacles to growth by around 55 percent of urban and 65 percent of rural enterprises respectively, and in both groups a majority considered it to be the main obstacle.[3] A banker in the agricultural bank explained in an interview that "many farmers want to borrow for small industrial machinery, but there is a lack of capital."[4] And a Vietnamese review of the economy states that "The lack of capital has been a common difficulty in the whole economy in general and in each branch, each field as well as in each productive enterprise in particular."[5]

Judging from official figures, capital accumulation is low. National savings were probably negative in the crisis years of 1986 to 1988,[6] but following the important 1989

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[2]*Vietnam Investment Review*, October 7, 1991.

[3]Ronnås (1992), pp. 153 and 110. Truong & Gates (1992) discuss investments in the private sector.

[4]Head office of ABV, January 3, 1992.

[5]Le Van Toan (1993), p. 34.

[6]de Vylder & Fforde (1995), p. 214.

reforms, national savings improved - growing from two percent of GDP in 1989 to some eleven percent in 1992.[7] Compared to its South East Asian neighbors, this saving rate is still not impressive: a rate of 30 percent of GDP has during the last few decades been the average in most of these countries.[8] Moreover, the Vietnamese government was a dissaver throughout the 1980s and until 1992, when there was a modest saving surplus.[9] There is a tendency to think of these low levels of domestic saving as a result of Vietnam's poverty. The state lacks resources while the people are incapable of any substantial saving. The transition exerts an additional strain on state finances, when direct transfers from the state sector cease and the implementation of an adequate tax system takes time. It is hoped that foreign savings will fill the gap brought about by the lack of domestic resources: "A less developed country caught in the transition of changing from a centrally planned economy to a market economy must be in a critical state of capital shortage; foreign capital is therefore sorely needed and must be welcomed".[10]

Foreign savings or capital may enter a country either as direct investments, loans, or aid. *Doi moi* opened Vietnam towards the world beyond the CMEA sphere, and foreign investments have been welcomed since the introduction in 1987 of a foreign investment law, further revised in 1990.[11] Foreign investors have indeed been eager to enter the Vietnamese market, alhough the low level of implementation indicates the many twists to the issue of attracting investments from abroad.[12] It is primarily through foreign investors that Vietnam hopes to gain access to international capital markets, since any extensive direct lending on commercial grounds to Vietnamese owned enterprises seems until now unlikely. The risks involved in venturing into Vietnam - the absence of legislation, information difficulties etc - make foreign lenders and investors hesitant, a view which is also held by the newly established foreign bank branches, which instead concentrate on trade finance and services to foreign investors and joint-ventures between Vietnamese and foreign firms.

Loans to the Vietnamese government have been restricted by the country's past poor repayment performance, and by the US government's disapproval of international organizations' lending to Vietnam. Back in 1989, foreign savings constituted nine

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[7]IBRD (1993), p. 8.

[8]Riedel (1993), p. 408.

[9]Dollar (1994), p. 367.

[10]Don Ton That (1993), p. 43.

[11]See Pitron & Eck (1993) for details.

[12]As mentioned in Chapter IV, only some 30 percent of 7.5 billion US dollars of FDI licenced had been implemented by 1993. See also Dollar & Ljunggren (1995), pp. 18-19.

percent of GDP, but then fell close to zero due to the cessation of USSR aid.[13] At this time, aid from the convertible area, with the exception of Sweden and Finland, was almost non-existant. Throughout the 1980s, Vietnam accumulated arrears on hard currency debt, borrowed in the late 1970s. In addition, Vietnam had borrowed considerable amounts of transferable rubles from the former Soviet Union. In total, external debt amounted to some 100 percent of GDP in 1992.[14] In the early 1990s the relationship with the United States has steadily improved. Vietnam has also reached agreements wih the Paris Club to establish a framework for rescheduling its external debt.[15] Relationships with the IMF and the World Bank have been normalized, and lending from these organizations as well as bilateral assistance from a number of countries have resumed. The repayments to the Russian Republic are not yet settled.[16] Access to international finance is welcomed by the government - to say the least; Vietnam craves foreign aid. The first priority is public infrastructure investments, but in interviews Vietnamese officials and bankers have also stressed foreign capital as an important source of funds for credit advancement, primarily in the context of rural credit.

During the critical years of radical reform (roughly the 1989 to 1992 period) Vietnam has essentially had to do without any foreign assistance. This circumstance has led to two slightly different conclusions regarding external assistance to Vietnam: one is that Vietnam, despite the relative success in the period, could have performed even better with access to international finance without the trade embargo;[17] another view is that it was precisely the lack of external backing which forced the Vietnamese government to accelerate the reform process and "put its house in order".[18] Be that as it may, it is the case that Vietnam, despite the low degree of domestic (and foreign) accumulation, managed to reach impressive growth levels. How was this possible? There are probably several answers. One points to a significantly low incremental capital output ratio (ICOR - measuring the additional capital required to produce additional output, where a low ratio indicates an efficient use of capital).[19] A low ICOR could be explained by the existence of slack in the production machinery at the time of

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[13]IBRD (1993), p. 8.

[14]This is based on a low estimate of GDP, however (see Andersen, 1994, p. 8).

[15]"International donors confirmed Vietnam's return to the world financial community in Paris on 10 November by pledging US$1.86 billion in aid for next year and by praising Hanoi's "remarkable" success in moving towards a market economy". *Far Eastern Economic Review*, November 25, 1993.

[16]Andersen (1994), pp. 6-8.

[17]Dollar (1994), p. 375.

[18]de Vylder & Fforde (1995), p. 217.

[19]Dollar (1994), p. 364.

reform. Thus new incentives managed to induce considerable output increases without major new investment. This explanation would seem readily apply to the agricultural sector: when farmers were given incentives to make better use of the fields that were there all along, output grew. Amptjer reöevamt factpr was that investments made under previous years began to pay off in this period (predominanttly in the oil industry). Another equally important answer may be that domestic savings are severely underestimated in official figures - an observation also made in most macro economic accounts of this period.[20] It is worth noting that the existence of slack in the production process could be hard to distinguish from saving (and investments): essentially, saving is everything that is not consumed. If the farmer invests his rice by planting it in the field rather than eating it directly, he is saving while also increasing output.

The degree to which domestic saving is underestimated is of course impossible to exactly assess. For one thing the savings ratio has probably grown steadily during the initial years of radical reform (something which is especially likely if the point of departure was a situation characterized by negative national savings during the crisis years). One can assume that as price liberalization began to generate income increases, there were initially great consumption needs which had to first be filled, before any great savings occurred.[21] In addition, however, there were important holdings of gold, foreign currency and rice hidden by the population during the hard years of socialism. There are stories of large volumes of gold buried in the back yards and in the fields, but the exact amount of gold reserves dug up or generated by the increasing income opportunities is unknown. A survey in Ho Chi Minh City showed that the population in the city held about 100 billion Vietnamese *dong* (some 10 million US dollars) of gold worth in 1991.[22] A figure often quoted is that there were/are gold and dollars equivalent to some two billion US dollars (some 20,000 billion Vietnamese *dong*) in the Vietnamese population.[23] In addition to these unknown reserves, quite considerable transfers have been made from overseas Vietnamese to relatives in Vietnam.

The private reserves are used for consumption and investment. Most striking is perhaps the important housing boom in the early 1990s. A Vietnamese observer noted that people kept their money idle until they had saved enough to buy a house.[24] According to a survey, private investments (mainly in housing), amounted to some

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[20]For example in IBRD (1993), pp. 7-8.

[21]See discussion by Le Van Toan (1993), p. 24 on the sources of the rising incomes in rural and urban areas and their use.

[22]Department of banking at the NEU in Hanoi, November 14, 1991.

[23]See for example *Far Eastern Economics Review*, August 25, 1994; the same figure was mentioned in interviews with foreign bankers already in late 1991. *Far Eastern Economic Review*, September 2, 1993, mentions gold and hard currency to a value of one billion US dollars hoarded in the population.

[24]Department of finance at the NEU in Hanoi, October 19, 1991.

2,500 billion Vietnamese *dong* by mid-1991, of which 1,400 billion Vietnamese *dong* came from household savings. These investments are roughly equivalent to 30 percent of total investments.[25] This savings volume is furthermore close to half of the total household savings in the state owned banks.[26] Private saving is also a major source for self-finance in various small scale enterprises. According to the enterprise survey referred to above, approximately 93 and 76 percent respectively of the initial capital in the small scale rural and urban enterprises came from within the enterprises themselves.[27] All these circumstances plainly suggest that the Vietnamese save to a considerable degree. Some of this saving is kept as passive inflation hoarding, some is invested in small scale private industry, and some is obviously also intermediated through the informal financial sector (further discussed in section 2.3 below). Furthermore, household saving into the banks increased in response to higher interest rates in 1989.[28] Probably, however, this was to a large extent a portfolio effect: interest rates' effect on the general saving propensity is ambiguous, although higher bank rates may have encouraged some people to transfer their holdings into the banks. This would in turn suggest that even in 1989 - despite the negative crisis in the preceding years (and the negative official saving rate) - there were substantial resources in Vietnam, which surfaced through the positive real bank rates. The degree to which the national saving rate is underestimated is unknown, but there is reason to believe that by 1993 the saving rate was as high as twenty percent.[29] Thus Vietnam would be approaching the level of other South East Asian countries.

The general cry for capital, the pattern of extensive inflation hoarding, and the high degree of self-finance of emerging private enterprises all point to problems in the banking system. Formal financial intermediaries do not manage to absorb the available saving and reallocate it in an efficient way. This conclusion finds support in a statement by prime minister Vo Van Kiet, who declares in a report to the National Assembly in 1994, that "the development of a capital market has become an ever more urgent demand of our economy. Weaknesses in ths field are holding back the maximum mobilization and utilization of all capital sources, both at home and from abroad".[30]

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[25]Nguyen Quang Thai (1992), and personal communication in November 1992.

[26]In Chapter VI it is shown that household saving in 1991 roughly amounted to some 3,000 bn VND in 1991 (Table 6.4, only counting the ABV and ICBV saving from the population).

[27]Ronnås (1992), pp. 56 and 69.

[28]See Dollar (1993), pp. 212-214, and Chapter IV, Figure 4.1.

[29]Fforde (1994), p. 57 and 58.

[30]Vo Van Kiet (1995), p. 17.

A measure to assess the extent to which the banking system fails as a financial intermediary is to look at the degree of financial depth and width.

1.2 Financial Depth and Width

An increase in the stock of financial assets, *ceteris paribus*, implies a deepening of the financial system. This means that more savings move through the financial system and can be put into productive use. Financial deepening can thus contribute to increased economic growth.[31] The common way to measure financial depth is to look at the ratio of monetary assets (currency and deposits) to GNP. Table 5.1 shows Vietnamese monetary data for the years 1988 to 1994. The numbers should be treated with skepticism, but they give an idea of trends and magnitudes of financial depth.

Table 5.1: Money supply 1988-1994 (December, billion Vietnamese *dong*);

	1988	1989	1990	1991	1992	1993	1994 (sept)
- cash in circulation	1,024	2,352	3,735	6,419	10,579	14,218	17,318
- demand deposits	{1,303	1,615	1,578	2,707	4,232	4,870	4,305
- time deposits		1,357	2,365	2,821	4,119	5,794	8,213
Dong liquidity (M2D)	2,327	5,325	7,677	11,945	18,931	24,883	29,836
- foreign currency deposits	242	2,096	3,680	8,354	8,213	7,406	8,594
Total liquidity (M2)	2,569	7,420	11,357	20,301	27,144	32,288	38,430
Currency as percent of							
- dong liquidity (M2D)	44.0	44.2	48.6	53.7	55.9	57.1	58.0
- total liquidity (M2)	40.0	31.7	32.9	31.6	39.0	44.0	45.1
Foreign currency deposits as percent of							
- total liquidity (M2)	9.4	28.2	32.4	41.1	30.3	22.9	22.4
			(percent of GDP:)				
- currency	7.7	8.8	8.9	8.4	9.6	10.4	10.5
- demand deposits	9.8	6.0	3.8	3.5	3.8	3.6	2.6
- currency and demand deposits (M1)	n.a.	14.8	12.7	11.9	13.4	14.0	13.1
- dong liquidity (M2D)	17.5	19.9	18.3	15.6	17.1	18.2	18.2
- foreign currency deposits	1.8	7.8	8.8	10.9	7.4	5.4	5.2
- total liquidity (M2)	19.4	27.8	27.1	26.5	24.6	23.6	23.3
GDP, billion VND	13,266	26,723	41,955	76,707	110,535	136,571	165,179

Source: 1988-1993: SBV; 1994 and GDP: IBRD (1995b).

[31]See World Bank (1989), Chapter 2, for a discussion on financial depth.

From the table we can see that Vietnam is financially quite shallow. *Dong* liquidity (or M2D) as a share of GDP was between 17 and 20 percent in years 1988 to 1994, while total liquidity (M2) as a share of GDP increased significantly from 1988 (around 19 percent) to 1989 (28 percent), and has since then gradually fallen to little more than 23 percent in September 1994. Evidently, and as a result of the 1989 stabilization measures, financial deepening has taken place. Monetary transactions have become more important. Until 1992 however, the deepening of the financial system largely consisted of increased foreign exchange deposits, which would reflect that the confidence and usefulness of domestic currency deposits or cash holdings did not increase. Note also that cash holdings of foreign exchange are not included in this data, although these may be significant. Foreign currency - in particular US dollars - is readily available in Vietnam. A small sign of expanding confidence in the domestic currency is, however, that *dong* liquidity as a share of GDP increased after 1991, while the share of foreign currency deposits and thus total liquidity declined.

The table also shows the dominance of cash transactions. Currency as a share of *dong* liquidity constantly increased in the time period - from 44 percent in 1988 to 58 percent in 1994, and currency also increased as a share of GDP. This means that the financial system is not improving as a reallocator of financial resources or as a means of payments. Holding cash is rather becoming more attractive than depositing money in the banks.

How does the Vietnamese financial depth compare with other developing countries? Using figures presented in a *World Development Report*,[32] the Vietnamese "currency depth" of about eight to ten percent is close to the average of around seven percent experienced in countries with per capita incomes of less than 450 US dollars, as well as in countries of middle and fairly high income - from 450 to 7,200 US dollars per capita. Only in high income countries is the share of currency to GDP significantly smaller, reflecting a more sophisticated financial system. M1 - demand deposits plus currency - as a share of GDP fell in Vietnam from some 15 percent in 1989 to 12 percent in 1991, but then rose to 13-14 percent in the following years. The corresponding M1 to GDP ratio in most countries - regardless of national income per capita - lies somewhere in the region of 15-20 percent, so Vietnam is thus more shallow in this respect. The Vietnamese M2 to GDP ratio of 23-28 percent in the 1989-1994 period should be compared to the M3 to GNP ratio in the *World Development Report* (M3 generally includes deposits in other financial organizations, but such organizations hardly exist in Vietnam). Low income countries have an M3 to GDP (or rather GNP) ratio of some 25 - 30 percent, which fits well with the Vietnamese figures (while high income countries have a financial depth of close to 70 percent by this measure).

[32]World Bank (1989), pp. 27-31.

The Vietnamese situation could also be compared with average M2 to GDP ratios for three different types of developing countries: high-growing (GDP growth of more than seven percent), medium growing (three to seven percent GDP growth), and (s)low-growing economies (less than three percent). The M2 to GDP ratios for these three groups of countries were around 43, 31 and 23 percent respectively for the years 1965-1987. In Vietnam, for the years 1988 to 1994, the average growth rate was seven percent, which qualifies Vietnam as a high growth country.[33] Meanwhile, the M2D to GDP ratio averaged about 18 percent for these seven years, and the M2 to GDP ratio averaged some 25 percent. Thus, financial depth in Vietnam does not fully reach the level even of medium growing countries, implying that Vietnam is significantly more financially shallow than other countries experiencing a relatively high growth rate.[34]

The specific features of the Vietnamese financial system can also be assessed by looking at the characteristics of financial assets: the relative distribution between different financial organizations's assets and the volume of assets related to total economic activities. The total assets in the banking system between 1989 and 1994 are shown in Table 5.2. The figures are again somewhat dubious, but indicate the magnitude and the division of assets between different groups of agents. The four state-owned banks predominate among the commercial banks (although this table exclude assets in several of the small so called share-holding banks due to lack of data.[35])

Once again an interpretation of the table benefits from a comparison with numbers presented in the *World Development Report*, where 21 countries are divided into two categories: "developed markets" and "emerging markets". The report studies the ratio of central bank assets to total financial assets, as well as the ratio of total financial assets to GDP. (There is also a division of assets between commercial banks and other types of financial organizations, but this is less relevant for Vietnam where basically only commercial banks exist.) According to the report, central bank assets in the selected

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[33]Based on Table 4.1.

[34]While contemplating these comparisons between Vietnam and other countries, one should bear in mind the problems with assessing GDP in Vietnam. On the basis of an average exchange rate to the dollar of 11,000 Vietnamese dong for 1992, the GDP given in Table 5.1 implies a per capita GDP of about 143 US dollars. This is significantly less than the around 200 - 220 US dollars per capita often reported to be a more accurate figure. With a GDP of 200 US dollars per capita, GDP for 1992 would be about 154,000 bn Vietnamese dong. M2 as a share of GDP would then only be 17.6 per cent. But then again, the figures of the money supply are equally incomplete: apart from the probably very significant US dollar cash supply, substantial financial activities take place outside the formal system, which the SBV is not able to include in their survey (for one thing some of the officials would not agree that these "illegal" financial flows should even be considered in the official figures).

[35]In late 1992, I happened to hear of an argument in a central bank department responsible for collecting and compiling financial data on the banking system. A bank official wanted to exclude the share-holding banks when surveying the banking system, arguing that "they" (i.e. the share-holding banks) "are not ours" (i.e. belonging to the state bank) so "we should not care about them", according to my informant.

emerging markets amounted on average to some 20 percent of total assets, while total assets constituted only 79 percent of GNP on average. In developed markets, assets in the central banks were a small share of total financial assets - the average was three percent - while total financial assets substantially exceeded GNP, averaging 188 percent.[36]

Some 31 percent of the approximately 40,000 billion Vietnamese *dong* of total assets in the Vietnamese banking system in 1991 were central bank assets. The share of commercial bank assets was somewhat greater in 1991 than in the two previous years, where central bank assets amounted to 36 and 38 percent respectively. In 1992 to 1994, the central bank asset share rose to above 40 percent. As a share of GDP, total assets in the banking system constituted between 52 and 56 percent throughout the period. Hence, compared to the average of other emerging markets, central bank assets play an even more important role in the financial market in Vietnam, while total financial assets

Table 5.2: Total assets in the formal financial system, 1989-1994 (billion Vietnamese *dong*);

	1989	1990	1991	1992	1993	1994 (sept)
SBV (i)	5,266	8,491	12,686	24,821	31,972	43,666
Commercial banks (ii)	9,214	13,803	28,018	34,468	38,825	48,439
of which						
- the four state-owned commercial banks (iii)	8,991	13,657	23,678	30,059	35,149	43,316
Total assets in banking system	14,480	22,294	40,704	50,289	70,797	92,105
				(structure:)		
(i) as percent of total assets in the banking system	36	38	31	42	45	47
(ii) as percent of total assets in the banking system	64	62	69	58	55	53
(iii) as percent of (ii)	98	99	85	87	91	89
				(percent of GDP:)		
SBV assets	20	20	16	22	23	26
Commercial bank assets	34	33	36	31	28	29
Total assets	54	53	53	54	52	56
GDP, billion Vietnamese dong	26,723	41,955	76,707	110,535	136,571	165,179

Source: SBV, IBRD (1991), IBRD (1995b); assets in the state-owned commercial banks according to Table 5.4

[36]World Bank (1989), p. 39. Developed markets are Australia, Canada, France, Germany, Japan, Sweden, the United Kingdom, and the United States. Emerging markets: Argentina, Brazil, Chile, India, Korea, Malaysia, Nigeria, Pakistan, Philippines, Portugal, Thailand, Turkey, Venezuela. The year is 1985, and the figures are based on IMF financial statistics and World Bank data.

constitute an even smaller proportion of GDP than in the other economies. This is again an indication of poorly functioning financial intermediation. In addition, the average share of Vietnamese central bank assets in total assets of some 40 percent in the years studied is probably an underestimate. The foreign exchange reserve is deposited with one of the commercial banks, and this should really be included with the central bank assets (as I understand it, although exact figures on the foreign reserves are not available).

Financial width

The span of financial instruments, i.e. the different types of loan contracts available, is yet another measure of the development level in the financial system. The larger the variety of instruments with different maturity dates, risks and returns, the wider and more efficient the financial system; the more diversified the financial market, the more resources can be reallocated to its optimal use. The diversification of instruments also implies an increased opportunity to handle risk.

In this respect, Vietnam is again a typical developing country. Few financial agents offer a limited number of and fairly unsophisticated loan contracts. Banks borrow from the public and the enterprises through savings accounts (savings books) and deposit accounts. The banks accept demand and time deposits of three, six, and sometimes twelve months, for which withdrawal regulations are quite inflexible. For example, no interest rate what-so-ever is paid on deposits if they are withdrawn prior to the maturity date). There are only a couple of very small finance companies which provide deb finance facilities for companies, and there is still no stock market in Vietnam. Some attempts are made to offer government bonds from the SBV to the public, and to introduce treasury bills. Commercial banks are also beginning to offer bonds as alternative deposit instruments. However, the limited diversification leaves lenders with few opportunities to invest their resources within the formal financial system.

In short, the Vietnamese financial system is in the early 1990s both shallow and narrow. Resembling other emerging markets, Vietnam has an undeveloped financial sector, where the central bank is a dominating agent. Given the substantial growth in the economy, financial intermediation seems even less advanced than in other developing countries. There is room for the financial system to expand and thus contribute to a more efficient reallocation of funds in the economy. However, if a large share of financial transactions were handled by a growing number of banks (or other financial organizations), this would not necessarily imply financial efficiency. If the banking system is fundamentally inefficient in reallocating resources, i.e. is not able to provide credit to productive investments - either not providing any credit at all or putting them

into loss-making activities - the relatively most efficient financial system is that which is not using these inefficient banks, but instead depends on cash transactions. The Vietnamese case may very well be of this kind. But the dominance of cash transactions and the limited importance of banking in economic activities is still an indicator of a problem. *If* the financial system were deeper *and* more efficient, more capital *could* be provided to productive investments.

1.3 The Market for Financial Resources

The administratively set interest rates have been a central feature of financial intermediation in Vietnam in the early 1990s. These rates have moreover often been negative both in real terms (in relation to the inflation rate), and with respect to the spread between deposit and credit rates: the former often exceeded the latter (making banking a comparatively unprofitable business). In addition, banks distinguished between state-owned enterprises, private enterprises, and individual citizens.

Figure 5.1 attempts to portray Vietnamese banking in this period. It shows the supply and demand of financial resources, where the x-axis gives the volume of funds, and the y-axis shows the different levels of interest rates. The three relevant curves in the graph are S_I, the supply of financial funds from the households (or individuals), S_E, the supply of funds from the enterprises, and D, enterprises' and individuals' total demand for funds (of which the demand from enterprises - and then predominantly state-owned - is by far the most important). It is assumed that the supply of funds increases with increased interest rates, while the demand for funds diminishes with higher interest rates.[37] It is furthermore assumed that the interest rate elasticity of savings from the households is higher than from the enterprises, thus causing a flatter slope of the former curve. If interest rates were determined by market conditions, the total supply of funds, S_{E+I}, would match demand at a point yielding a total volume of financial intermediation, q^*.The market determined interest rate would then be i^*.

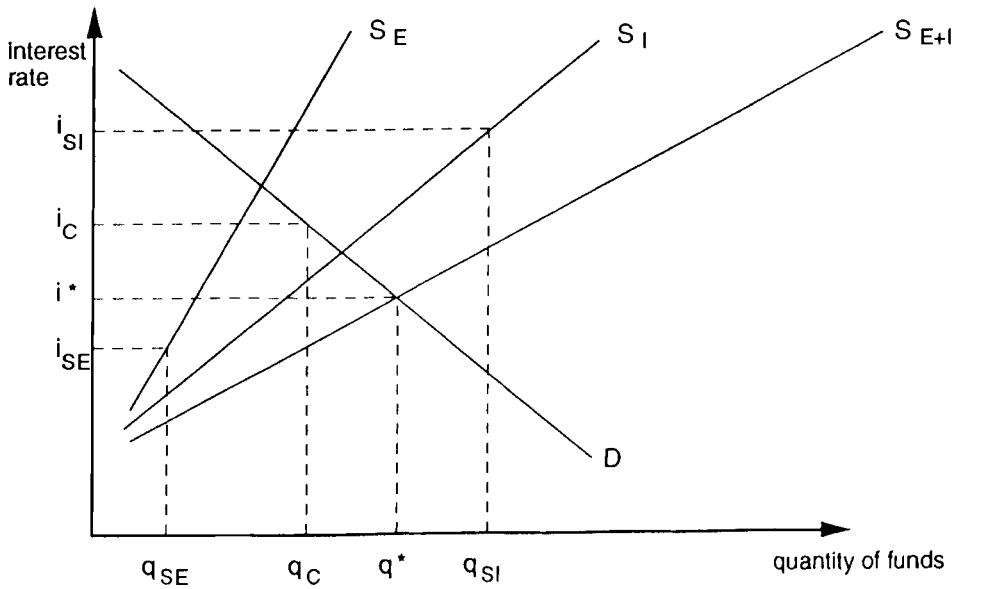
The Vietnamese situation is different. Apart from i^*, there are three different interest rate levels marked on the y-axis. These illustrate different administratively determined rates: the banks will pay a relatively high interest rate on savings from the population, i_{SI}, and a relatively low interest rate on savings from the enterprises, i_{SE}; the average interest rate charged for credit lies somewhere in between: i_C. In the figure this average rate is assumed to be higher than the equilibrium rate, but the main point is that this rate is higher than the interest rate paid for enterprise deposits and lower than interest rates paid for household deposits.

[37]Note that due to the income effect, the net effect on total savings of increases in the interest rate is in general ambiguous. However, higher interest rates would in any case cause a portfolio effect: i.e. people would rather deposit their money in the banks than keep other types of inflation hedges.

Section 1.1 argued that economic activities in Vietnam were constrained by a lack of capital, despite possibly considerable domestic resources within Vietnam. Figure 5.1 illustrates how deficiencies in the interest rate structure contribute to the failing intermediation function: households could potentially supply large volumes of funds, q_{SI}, at the going interest rates; the banks, however, are not eager to accept these funds, given that these deposits would cost them more than they could charge from borrowers. In fact, it is unlikely that the banks would even want to advance credit to a degree which satisfies demand, i.e. q_c, since the financing of these funds incurs losses. Meanwhile, the supply of the less expensive saving from the enterprises is limited - only q_{SE} - due to the relatively low interest rates paid for these deposits. Bankers in interviews confirmed that interest rates on lending were too high - these rates only attracted risky projects. Meanwhile, bankers also complained that mobilization of resources from the population was too costly, while enterprises did not want to save in the banks since this offered a too low return.

The figure is a simplification. In reality, there are different interest rates for different types of deposits and credit for various agents and economic sectors. Moreover, the interest structure as it is depicted in Figure 5.1 is subject to change. The situation illustrated is that of the late 1980s and early 1990s. Since then, interest rates have since then become more uniform. From 1992 the SBV has determined minimum

Figure 5.1: Supply and demand of funds with administratively determined interest rates;



and maximum rates from which the individual banks may deviate. Although the depictedsituation has been slowly abandoned, the figure does not merely illustrate an episode in history. By studying banking under these conditions, we can understand the problems as they were, as well as the prerequisites for changes in Vietnamese banking and the economy as a whole.

The interest rate structure is not the only clue to the problems of banking in Vietnam. It is the aim of this study in the present and the following chapters to analyze the reality underlying Figure 5.1, by examining several of the institutional features which give rise to the fixed interest rate structure as such, as well as the shape and position of the supply and demand curves. For example, a simple solution to the problems so far discussed might be to liberalize the interest rates. Given the institutional framework, however, much of the immediate liberalization may be problematic. We know that adverse selection and moral hazard problems appear in situations of inadequate information. Even a banker experienced in commercial banking may encounter difficulties in Vietnam when trying to evaluate the characteristics of bank clients: What are their projects? What are the risks involved? If competition is severe, bankers may anyway squeeze margins and increase their risk exposure. In addition, most Vietnamese bankers are inexperienced: the bank staff often lacks knowledge of how to manage risk and perform project evaluations. This may lead in turn to excessive risk taking. Without a functioning bank supervision to check such behavior, the fragile confidence towards banks currently held by the Vietnamese population may be destroyed. Indeed, this e experience has already been encountered in association with the crash of a number of small so called credit cooperatives in 1990. An alternative to extensive risk taking is a highly conservative banking policy. From the theory of credit rationing we know that even experienced bankers may refrain from providing loans to the most needy borrowers if they are not combinaed with appropriate methods of screening and monitoring clients, despite market determined interest rates on credit. Bankers who are less experienced could possibly be even more conservative, since their appraisal of the risks involved and effects on certain lending on their bank's portfolio etc may be even more obscure.

Turning back to the figure, another possible way to alter the awkward situation could be a shift in the demand curve to the right. Imagine a hypothetical point where demand intersects with total supply so that the market interest rate would be the higher rate, i_{SI}. But what would it take for the demand curve to shift in that direction; i.e. what determines the demand for credit from banks? In Vietnam, it is perhaps not only a matter of appropriate interest rates, but also a question of the emerging entrepreneurs being given a proper legal framework so that they dare to invest. Or perhaps demand is low because banks are not viewed as a credible counterpart in a finance agreement. Finally, the potentially large supply of household saving is in the figure not mobilized

into the banks because it is too expensive. Saving mobilization is also restricted by the public's general lack of confidence in the banks. Banks may be reluctant to accept these funds, but perhaps it is also the case that the S_I curve lies fairly close to the S_E curve, since depositors do not want to deposit their money in the banks *under the prevailing circumstances*. Chapters VI and VII will explore these and similar questions at length.

2. The New Legislation and the Emerging Structure

Apart from a few experiments in commercial banking in 1987,[38] the banking system remained in its old monobank costume until March 1988. A Council of Minister decision at this time separated the former State Bank into a two-tier system, with two distinct functions: a central bank and a commercial bank system.[39] In October 1990, a new banking law was passed which confirmed and further specified this new structure. This banking law consists of two decrees: the first regulates the *State Bank of Vietnam*, the SBV, i.e. the central bank; the second concerns the commercial banks.[40] In addition, the government in June 1991 passed a law regulating the establishment of foreign bank branches and joint-ventures between Vietnamese and foreign banks.[41] Apart from these decrees, banking is regulated by decisions and circulars, predominantly issued by the SBV. Most of these regulations have been formulated from 1991 and onwards.[42] In accordance with these decisions and decrees, a reorganization of the banking system has been initiated. Laws and regulations do not by themselves ensure a successful implementation of new organizational structures or even a well-functioning legal system. For the latter to emerge, a general knowledge and agreement with the new rules are necessary, while legal authorities develop and gain experience in practicing the laws. Nevertheless, the content of the new banking law indicates the official intention behind the transformation. I use it as a point of departure for a description of the present structure.

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[38]See Nguyen Duc Thao & Pham Dinh Thuong (1994), p. 17 on the experimental banking in Hanoi, Ho Chi Minh City, Hai Phong and Da Nang.

[39]Council of Ministers, Decision no 53/HDBT, March 26, 1988.

[40]*Decree law on the State Bank of Vietnam* (Decision no 37, May 1990), and *Decree law on banks, credit cooperatives and finance companies* (Decision no 37, May, 1990).

[41]Council of Ministers, Decree no 189/HDBT, June 15, 1991.

[42]See Ministry of Trade (1993), and Nguyen Duc Thao & Pham Dinh Thuong (1994) for detailed accounts of the various regulations.

2.1 Central Banking

The decree on the central bank stipulates the objectives, organization and management of the SBV. The bank has the governmental function of administering monetary, credit and banking transactions, and of ensuring the stability of the currency. The SBV is run by a Board of Directors, with ten members. The Governor is the president of the board, and is notably also a member of the Council of Ministers, the chief executive body of the government (from 1992 transformed into a Cabinet).[43] There is a vice president, being the first deputy governor of the bank, and four deputy ministers.[44] In addition, the board consists of four administrators who are to be "specialists in the fields of economics and monetary matters".[45]

The SBV is organized into twelve or fifteen departments and a number of sub-departments.[46] In addition there are two Banking Colleges in Hanoi and Ho Chi Minh City, which have examined students (under the old curriculum) at least until the end of 1993. These colleges are directly under the guidance of the SBV, as are some of the enterprises: the money printing house, a material supply company, an engineering factory, and a construction company. There are also a number of SBV branches throughout the country. The SBV is, finally, in charge of the two foreign exchange centers in Ho Chi Minh City and Hanoi. From August and November 1991 respectively, these centers have handled daily auctions of foreign currency, as a first step to improve the method by which the official exchange rate is tied to the market rate. The total number of employees in the SBV is between 6,000 and 6,500 - a figure which has been fairly constant since 1989. The number encompasses some 1,300 in the SBV controlled enterprises (perhaps also including staff in the banking colleges), while some 600 are

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[43]Along with the reorganization of the government in 1992 a Council of Monetary Policy was formed - reporting directly to the prime minister and in charge of all financial matters; this council was however dissolved in 1994, according to Fforde (1994), p. 66.

[44]The vice-ministers representing the Ministry of Finance, Ministry of Trade, State Committee for Planning, and State Committee for Cooperation and Investment respectively.

[45]*Decree law on the State Bank of Vietnam* (Decision no 37, May 23, 1990), Chapter II, Article 5.

[46]Apart from the Governor's Office, these include departments of Supervision, Economic Planning (or "Economic Research", the main policy department), Credit (possibly equivalent to Cash or Currency Issue and Vault department), Commercial Banks and Credit Institutions, Personnel and Training, Accounting and Auditing, Foreign (for international policy), Foreign Exchange, Administration, Information (publishing the Banking Review), and also an Computer Department. The number of departments according to decision no 138 - HDBT, May 8, 1990 is 12 (including the Governor's Office and the Banking Review). The organizational chart in Nguyen Duc Thao & Pham Dinh Thuong (1994) consists of 14 departments of which several have somewhat different names than in the decision - there is for example a "logistics department" which is most probably the "administration department". Notably there is a credit department *and* a treasury department, whereas the Council of Ministers' decision only mentions a cash department. This is not important other than as an illustration of the difficulties in penetrating the organization and understanding the structure.

employed in the SBV head-office.[47] The Ho Chi Minh City office is the largest of the SBV branches, employing some 180 persons, while the other branches on average employ some 100 persons.

Although the law sees the central bank as a distinct body, the SBV in the early 1990s is organizationally still closely linked both to the government and the four state-owned commercial banks. Its independence and power is debatable, as will be further discussed in Chapter VII. Physically, the head-office of SBV in central Hanoi has shared its premises with several of the state-owned commercial banks.[48] These banks are gradually finding new office space, however, while the SBV restores the buildings.

2.2 The Commercial Banks

The decree on the commercial banking system distinguishes between commercial banks, investment- and development banks, credit cooperatives, and finance companies. The law specifies the equality between four types of commercial banks: 1) state-owned commercial banks (100 percent of capital provided by the State Budget); 2) joint-stock commercial banks (where individuals or organizations may own a block of shares not "greater than the percentage fixed by the State Bank"); 3) foreign bank branches (with foreign ownership but operating under Vietnamese law); 4) joint-venture banks (banks with capital from Vietnamese banks and foreign banks, whose head office is in Vietnam and is subject to Vietnamese law).

Although the law makes no distinction between commercial banks of different types of ownership, there is a hegemony of the state-owned commercial banks *vis-à-vis* the share-holding banks (i.e. joint-stock commercial banks), and the foreign banks (joint-ventures and foreign bank branches). Using a Vietnamese metaphor, the state-owned banks are the offspring of the state, while the other banks are merely adopted.[49] In practice, the different banking organizations are thus grouped differently than the categorization in the banking decree. Table 5.3 shows the types and numbers of financial organizations for the years 1989, 1991, 1992, and 1994. The initial capital requirements for the different types of organizations are also listed in the table.

At the core of the system are the four *state-owned commercial banks*, including the investment- and development bank. The *joint stock commercial banks* or *share-holding banks* are much smaller and newer.[50] In the category of *other domestic*

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[47]Eklöf (1993), pp. 3-4.

[48]"We are divorced but still live together", as one SBV interpreter put it in November 1991.

[49]Several bankers made the analogy in interviews during 1991, presumably implying that adopted children could expect less attention and care.

[50]The term *share-holding bank* will be used interchangeably with *joint-stock bank*.

organizations are several quite different types of financial intermediaries, with the common feature of having so far played fairly insignificant roles in the financial system. Recently, international banking has entered the market in the form of *joint-ventures and foreign banks* branches. Finally, *gold-shops* are part of the formal financial system.

Table 5.3: Structure of the financial system in Vietnam, 1989, 1991, 1992 and 1994;

	Type of organization:	Total numbers: 1989	1991	1992	1994	Initial capital requirement:
1.	State-owned commercial banks	4	4	4	4	200 bn VND
2.	Share-holding banks:					
	Urban share-holding banks	15	23	+24	30	3 - 50 bn VND
	Rural share-holding banks	-	-	5	16	300 - 5 bn VND
3.	Other domestic organizations:					
	Urban credit cooperatives	500	100	40	{69	500 - 600 mn VND
	Rural credit cooperatives	7,000	160	34		10 - 30 mn VND
	Finance companies	-	1	2	2	10 bn VND
	Insurance companies	-	1	1	1	
	People's credit funds	-	-	-	153	
4.	Banks with foreign affiliation:					
	Joint-venture banks	-	1	2	3	10 mn USD
	Foreign bank branches	-	-	5	13	15 mn USD
	Foreign bank representations	-	7	10-15	10-15	
5.	Gold shops			?10,000		deposit of 100-500 grams of gold in the state bank

Source: SBV, various documents, interviews, Dao Hung & Nguyen Huu Tai (1993), Nguyen Duc Thao & Pham Dinh Thuong (1994), (IBRD 1995b);

State-owned commercial banks

Two of the state-owned commercial banks emanate from two departments of the former State Bank: the *Industrial and Commercial Bank of Vietnam* (ICBV), and the *Agricultural Development Bank of Vietnam* (from 1990 the *Agricultural Bank of Vietnam*, ABV). In addition, the two specialized banks that already existed, the *Bank for Foreign Trade* (BFTV) and the *Bank for Investment and Development* (BIDV), have been given the rights to engage in domestic and short-term banking operations.[51] At the same time the *Socialist Savings Bank*, which had been the receiver of savings from individuals, was merged into the ABV and the ICBV.[52] The initial capital of 200

[51]The BIDV was previously called the *Bank for Investment and Construction,* but its name changed in 1990.

[52]The existence of the Savings Bank is somewhat unclear. It is mentioned by de Vylder and Fforde (1988), but is never dealt with at any length. IBRD (1993) denies any existence of a separate savings bank. The *Area Handbook of Vietnam* (1967) claims that there was a number of small savings banks in North Vietnam, something which Vietnamese observers seem to confirm by explaining that there used

billion Vietnamese *dong* for each of the state banks, was supplied from the state budget upon formation. The banks also took over relevant parts of the former State Bank's portfolio, partly consisting of unrecoverable outstanding debt. Quite possibly, the state-owned commercial banks were actually insolvent from the start, and in addition continued to provide high risk credit to loss-making borrowers for various reasons. This matter will be further dealt with in Chapter VI, although the debt dilemma of the state-owned banks is an important feature and deserves to be mentioned at this point.

Although aggregate data for the other types of financial organizations are largely missing, it is evident that the four state-owned commercial banks dominate the banking sector. Table 5.4 gives some basic facts about these banks, and developments in the 1989-1994 period. Generally, there has been a decline in total employment (from close to 50,000 persons in 1989 to 38,000 in 1992), parallel to an increase in the number of branches (from 661 in 1989 to 956 in 1992). The asset volume has meanwhile grown in nominal terms. In real terms, the asset volume decreased, however, between 1989 and 1990 by some nine percent. It then rose steadily: by 3.4 percent in 1991, and then between 7.7 and 11 percent in the following years.

An element in the reform has been to explicitly promote competition in the banking sector and to allow the state banks to engage in business in new sectors. The four state-owned commercial banks are, however, to a considerable extent geared to different segments of the economy, a feature observable from the very different organizational structures of the four banks. The ABV is the agricultural bank, with a huge organization but a relatively modest asset volume. It is by employment standards the largest, and has a considerable network of branches throughout the vast countryside.

Table 5.4: The state-owned commercial banks: number of branches and employees in 1989 and 1992; total assets in 1989-1994 (billion Vietnamese *dong*);

	Branches:		Employees:		Total assets (billion Vietnamese dong):					
	1989	1992	1989	1992	1989	1990	1991	1992	1993	1994 (sept)
ABV	490	751	33,470	23,000	2,539	2,756	4,199	5,183	7,498	9,588
ICBV	96	96	12,970	11,000	1,815	3,729	5,027	6,246	8,284	10,063
BFTV	10	16	650	1,060	3,936	5,971	12,316	14,422	13,790	16,097
BIDV	65	93	2,354	3,081	701	1,201	2,136	4,208	5,577	7,568
Total	661	956	49,444	38,141	8,991	13,657	23,678	30,059	35,149	43,316

Inflation adjusted total asset volumes (base year 1989)					8,991	8,158	8,439	9,110	10,117	10,898
						(percentage change from previous year):				
						-9.2	3.4	7.9	11.0	7.7
memorandum: CPI					34.7	67.4	67.6	17.6	5.3	14.4

Sources: SBV, the individual banks, and IBRD (1995b);

to be savings *funds*, where people were encouraged to deposits their money for ideological reasons.

It provides relatively small loans to agricultural enterprises and farmers. The ABV organization is in the process of change. In fact, the considerable reduction in employment has affected the ABV alone. There is also a substantial increase in the number of branches (751 in 1992, including subcommune banks), while there are close to 1,000 (995) so called deposit taking units, probably partly replacing the vanishing rural credit cooperatives. These units are often mobile offices - also called "saving tables" - where bank staff visit different villages and accept deposits from the individual peasants. In addition, the bank organizes some 5,000 farmer groups.[53]

The ICBV is by employment standards the second largest bank, with some 11,000 employees in 1992, divided into close to 100 branches throughout the country. It is largely an urban bank, that focuses on industry and trade clients. The BFTV is even more of an urban phenomenon. It concentrates its activities on foreign trade transactions, and has offices only in the larger cities. It is gradually expanding the number of offices, and increasing its staff. The asset volume is impressive but to an extent an illusion: some of the BFTV assets are part of the foreign exchange reserve, although the exact proportion is unknown.

The banking decree singles out the investment- and development banks. Unlike the commercial banks, such a bank allocates investment funds from the State Budget for "technical and economic development projects of the State", and mobilizes long-term and medium term deposits for long-term and medium term credit.[54] There is one such bank in Vietnam - the BIDV. More than half of the banks' assets consist of funding from the state budget, and are allocated to credit labelled as development financing - largely infrastructure.[55] These funds are excluded from the assets shown in Table 5.4. The around 3,000 employees in the more than 90 branches, are to a large extent technically skilled, providing competence in assessing and advising the investment projects financed by the bank.[56]

Share-holding banks

An ingredient in the initial financial reform measures in 1987-1988, was the government supported establishment of some fifteen small joint-stock banks, with capital largely provided by the state. After the introduction of the banking decree in 1990, six of these fifteen banks were reorganized and granted licenses as share-holding banks. By

[53]Head office of ABV, December 11, 1993.

[54]*Decree law on banks, credit cooperatives and finance companies* (Decision no 37, May, 1990), Chapter I, Paragraph 2.

[55]*BIDV Annual Report*, 1992.

[56]In 1991 there were 401 technical engineers out of a total of 1,175 graduates (BIDV brochure, 1991).

1992 four of these banks were dissolved, while five were under reorganization.[57] Altogether there were around 23 of these share-holding banks in 1991, although a complete account of the banks, their exact number or main activities, has been difficult to compute. At the end of 1994 the number had grown to some 30. Table 5.5 gives a list of some of the share-holding banks identified in late 1991.[58] Joint stock banks were first established in South Vietnam, and most of the share-holding banks are still found in the South, in particular in Ho Chi Minh City. New banks appear while former credit-cooperatives are merging and transforming into share-holding banks. A new share-holding bank is, however, dependent on licenses issued by the SBV. The Vietnamese policy seems to be to support a gradual expansion of the share-holding banks. In late 1993, the role of some of the share-holding banks was increasing, mainly by expanding the branch network of the already existing banks.

Table 5.5: Some share-holding banks in operation in the end of 1991;

		Year founded:	Ownership structure:	Capital at formation (VND):	Employees:
1.	South Vietnam:				
	Saigon Bank for Industry and Trade	1987	People's Committee, HCMC	650 mn	300
	Eximbank, HCMC	1990	93 % SOEs, 7 % private	53 bn	60
	Dai Nam Bank, HCMC	1990		2 bn, now 5 bn	
	Saigon Credit Bank, HCMC (previously Go Vap, now Saigon Thuong Tin)	1991			
	Bank for House Development, HCMC	1987/88			
	Nam Thanh Joint Stock Bank, HCMC	1987/88			
	Co Do Bank, Hau Giang province	1987/88			
	Phu Tam, Hau Giang province	1987/88			
	Joint Stock Commercial Bank of Dang Tau	1987/88		5 bn	
	Commercial Bank of Vong Tau			3 bn	
	Bank of Long An	1989		500 mn	
	Dong Thap Bank	1991	export and import unions	5 bn	
	Buildbank, HCMC	1990	joint-stock		
2.	Central Vietnam:				
	Danang National Bank	1987/88	SBV 16.7%, ABV 3.3% Danang City 13.3% private 66.7%	600 mn	20
3.	North Vietnam:				
	Haiphong Share-holding Bank	1988	SOEs 23%, coops 16 % industry 61 %	700 mn	16
	Maritime Commercial Stock Bank, HP	1991	SOEs 100%	40 bn	53
	Bank for House Development, HP	1987/88			
	Bank for House Development, HN	1987/88 (?)			

Source: Interviews in the banks and at the SBV; selection of second-hand material from the SBV, (IBRD 1991), newspaper articles, consultancy reports etc.

[57]Dao Hung & Nguyen Huu Tai (1993), p. 9.

[58]Table 5.5 is not complete. According to Cao Cu Boi & Dao Hung (1992), 21 out of 23 share-holding banks, were situated in South Vietnam in 1991. My list includes 14 Southern banks out of 19.

The ownership structure of these banks varies. The legislation broadly speaks about owners being individuals and/or organizations. Some banks seem more like cooperatives, with the shares being owned by the clients of the bank. Other banks are owned by state-enterprises and private enterprises and/or individuals. Others are owned by a few, individual share-holders. Some of the share-holding banks were founded by a group of export oriented state-owned enterprises, whose primary objective is to service these enterprises with foreign exchange, payment transfers, and also some short-term credit. The owners of the *Eximbank* in Ho Chi Minh City, for example, are to the extent of 93 percent state-owned export and import enterprises. The bank started in 1990 at the initiative of persons previously employed in the BFTV. The bank has some 60 employees, and its main focus is international business.[59]

Another category of banks is more domestically oriented. Their objective is to fund domestic investment projects which have difficulties in finding funding from the state-owned commercial banks. Most of these banks are rather small, although there is a lot of diversification between the banks with respect to size, experience and success. The *Saigon Bank for Industry and Trade*, for example, with some 300 employees, remains a comparatively large share holding bank. It opened as a pilot banking project in 1987, predominantly dealing with domestic banking. In 1991 the bank had begun international operations. The large majority of clients are State enterprises, and the bank, although on paper an independent bank, is in many respects more like a state bank, according to interviews with bankers.[60] Much smaller is the *Danang National Bank* in Central Vietnam. The bank, licensed in 1989, was in 1991 67 percent owned by individual share-holders - businessmen of Danang. The bank had some 20 employees, and predominantly provided credit to the handicraft industry.[61] The Northern based *Maritime Bank* was founded in the seaport of Haiphong in June 1991, and has rapidly expanded its network with offices in Hanoi and Ho Chi Minh City by 1992, as well as in Quang Ninh, Da Nang, and Can Tho by 1993. The main task of the bank was - initially - to service the share-holders: the navigation industry, the government, and the computer science and airline companies. The bank's main owners are a number of state enterprises, mainly in the shipping industry; by 1993 there were also apparently individual owners of the bank. Its prime objective has been to service the owners with financial services, although the bank is also expanding in general banking activities.

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[59]Eximbank in Ho Chi Minh City, December 19, 1991.

[60]Saigon Bank for Industry and Trade in Ho Chi Minh City, December 18, 1991, and December 3, 1993.

[61]Danang National Bank in Danang, December 4, 1991.

Notably the bank has been comparatively well equipped with computer facilities, providing rapid payment services throughout the country within the branch network.[62]

All the banks so far mentioned could be labelled *urban* share-holding banks. There is also a category of *rural* share-holding banks, or rural region banks. There are fairly few of these and several of them have some kind of ABV affiliation. They are moreover mostly small, and often founded and owned by richer groups of farmers in a village or a region. Sometimes these banks were previously credit cooperatives, now transformed into share-holding banks.[63]

Finally, there are *housing banks*, which have acted in a sense as specialized development banks, as they engage in construction development, acting both as financier and contractor. In addition, these banks accept deposits - possibly by denominating these deposits in gold (and still paying a competitive interest rate). Although sometimes distinguished as a special category of banks, housing banks seem to be included among share-holding banks in Vietnamese reports on the banking system.[64]

Other domestic organizations

According to the legislation, a *credit cooperative* belongs to a collective. It uses funds collected from its members to provide financing to its members. There is a distinction between urban and rural cooperatives. Apart from the different localization of these two types of categories, the urban credit cooperatives are less of cooperatives in the traditional sense, since they may be owned by up to 49 percent by one single owner.[65]

The number of *rural* credit cooperatives has drastically fallen since the beginning of reforms. The majority of the some 7,000 credit cooperatives existing in 1989 were founded in the 1950s, each closely linked to an agricultural cooperative. The cooperatives were predominantly engaged in credit transactions between each other - individuals were part of the collective and had no need for credit.[66] In the aftermath of the decollectivization of agriculture, the credit cooperatives lost their role, and

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[62]Maritime Bank in Haiphong, November 11, 1993, in Hanoi, December 1, 1992, and in Ho Chi Minh City, December 3, 1992; *Maritime Bank, Annual Report* (1993).

[63]Dao Hung & Nguyen Huu Tai (1993).

[64]See discussion in McCarty (1994), p. 30, and IBRD (1991), p.55, Dao Hung & Nguyen Huu Tai (1993), Nguyen Duc Thao & Pham Dinh Thuong (1994), and IBRD (1995b), pp. 79-85. The IBRD (1993) does not mention these banks in their account of the financial market. On the other hand this account is rhapsodic. Ministry of Trade (1993), pp 124 -134, mentions these "construction" or "housing" banks in an (incomplete) list of banks in Vienam. Nguyen Con Nghiep *et.al.* (1993) mentions house construction banks among different types of share-holding banks.

[65]Seibel (1992), p. 65.

[66]CIEM in Hanoi, October 22 and 29, 1991.

significant reorganization and new strategies for rural credit are currently on their way (also involving activities by the ABV). Only a few of the old cooperatives have been licensed by the SBV according to the new legislation. Some of these rural credit cooperatives are being transformed into so called rural share-holding banks. A recent development is the introduction of People's (or Popular) Credit Funds, beginning in 1993-1994. The SBV had licensed 153 such groups by the end of 1994. Their funding comes mainly from member shares and deposits, and credit is used for farming activities. Each fund has on average about 300 members, and the loans vary between 250,000 and one million Vietnamese *dong* on average.[67] As in many other developing countries, the whole issue of rural credit is important, although the topic will not be dealt with in depth in this thesis.[68]

Urban cooperatives grew like mushrooms, especially in the South, in the late 1980s, in response to liberalized economic conditions in general, and the measures taken to welcome alternative financial organizations (basically consisting of a lack of intereference on the part of the SBV, as I understand it). Attracted by escalating interest rates in 1989, people deposited their money in small urban cooperatives during the 1989-1990 period. Some 300 credit cooperatives were formed at this time. Many of the small banks had a pyramid structure, but lacked reserve assets and deposit insurance. The absence of relevant legislation meant that these organizations were beyond supervision and control. Unsound banking procedures led some of them into bankruptcy. Depositors panicked and caused a domino-like effect where a number of small-scale enterprises were forced to join in the bankruptcies. The credit cooperative collapse in 1990, severely damaged the credibility of any kind of bank organization in many people's eyes.[69] To some observers it was the high interest rates set by the SBV in 1989 which caused the collapse, since this caused the cooperatives to out-bid each other for deposits.[70]

After the collapse only a few urban credit cooperatives remain. A cooperative in Ho Chi Minh City, visited in late 1991 provides an example of the surviving type. Situated right on the market place in one part of Ho Chi Minh City, the cooperative had some 1,000 members, mostly merchants with stalls in the market. There were two kinds of membership: shareholders were entitled to dividends related to profits made by the cooperative - out of lending to the members; owners of so called long-term deposit

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[67]IBRD (1995b), pp. 69-71.

[68]See further Tran Van Anh *et. al.* (1992), Dao Hung & Nguyen Huu Tai (1993), and IBRD (1995b), pp 61-75.

[69]See also de Vylder 1990, *Far Eastern Economic Review*, November 1, 1990, and IBRD (1991), p. 79. Thayer (1991) mentions political demonstrations following credit collapse (p. 32).

[70]Finance department of the Economics University in Ho Chi Minh City, March, 1991.

shares were entitled to a predetermined interest rate. Such urban credit cooperatives could apparently provide loans on conditions different from the state-owned commercial banks. Short-term loans of one month was mentioned, with an interest rate of six percent per month (which was higher than the lending rates set for the banks), with fairly flexible repayment terms. Borrowers could either make small installments every day, or at the end of the week.[71] A fairly common trend seems to be the merger of several urban credit cooperatives, which then transforms into share-holding banks.[72]

There are in addition some other non-bank financial organizations in the financial market. A *finance company* is a "state-owned or joint-stock company whose principal operations are to finance the purchase of goods or services with its own funds or publicly borrowed funds".[73] Up until 1995 only two of these companies exist (in South Vietnam), and they seem to to be the concern of only a few enterprises. There is also one (state-owned) insurance company, whose role as financial reallocator is of limited importance.

Foreign banks and joint-venture banks

In 1991 the Council of Ministers provided guidelines for the regulation of foreign bank branches in Vietnam, prepared for in the banking law of 1990. Most of the foreign banks with representative offices in Ho Chi Minh City and/ or Hanoi (about ten altogether) applied for a license.[74] Six banks, four of which were French, in January 1992 received permission to open branch offices. Foreign bank representatives motivated their willingness to establish branches, despite bureaucracy and the distant prospects of profitability, with the importance of establishing presence in the booming Vietnamese market. By 1994 some 13 branches had been licensed, out of which nine had also opened offices.[75]

Prior to these foreign bank branches' establishment, the Indonesian *Bank Summa* and the BFTV engaged in a joint-venture bank, the *Indovina Bank*, with the head-office in Ho Chi Minh City. In early 1992 the *VID Public Bank* came into existence, centered in Hanoi, this time a joint-venture between the Malaysian *Public Bank Berhad*, and the BIDV. A third joint-venture, between BFTV and a Korean Bank, started in early 1993.Foreign banks and joint-ventures focus on operations in the foreign trade and

[71]Urban Credit Cooperative 1 in Ho Chi Minh City, December 16, 1991.

[72]Another urban credit cooperative visited in Ho Chi Minh City was in the process of such a transformation together with yet another cooperative.

[73]Decree law 38 (1990), Chapter 1, Article 1.

[74]Council of Ministers, Decree no 189, September 1991.

[75]IBRD (1995b), p. 9.

foreign investors' activities in Vietnam. Capital requirements, both for joint-ventures and foreign bank branches, are substantially higher for foreign banks than for new domestic banks: 10 and 15 million US dollars respectively,[76] compared to, for example, 40 billion Vietnamese *dong* (for the Maritime bank), equivalent to some four million US dollars.

Gold-shops

A final, unusual ingredient in the *formal* financial system are private and state-owned gold-shops.[77] Gold has remained an important wealth keeper in the Vietnamese society. State-owned gold shops have existed in Vietnam since 1954. Following the pragmatic adaption to the free market exchange rate in 1989, the government decided to recognize the private gold market by legalizing the gold trade and issuing licenses against a deposit of some 400-500 grams of gold in the banks.[78] There is a "union for gold and precious stones", licensing the private gold shops, and in charge of the state-owned gold shops. According to the SBV, the union belongs to the department of foreign exchange at the SBV. Its director is a deputy governor of the SBV,[79] but it is possible that the union is somehow also a part of the BIDV.[80] According to the SBV in Danang, the union was also granted permission in 1991 to give loans to individual organizations.[81] In Hanoi, in 1991 there were some fourteen public gold shops,[82] and a large number of private shops. In 1991, in Ho Chi Minh City there were some 600 licensed gold-shops of a total of 2,000 jewelry shops and in addition 200 private shops for foreign exchange.[83] Apparently, regular commercial banks also engage in gold trade. An example is the *Maritime Bank*, which in addition to the bank branches in

[76]The application fee was 0.2% of chartered capital, altogether some USD 300,000 if ten banks were applying. The original drafting of the regulation, stipulated the double capital requirement, according to *Vietnam Investment Review*, October 7, 1991.

[77]See *Far Eastern Economic Review*, August 29, 1991.

[78]A private gold shop owner said that the deposit was 112.5 grams (or 30 chi, where one chi is 3.75 grams).

[79]SBV official in Hanoi, October 22 and 25, 1991.

[80]Nguyen Duc Thao & Pham Dinh Thuong (1994), p. 43.

[81]SBV official in Danang, December 2, 1991. I asked around whether the private gold shops also lent money. Almost nobody claimed that they had ever heard of that.

[82]State-owned gold shop in Hanoi, November 20, 1991.

[83]SBV official in Ho Chi Minh City, December 13, 1991.

Hanoi and Ho Chi Minh City, also had two branches labelled gold shops in these cities in 1993.[84]

The private gold trade, along with the foreign exchange market in the streets and the shops in the urban centers are part of a kind of semi-formal finance. While banks, and in particular the state-owned banks, have difficulties in meeting individual demands for service and financial conditions, gold shops seem a convenient way for people to keep their savings. During my visits to Hanoi and other cities between 1991 and 1993, I observed a lively commerce in the many shops. Even the small shops kept bill-counting machines, and technical equipment to establish the gold content in pieces of jewelry. Women would carry one or two extra pieces of gold rings which they could exchange for *dong* currency when in need of cash. A state-owned gold shop manager explained that the demand for gold varies; following the opening of the Chinese border, the demand increased considerably, because of the increase in trading income (predominantly smuggling). After harvests there is also ususally a high demand for gold, while during the Lunar New Year (*tet*) season, the public would sell their gold holdings. The manager furthermore claimed that the quality of the gold work - the craftsmanship - was generally better in the private gold-shops.[85] Fraudulent behavior - a slight reduction in the gold content of the jewelry for example - among private gold shops was however often informally reported, although it was also claimed that private shops were more reliable than the state shops. Personal contacts and recommendations are necessary in order to establish a reliable business relationship with a gold trader.

2.3 Informal Finance

The Vietnamese financial structure also consists of *informal* finance. Chapter IV touched upon the roots of various forms of informal finance in contemporary Vietnam. Today we can distinguish at least five kinds of informal financial activities: Firstly, loans are given for various investments and consumption purposes by professional money-lenders; collateralized loans in the form of pawned items belong to this category. Secondly, loans are provided by friends or relatives. For these two types of loans, the interest rates charged depend on the relationship between the lender and the borrower (the closer you are, the less you pay), and the riskiness of the investment. Loans among family and friends are often interest free or dependent on future profits of the projects. There is, thirdly, the traditional rotating saving club, the *hui* or *ho*. Fourthly, there are

[84] *Maritime Bank Annual Report* (1993). Among the ICBV's sub-branches in Ho Chi Minh City, there was also a "gold union", according to ICBV in Ho Chi Minh City, December 11, 1991. The *ABV Annual Report* (1992) mentions that 310 provincial and district branches deal with gold, silver, precious stones, and pawnbroking, of which 139 are gold, silver and precious stones shops.

[85] State-owned gold shop in Hanoi, November 20, 1991.

advances given among traders in cash or kind, on the promise of buying or receiving products at a later date. Fifthly, there is what may be referred to as an informal corporate capital market taking different forms, but with the common feature that the contracting between entrepreneur and financier is beyond formal regulation and control. An example is that of the informal cooperatives where the membership group provides initial capital for an enterprise; there are also joint ventures between regular production units and private individuals on an informal basis.[86] A fairly important source of capital for small scale enterprises seems to be that of workers' contributions, provided against a share in the enterprise, profit dividends, a certain interest on the provided capital, or perhaps only a guaranteed employment.[87]

Assessing the magnitude of informal finance is difficult. Evidence is largely anecdotal or based on surveys made in limited segments of the economy. It seems that almost any Vietnamese, in the North and in the South, is familiar with the tradition of *huis* and can describe how the saving schemes have developed intricate methods to adapt to the inflation economy.[88] However, a survey among 1,000 households in Hanoi in 1991, revealed that although knowledge of informal finance was common, less than five percent of the households were engaged in *huis* or informal lending.[89] The frequency of *huis* might differ between regions. In the more monetized South, the system is possibly more common than in the North. In December 1991, I interviewed a woman who was the head of a number of *huis* in Ho Chi Minh City. She contended that the practice was well spread among the Vietnamese population. Some of her saving circles had been going since 1983. The participants would each contribute a weekly or monthly instalment, and they would bid for the joint lot by offering an interest rate. The person who had made the largest bid got the lot in the first round. The role of the *hui* head seems to be close to that of a more traditional moneylender. She is in control of the bids and can make extra profits from her information about the different bids. She has to closely screen the members, and ensure their instalments or else she needs to enforce the payments with what means she has available. The woman told me that she put away some 50 percent of the (considerable) profits she made from the circles to cover for losses, although she claimed that she was also cautious to select members who had a good reputation.

Regular money-lending also seems quite common - at least in the South - and can apparently be quite well organized. A Vietnamese magazine explored the phenomenon

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[86]Seibel (1992), p. 73.

[87]Ronnås (1992), pp. 121-122.

[88]Interviews in Ho Chi Minh City, and Hanoi in 1991; see also *Far Eastern Economic Review*, March 4, 1993.

[89]McCarty (1994), p. 33.

in late 1991. In several of the large markets in Ho Chi Minh City, the area was divided between different moneylenders. Some moneylenders were also shop-keepers, others were employed full time with moneylending. Physical appearance was important: by showing off wealth, the moneylender gained credibility and trust, and also advertised herself. The article from which this information originates is quite enthusiastic about this trade, not least because of the high and tax-free incomes.[90]

The conditions for professional money lending seem to vary. A very limited sample suggests certain regional differences. An observer in Hanoi claimed that extreme short-term credit - five to seven days - was during the period under study common at high interest rates. In late 1991, the rate was as much as ten percent per day (so called "hot credit - the inflation rate was around five to six percent per month at this time).[91] This rate was confirmed by a share-holding banker in Haiphong, while he claimed that long-term credit would be provided at an interest rate of 15-20 percent per month, and this finance would be exclusively given for trade purposes - the only business that could handle such high rates.[92] According to bankers in Danang, the interest rates charged in the "free market" were rather, in late 1991, some six to twelve percent per month. Lenders would be individuals with surpluses - possibly private entrepreneurs - and the purpose of borrowing was to engage in trading activities.[93] These rates roughly coincide with those reported from Ho Chi Minh City: loans in Vietnamese dong would normally cost between six and eight percent per month without collateral, and be relatively short term (maximum one month).[94] Hence, there is a possibility (which one would like to investigate rather than claim) that interest rates in the private market is higher in the North than in the South. This would not be totally impossible, given the higher degree of monetarization, and longer experience of business and conceivably a greater degree of competition in this field in the South.

Loans provided by enterprises and inter-enterprise lending is probably quite common, but the magnitude of this type of informal financing is - also - difficult to assess. A report on business and the monetary system in Ho Chi Minh City refers to the "public sector" where interest rates also vary "depending on the business contact and the affection of the directors. Popularly, the rates are equal to or 0.5-1%/month higher than the bank's rate".[95] Presumably, this paragraph refers to the lending by state enterprises - or state enterprise management - to other enterprises, beyond any formal control.

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[90]*Young Age Magazine*, Ho Chi Minh City, autumn 1991.

[91]CIEM in Hanoi, October 22 and 29, 1991.

[92]Maritime Bank in Haiphong, November 11, 1991.

[93]Danang National Bank in Danang, December 4, 1991.

[94]Document from the Market and Price Institute, Hanoi, 1992.

[95]Document from the Market and Price Institute, Hanoi, 1992.

As a source of capital for private enterprises, informal financial sources seem more important than formal credit. The survey of small scale enterprises from 1991, reveals that interest free loans from family and friends had contributed with five percent of the total initial capital in urban enterprises, while credit from private money lenders constituted 1.6 percent. Formal bank loans contributed with only 0.6 percent of total initial capital. By far the most important source was, however, own capital (75.9 percent), followed by workers' contributions (13.5 percent). In private and household enterprises in rural areas, the importance of informal sources was somewhat higher, according to the same survey: on average 7.5 percent of the capital were interest free loans, and 5.4 percent was provided by private money lenders (own capital consisted of 82 percent, bank loans contributed with 0.8 percent, while workers' contributions were insignificant).[96] Judging from these figures, informal finance obviously plays a role in financing production enterprises. However, informal finance, particularly in urban areas, is probably primarily geared towards trade and house-building.[97] Although no figures are available, it seems likely that the extensive smuggling of consumer goods into Vietnam - ranging from Chinese beer to Korean TV-sets - is partly financed by informal credit. People that I have asked have generally claimed that interest rates charged are too high for any other kind of business activity. Credit for consumption purposes is more likely to be provided by relatives and close friends.

In the rural areas informal credit is also used to improve housing facilities. Credit needs are moreover substantial for financing economic activities in the newly reestablished private farms. The old tradition of various village funds, seem largely gone, while *huis* prevail - at least to some extent. According to Vietnamese observers, it is more common in the North than in the South that people save in rice, and the *huis* can also consist of rice pooling.[98] Rice can also be the object for a kind of usurious trade. At harvest time, the rich lender will buy cheap rice, which he sells to poor peasants when their supply is running out towards the end of the season. Their only means of paying for this rice is thus to sell off in advance part of the next harvest.[99] In two surveys from 1990 and 1991, 40 to 94 percent of rural households received informal credit.[100] In another survey in 1992, 46 percent of households who had received credit during the last year, had made use of informal sources. The common average interest rate charged was six to seven percent per month.[101]

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[96]Ronnås (1992), p. 56 and p. 69.

[97]Tran Van Anh *et.al.* (1992) p. 26.

[98]CIEM in Hanoi, October 22 and 29, 1991.

[99]Institute of Economics in Hanoi, November 16, 1991.

[100]Seibel (1992) p. 72.

[101]Tran Van Anh *et.al.* (1992), pp. 10 and 26.

Informal money-lending builds on mutual trust and reputation. An underlying message when discussing impersonal credit relations (i.e. when the lender is not a relative) is that credit is expensive because the lender has to bear a considerable risk of default. The borrower, in his turn, often bears a definite risk of physical violence if defaulting: The "normal routine [which] is based on the confidence in each other and the application of 'Mafia rules'".[102] Long-term relationships are important to off-set these risks.[103] The woman in charge of *huis* in Ho Chi Minh City explained that she would have problems in terminating the saving circles, since the convention was that trustworthy clients would receive some sort of preferential treatment from the head. If the members had to enter new circles, they needed to establish their reputation all over again, which would take time and be costly to them. Thus, if the head wanted to close the circle, she would have to bribe her clients, or else they would insult her, do things to her, and make her lose face in public.

Formal and informal finance form a continuum of financial organizations. In a future Vietnam, perhaps money lending and wealthy peasants' small scale rural banking may grow into organized and larger scale activities, contributing to a more diversified and formalized financial sector. Prior to that day, financial intermediation in Vietnam suffers from short-comings in the formal system, currently dominated by the state banks.

3. The Agents' Views

What do agents in the state bank system believe are the main problems with Vietnamese banking? The following two chapters examine the short-comings in the banking system. The analysis makes extensive use of the interviews with the agents involved. As an introduction, this section summarizes the main points revealed in the interviews, divided into four categories: officials in the SBV, bankers in the state-owned commercial banks, bankers in the share-holding banks, and other Vietnamese and foreign observers. Some of the information supplied in these interviews has been used in the previous sections of this chapter. The purpose here is to give an overview of some general themes presented by these different groups. The methodological discussion in Chapter I highlighted some of the problems connected with gathering information from a fairly limited number of more or less official statements. This caution is worth repeating: I use the interviews along with other data as a source for propositions about the state of the Vietnamese banking system. The quality of these data in combination with my ability to use them determine the value of these propositions.

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[102]Tran Van Anh *et.al.* (1992), p. 26.

[103]See also *Far Eastern Economic Review*, September 2, 1992 on collapsing *huis*.

3.1 The SBV

At the head office of the SBV in Hanoi, interviews were made with people at some of the departments and sub-departments of the SBV.[104] The organizational structure of the central bank is not easy to understand, and in the period studied there definitely seemed to be some ambiguity in the areas of authority for the different departments and officials. Some activities were evidently overlapping, while some individuals and departments were more or less marginalized in the organization. The difficulties in penetrating the organization raises the question whether I have met with knowledgeable people in central positions in the SBV. This is difficult to know, but at least some of those that I have interviewed at the head office in Hanoi are surely important people - judging from the kind of information they provided me with, and judging from what other people told me. In Haiphong, Danang, and Ho Chi Minh City, I talked to directors or vice directors of the SBV branches in these cities.

I interviewed people in the SBV because they are key agents in the reform process. For the purpose of understanding the banking reform, I need to identify the specific role that the SBV plays in the financial system. But I also interviewed the SBV officials for the same reasons that I spoke to other observers of the Vietnamese economy and the banking system: to clarify specific questions about the banking system and the economy in general. Depending on the department visited, the discussions would, for example, focus on the structure of the financial system (at the Financial Institutions Department), the relevant banking legislation (at the Policies Division of the Economic Research Department), or the general economic and monetary development of the economy (at the Foreign Department and the Economic Planning Department). For this reason, the SBV interviews were not standardized. However, there were some issues which most of the SBV officials would discuss in one way or another.

The SBV officials would, like most other interviewees, express concern with the problematic interest rate structure. They also complained about the slow payment transfers in the country, the cash shortages, and other problems which made day to day banking difficult to pursue. The SBV interviewees discussed the problems of profitability of the commercial banks, and the still limited competition between banks. They would relate these problems to the difficulties in the state sector, where a large share of enterprises were close to bankruptcy, and they would often express a concern for the poor farmers. Many SBV officials thought the state-owned commercial banks were closer to the SBV than the share-holding banks, which, they complained, were much more difficult to monitor and control. On the other hand, the state-owned commercial

[104]Apart from one of the deputy governors, I met with people at the Monetary and Credit Institute, the Economic Planning Department, the Financial Institutions Department, the Foreign Department, the Credit Department, and the Policies Division of the Economic Research Department.

bankers had problems in understanding commercial banking, according to many of the SBV officials, who worried about the lack of banking skills in the staff: persons in high positions would not have the relevant training for the market system, while knowledgeable persons would be in positions with little authority. While the SBV officials made this remark with reference to the staff in the commercial banks, the problem is also likely to be relevant in the SBV itself. Many of the SBV officials emphasized the tension between the political leadership and the SBV management. The interest rate structure was an area of conflict, where banking considerations - essentially the necessity to maintain positive spreads and positive real interest rates - would go against more social considerations, important to the government.

3.2 The State-Owned Commercial Banks

Interviews in the state-owned commercial banks were made with directors or deputy directors in the head-offices and in the different branches.[105] The interviews would often begin with the bankers giving an account of recent developments in the banking system, starting with the abolishment of the "subsidy system" within the former monobank structure, the consequent split of the old State Bank, and the foundation of their particular bank. The bankers would explain that the new banking system was a two-level system. As for the economy as a whole, the subsidy system contained only two sectors (the state and the collective) but the entry of private enterprises and joint-ventures now transformed Vietnam into a multi-sector economy.

I used a questionnaire as a starting point for the discussion, which comprised two types of questions: one asked about quantitative data about banking activities, and the other asked for the general problems in the banking transformation process. As regards the latter matter there were two specific questions: 1) What did they see as the main problem in the transformation of the banking system? and 2) What was the main challenge for the respondent's bank in the future? Most of the bankers would list the three or four most urgent problems in their view. When the bankers then discussed quantitative data in more or less detail, this would lead to additional comments about problems, as well as a more detailed account of the banking activities as such. For example, when presenting figures about credit volumes, a banker could explain that the small share of credit to the private sector had to do with the risks involved in granting credit to private clients. Furthermore, when presenting figures about saving volumes, this would lead to questions and answers about the saving accounts, and other aspects

[105] I met with the head-offices of all the banks, their branches in Hanoi, Danang and Ho Chi Minh City, and also with one of the banks in Haiphong. On some occasions I met with managers of the department for foreign business relations - in particular in the banks visited in Ho Chi Minh City. At the head offices of the banks I interviewed the deputy directors.

of savings. The phrasing of the two questions gives room for responses which do not necessarily reveal the largest worries of the individual banks. Some bankers, in particular in the branch offices, would refer me to SBV officials for their views on the banking reform. At these times I explained that his or her particular view on these general issues was of interest to me. Some bankers found the second question partly overlapped the first. Most of the replies, however, connected the state of the banking system and the economy as a whole with the operations of the individual banks. The bankers seemed to understand that I approached them because I was interested in their particular bank.

Table 5.6 provides a list of problems which the bankers in the seventeen state-owned commercial banks reported. The problems are listed according to frequency, i.e. the number of bankers who, in the 1991-1992 period, reported each of these items as a concern. The list is prepared by reading through the interview typescripts and noting each type of topic mentioned by the banks. Some of the items are somewhat differently phrased by the individual banks, but are here gathered under one heading. The sample is small and the interview method does not guarantee, for example, that the most frequently mentioned problem is truly the dominating headache for the individual banker, nor that problems rarely or never mentioned are not of importance to many banks. The list is thus highly subjective. It indicates some of the worries among bankers, and should be viewed as a way to identify obstacles in the transformation process, which will be further scrutinized in the next chapters.

The inflation rate and the interest rate structure are the top items on the list. In late 1991 the monthly inflation rate was close to five percent, whereas, for example, the highest deposit rate for savings from the households was around three percent, and lending rates were, by November 1991, somewhere in that region. Real rates were thus largely negative, and the inflation rate was putting pressure on the banking system and the economy as a whole. The inflation rate being a main worry for thirteen of the bankers, along with a concern for the interest rate structure (stated by eleven of the respondents) which is hardly surprising. Bankers' problems with the interest rates were also due to the negative spread between deposit and lending rates (still partly prevailing at this point in time), and also, in a couple of instances, due to new and higher lending rates causing problems for the banks to find borrowers. Eleven bankers mentioned capital shortage as a problem. This is mostly stated as a general complaint, but sometimes bankers explicitly referred to lack of credit as well as difficulties in mobilizing funds. A fourth item on the list is the problem of unskilled staff, which nine bankers reported: the employees were not acquainted with the methods and requirements of commercial banking. Sometimes the bankers mentioned this in connection with the need of retraining, and specifically stressed the need of language skills. Some bankers associated the problem with the difficulties of understanding the market mechanism as

a whole. The problem of bad debt was reported by eight banks, although the way bankers discussed repayments varied a lot (which, like most of the other points on the list, will be further discussed in Chapters VI and VII).

Six respondents talked about shortcomings in the legal framework. The item includes complaints about problems of implementing the banking regulation, the lack of tax policies, and that bank reforms were not in phase with the economic reforms in general. Cash shortage and the poor functioning of the payment system were the concerns of five respondents each. Four bankers mentioned the problem of the foreign exchange rate, both with respect to mobilization difficulties and the fluctuations in the exchange rate, which caused uncertainty. One can add that in this period, the Vietnamese dong was rapidly depreciating, and this produced substantial repayment problems to clients borrowing foreign exchange.

Table 5.6: Problems of transformation reported in the state-owned commercial banks;

Type of problem:	Number of incidences:	of which in the head offices:	in the branches:	of which in the North:	in the South:
Inflation rate	13	4	9	3	6
Interest rate structure	11	4	7	3	4
Capital shortage	11	4	7	3	4
Untrained staff	9	3	6	2	4
Repayments, arrears	8	1	7	3	4
Lack of legal framework	6	1	5	3	2
Payments system	5	1	4	3	1
Cash shortage	5	3	2	1	1
Foreign exchange rate	4	1	3	1	2
Government interference	4	1	3	1	2
SOEs and farmers not surviving without subsidies	4	2	2	1	1
Lack of adequate information	4	1	3	1	2
Lack of computers, equipment	4	2	2	0	2
State-owned enterprises or farmers not repaying	3	1	2	2	1
Private enterprising risky	3	0	3	1	2
Macro-economic instability	3	0	3	2	1
Project evaluations difficult to perform	2	0	2	1	1
Lack of profitable projects, investments	2	2	0	0	0
SBV interference	2	1	1	0	1
Lack of confidence in banks	2	0	2	0	2
Cumbersome organization	2	1	1	1	0
Corruption	1	0	1	0	1
Head-office interference (out of 12 branches)	1	0	1	0	1

Total sample size: 17
of which
- head-offices 4
- branches 13
  of which
  - in the North 5
  - in the South 8

Four bankers stressed the problem of government interference in their activities. Likewise, four bankers mentioned that state-owned enterprises as well as farmers were dependent on subsidized credit. Arguably, this and other circumstances point to a dilemma for the banks, playing a double role in the economy - something which will be further discussed in the next chapters. By themselves, however, the statements merely indicate a general concern for the economy as a whole, thus responding to the question on the main problems during the banking transformation. Another four bankers considered the lack of adequate information systems, specifically accounting systems and financial statements, as an important obstacle, and four bankers referred to the lack of computers and other equipment as a hinder to efficient banking. Three bankers stressed that state-owned enterprises and farmers were unable to repay their loans - an item which could be seen to combine the general problem of repayments with the concern for the enterprises' and the farmers' repayment capacity. However, the repayment problems of the state-owned enterprises does not necessarily open the door for increased credit to the private sector: three bankers worried about the riskiness of the private sector. The problem of the macro-economic instability - not only with respect to the inflation rate but also the general development of the economy, and for example the lack of infrastructure - was mentioned by three bankers.

Further down on the list we find two bankers' remarks that project evaluations were problematical - an obstacle which presumably referred to the inferior access to adequate information, but also to the lack of skilled staff, as well as to the instabilities in the economic environment. This is possibly associated with the shortage of profitable projects, which two bankers mentioned. Other problems discussed were the interference of the SBV, the general lack of confidence in the banks, the cumbersome organizational structure of the bank, and the difficulties in overcoming this by reorganization. Finally, one banker mentioned corruption as a problem, and another branch manager head-office interference.

One may ask if at some point on this list major problems become minor problems. Is a problem less important because only one or a few bankers mentioned it? Once again: the list indicates a direction of inquiry. The table reveals problems and viewpoints from the bankers when explicitly asked about certain features of their banks. I cannot claim that a problem is insignificant because only one banker mentioned it. Rather, the fact that one banker stressed a particular obstacle, indicates that it is at least of some importance to some agents. For example (only) one banker discussed the problem of corruption. Based on this unique incidence, we could argue in several (dubious) ways. We could conclude that corruption is not important to the banks,

because only one banker in my sample said it was. Or we could say that it is of importance, because at least one banker thought so. We could also claim that corruption probably is very important in Vietnam, although these bankers - and banks in general - seemed not very involved or affected or concerned with it. Or we could even suggest that corruption must be important in Vietnam - "everybody" says it is - and bankers not mentioning it is just a sign that they were seriously corrupt themselves. All these statements are speculative. The small sample gives no justice to anyone of them. The most acceptable is to say that corruption was mentioned, which warrants a further investigation of the issue. Incidently, the extent of corruption in Vietnam is difficult to appraise. In Chapter VII the discussion will try to analyze the type of circumstances in the present institutional structure which give room for corruption, thus indicating the possibility of corruption in the Vietnamese banks.

Finally, I have tried to see if there are, in this small sample of seventeen banks, any important differences in problems reported between the four head-offices (all localized in Northern Hanoi), and the thirteen branches, or between the five branches in the North and the eight branches in the South. Generally, this subdivision shows that the problems divide themselves fairly proportionally between the different categories, although it is perhaps remarkable that only one head-office reported a concern with repayments. I choose not to dwell on this subject further, since I fear it merely assigns an exaggerated significance to the quantification of the interviews, without adding very much to the discussion.

3.3 Share-Holding Banks and Other Credit Organizations

The interviews in the share-holding banks and the other credit organizations were less systematized than those with the state-owned commercial banks. Altogether I made twelve interviews in these banks, ten of which in the 1991-1992 period. A questionnaire similar to the one given to the state-owned commercial banks preceded the visits to these banks in some cases. In other cases, the possibility of arranging an interview arose unexpectedly, and the interview had to be more or less improvised. It was not possible to obtain a complete list of the existing "private banks" - a common epithet for these organizations - from either the SBV department for financial institutions or with any other agent or organization. Hence the selection of the banks finally visited became quite arbitrary. In Ho Chi Minh City, I also visited a couple of small urban credit cooperatives, two out of very few survivors of the credit cooperative crash in 1990.

The size and type of activities in these banks vary. All of the banks visited had, however, a few common characteristics. They had come into existence because of the lack of capital and the short-comings of the state-owned commercial banks, which inhibited their specific interest group, irrespectively whether it was a group of state-owned enterprises in the shipping industry or the owners of petty shops in the local market. Hence they found it difficult to obtain funds for financing, or gain access to adequate financial services (like the possibility to deposit daily earnings, specifically relevant in the case of the clients of the urban credit cooperatives). Most of the bankers claimed that they could make use of specific skills, absent in the state-owned commercial banks: the share-holding banks were much more service oriented, and could more easily provide the necessary banking services. The banks - with staff previously employed in the type of industry which had founded the bank -also had the relevant business knowledge and could therefore better service and evaluate clients coming from this industry or trade. The banks would stress their advantage in being new and modern, when entering into the market economy, and they saw their independence *vis-à-vis* the SBV and the government as important. They would also, generally, emphasize how private banks could make a contribution to the development of the private sector - neglected they claimed by the state-owned banks. This statement was common, although many of these banks technically were - at least partly - state-owned through the state-owned owners (the founding enterprises). However, in several cases the banks primarily served clients from the state sector.

The private bankers also discussed a number of common problems in the banking system. Above all, the interest rate restrictions imposed on the banks obstructed their opportunitites to mobilize resources (since this was too expensive), and advance credit (because the banks could not charge the interest rates they wanted). Most of the bankers stressed the discriminatory treatment they received compared to the state-owned banks. The latter would, for example, obtain less expensive funds from the SBV. The share-holding bankers often mentioned the limited banking knowledge of the staff as a problem. In comparison to the state-owned commercial banks, the share-holding banks more frequently complained about the state-owned enterprises that failed to repay their debts and the associated problems of government interference and the lack of a legal framework to settle the problems. The share-holding bankers also talked about corruption on several occasions, and often mentioned lacking information systems as a problem. Finally, several share-holding bankers alluded to the credit cooperative crash in 1990, which - they claimed - had severely affected the psychology of the members of these cooperatives, and the public's general confidence in banking.

3.4 Other Observers

A fourth type of interviews were made with Vietnamese and foreign observers. This group includes Vietnamese scholars in various research institutes and ministries, and bankers in the joint-venture and foreign banks.[106] In addition, I made interviews and had conversations with other Vietnamese and foreign observers - consultants, businessmen and representatives of the larger aid associations (the IMF and the IBRD). The result of these interviews appear in various places in the text. Here I will only try to briefly summarize a few points on the state of the banking system made by the Vietnamese researchers and the foreign bankers.

Not surprisingly, most of the Vietnamese observers I spoke with would confirm that the banking system functioned poorly; the two-tier system, existing on paper, was still not a reality. The SBV was closely linked to the state-owned commercial banks, which were not very efficient. The interest rate structure was - naturally - a problem to the banks, but also the lack of competence, the lack of legal structure, and the high degree of specialization between the four dominating banks. "If a farmer plant a rubber tree, it will yield a return in ten years; the BIDV should then help to finance. But underneath the tree he can plant fast-growing peanuts, and ask for credit from the ABV. If he then wants to export the crop, he must contact the BFTV. This is not efficient", one observer explained.[107]

Several of the observers put the banking reforms into the larger context of economic reforms and the political climate. The state-owned banks' close linkage to the state enterprises meant that the banks would not change until enterprises had also undergone reform and become independent and profitable. The ambiguous attitude from the political leaders was also a reason behind the slowly changing banking methods. Certain politicians would only go half way with reform, for fear of losing power.

It is also worth noting that several (although not all) of the Vietnamese observers, and in particular those in policy making organizations, in the 1991-1992 period seemed fairly uninterested in the banking issue, and thus in my inquiry. This was probably

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[106]Among Vietnamese observers I met in Hanoi with people at research departments of the Central Institute of Economic Management (CIEM), the State Planning Committee (SPC), the Institute of Economics, the Institute of Market and Price, the National Economics University (NEU), and the Ministry of Finance. In Ho Chi Minh City I visited the Economics University, the Finance and Accounting College and the Banking College. I talked with people in the two joint-venture banks Indovina and VID Public Bank, and with bankers in BNP, Credit Lyonnais, and Standard Chartered Bank.

[107]Department of Banking at the NEU in Hanoi, November 14, 1991.

partly a selection problem: it was not always easy to know whether the people I met with were those who were most knowledgeable in my area. But I believe it was also a reflection of an attitude prevailing at this time: during the socialist era, the focus was on the real side of the economy, on the production units, the resource base and on technology. Banking was of minor importance. It was an accounting method, or control mechanism, which had little to do with the important decision making in the economy. This attitude persisted in the period of reform. The linkage between the agonizing capital shortages and lack of investments funds, and the obvious short-comings in the banking system was not obvious or important to many of those to whom I spoke.

Foreign bankers invariably reported on the lack of management knowledge in the banks, the problems with the poorly functioning payment system and the lack of adequate accounting principles and legal regulations. These bankers also emphasized the general Vietnamese distrust of banking, nourished by the Vietnamese bankers' failure to honor contracts. According to some foreign bankers, although predominantly a feature of the old system, this behavior persisted to a degree. One foreign banker gave the example of a Vietnamese share-holding bank which owed a comparatively small sum of money to the foreign bank in some trade transaction. The Vietnamese bank, when it failed to repay the sum in time, referred to the foreign bank as being so rich that it really did not need the money.

The foreign bankers also observed that the management capacity of the SBV was limited. The SBV should control the commercial banks, but had hardly the competence and resources for this task. This accounts for the hesitancy of the SBV towards the establishment of foreign banks. On the other hand, the government has largely supported the entry of foreign banks, hoping that this would be the key to an increased inflow of foreign investments. Although the foreign bank representatives I spoke to all wanted to be granted foreign bank branch licenses, they approved the SBV's cautious policy. The bankers also expressed their admiration of the hard working Vietnamese people, who were eager to learn and adapt. Perhaps somewhat overemphasizing the element of philanthropy in their mission, the bankers underlined that their presence in Vietnam at this stage was largely a matter of introducing new ideas and methods in the field of banking and business, in order to open up and expand the Vietnamese market. It is a fact that foreign banks have provided Vietnamese bankers with various seminars and short-term courses (and judging from what the Vietnamese bankers told me, participation in these seminars and courses was indeed very attractive).

4. Summary

Vietnam suffers from capital shortages, despite a probably considerable savings potential. The formal financial system is both shallow and narrow; the system hardly manages to mobilize saving into the banks, and lend this for productive investments. Cash transactions dominate. The perverse structure of the administered interest rates provides considerable disincentives for banks to act as a financial intermediary. However, there are probably additional reasons why banks are of little importance to the economy (which will be further explored in the subsequent chapters).

The 1987-1988 bank reform outlined the structure of a two-tier system with a central bank and commercial banks. The four so called state-owned commercial banks are still the dominant agents on the market, although they are facing increasing competition from more or less private share-holding banks and foreign bank branches. A specific feature of the Vietnamese financial sector is the existence of gold-shops, which constitutes a kind of semi-formal finance. Informal finance seems also to be of importance to the ordinary Vietnamese - for savings and small scale investments, as well as for risky short-term credit in the lucrative trade sector.

The chapter summarizes the main points presented in a number of interviews with four categories of respondents: SBV officials, bankers in the state-owned commercial banks, bankers in the share-holding banks, and Vietnamese and foreign observers. This fairly straight-forward reporting of what the bankers and observers said provides a background to the discussion in the two following chapters, which make extensive use of the interview statements. The analysis there will be structured around the different problems which seem to burden banking in Vietnam.

CHAPTER VI

BANKING IN THE EARLY 1990s: INTERMEDIATION AND PERFORMANCE

It is time to connect the Vietnamese case with the discussion in Chapters II and III. Chapter V showed how a commercial banking system in Vietnam is in its infancy. This chapter and Chapter VII examine the conditions for banking operations in the time period under study. A leading theme is how information exchange and incentives in the banking system are affected by the institutional structure. The analysis is guided by the approach outlined in Chapter II. More or less explicitly, the discussion examines how the agents (the banks, the bank clients, and the bank authorities) manage to coordinate their interests (i.e. how they manage to acquire, process, and exchange information), and how the given situation affects motivation (i.e. the possibilities to specify contracts, to observe and verify each other's characteristics and behavior, and to enforce the implicit or explicit agreements established). In more concrete terms, I discuss the various ways in which the Vietnamese banks are able or unable to mobilize resources and allocate credit. The current chapter includes quantitative measures of bank performance. It examines deposit mobilization and credit allocation, interest rates, the payment system, debt and repayments, and finally profitability and competition. The discussion in Chapter VII is broader and more qualitative.

The focus is on the state-owned commercial banks. In many respects they are relics of an ancient era, although they nonetheless dominate the scene. Other financial

intermediaries continuously enter and expand in the Vietnamese market. Whether the state banks will remain the leading agents as and if the country continues to develop in economic terms remains an open question. The concern of the present chapter is, however, how these banks, in this particular time period, manage to transform themselves from state bureaucracies to commercial banks, and accordingly how the banking system contributes to or frustrates financial intermediation. Each of the following sections deals with a particular feature of banking. Their titles indicate the main topic under consideration, but as one thing often leads to another, the discussion in one section often carries over to the next.

1. Resource Mobilization and Credit Allocation

Vietnam is financially shallow: A limited amount of saving moves through the financial system, and little credit is available for productive investments. Thus savers have difficulties in coordinating their needs with those of potential borrowers in the economy. Underlying this difficulty are coordination failures between the banks and the bank clients. In addition, there are motivation problems, which inhibit the agents' smooth interaction.

To understand why the banking system fails as an intermediary, we need first to explore the magnitude of the problem. Let us look at the general pattern, before discussing sources of funds as well as credit allocation in some more detail. Table 6.1 specifies credit and deposit volumes in the four state-owned and other banks in 1989 to 1994. The data come from various sources and are - as always - uncertain. The table illustrates, however, the dominance of the four state-owned commercial banks, i.e. the *Agricultural Bank of Vietnam* (ABV), the *Industrial and Commercial Bank of Vietnam* (ICBV), the *Bank for Foreign Trade of Vietnam* (BFTV), and the *Bank for Investment and Development of Vietnam* (BIDV). These four banks received on average some 90 percent of total deposits in years 1989-1994, and provided some 92.5 percent of total credit in the same period. Note, however, that the figure for "others" (i.e. mainly joint-stock banks and cooperative banks) is even more uncertain than those for the state-owned commercial banks. Nevertheless, the declining role of the share-holding banks after 1989 is probably valid. The state-owned banks held around 85 percent of total deposits in 1989. Between 1990 and 1993 this share rose however to above 90 percent. The positive real interest rates in 1989 caused an inflow of deposits into the banks. This did not persist throughout 1990 because of accelerating inflation and the credit cooperative crash. The general breakdown of the confidence in the banks following this episode probably hurt the share-holding banks in particular. The table illustrates the growth of deposit and credit volumes adjusted for the inflation rate. In real terms, both

deposit and credit volumes declined in 1990. The deposit volume did not recover until 1992, while the real credit volumes have grown ever since 1991.

As for the relative importance of the different state-owned commercial banks, the prominence of the BFTV is to a degree artificial. As mentioned in Chapter V, assets in the BFTV include part of the country's foreign exchange reserve which exaggerates the asset volume of this bank. So far, I have not obtained any comprehensible data which distinguishes between these foreign reserves and foreign assets that refer to the bank's own commercial activities. The insignificance of the BIDV is, on the other hand,

Table 6:1: Deposits and credit in the banking system, 1989-1994 (billion Vietnamese *dong*, end of year);

	1989	1990	1991	1992	1993	1994
Deposits:						
- ABV	807	1,104	1,449	2,131	3,258	4,274
- ICBV	1,185	1,901	[1]2,688	[2]4,000	5,485	7,832
- BFTV	3,080	4,642	6,926	10,391	8.368	9,055
- BIDV	194	134	291	547	842	779
- Others[2]	950	500	900	1,600	2,000	3,000
Total	6,216	8,281	12,254	18,669	19,953	24,940
(state-owned commercial banks' share of total deposits in percent)	(85)	(94)	(93)	(91)	(90)	(88)
Deposits in the banking system according to SBV	5,068	7,622	13,882	16,564	18,071	-
---						
Credit:						
- ABV	1,271	1,542	2,847	3,465	6,127	7,038
- ICBV	1,126	1,759	3,032	4,190	6,189	6,670
- BFTV	1,638	2,248	2,868	3,845	4,976	5,597
- BIDV	320	760	1,434	2,025	3,725	6,376
- Others[2]	400	250	500	1,200	2,000	3,000
Total	4,755	6,559	10,681	14,725	23,017	28,681
(state-owned commercial banks' share of total credit in percent)	(92)	(96)	(95)	(92)	(91)	(89)
Credit in the banking system, excl. gov. credit according to SBV	4,118	5,928	10,155	12,682	17,227	-
Credit in the banking system, excl. gov. credit according to IBRD (1995)	3,982	5,710	10,051	15,093	23,180	27,621
Credit on working and fixed capital according to a statistical publication[3]	3,353	4,463	9,009	36,483	-	-
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inflation adjusted total deposits (i)	6,216	4,941	4,367	5,659	5,743	6,274
(annual percentage change)		(-20.5)	(-11.6)	(29.6)	(1.5)	(9.2)
inflation adjusted total credit (ii)	4,755	3,764	3,806	4,464	6,625	7,215
(annual percentage change)		(-20.8)	(1.1)	(17.3)	(48.4)	(8.9)
(CPI, annual percentage change)	(34.7)	(67.4)	(67.6)	(17.6)	(5.3)	(14.4)

Notes: [1]September; [2]estimate; [3]Economy and Finance of Vietnam 1986-1992, Statistical Publishing House, 1994, tables 70 and 71;

Sources: 1989-1992: the banks' balance sheets of 1992; 1993-1994: SBV; estimates based on interviews, IBRD (1991), Dao Hung & Nguyen Huu Tai (1993);

also partly a delusion. Only deposits from enterprises and from households, and credit given on commercial terms are included in the table. This results in very limited deposit volumes, while the considerable direct state funding to the BIDV is excluded (but shown in Table 6.2 below). These provisions have increasingly been allocated as commercial credit; which explains the growth in credit volumes in the BIDV. Among the two remaining state-owned commercial banks, the ICBV has generally somewhat higher volumes than the ABV, although in 1989 and 1994, the ABV provided a larger volume of credit.[1]

1.1 Sources of Funds

In the period under consideration, the state-owned commercial banks used three main sources of funds: deposits from economic units (i.e. enterprises), savings from the population (i.e. households), and borrowing from the central bank, the *State Bank of Vietnam* (SBV). Recently, various types of bonds and bills have been introduced as new instruments of mobilization, issued both by the government, the SBV, and the commercial banks. Table 6.2 illustrates the degree to which the banks have depended on the first three sources, albeit data is not fully comparable between the banks.

Savings from the households predominate over deposits from economic units in the ABV and in the ICBV. The BFTV situation is more difficult to interpret: foreign currency deposits (the share which does not refer to government deposits) could partly be individual savings (since deposit accounts in foreign currency were permitted from 1991); probably, however, the bulk of such deposits comes from enterprises.[2] The BIDV data does not account for any savings mobilized from the population: deposits are only a small share of the bank's total resources, and SBV borrowing is even less

[1]The table uses a mix of sources: mainly the banks' own balance sheets (when available), but also interview statements, data from the SBV and other written sources. For a comparison, and to give an indication of the degree of shakiness in the data, the table gives the deposits in the banking system according to SBV data, and credit in the banking system according to SBV data, a World Bank report, and a statistical publication. The SBV figures are lower than mine (except for credit in 1991). The lower *deposit* volumes are conceivably due to the SBV's lower estimates of the deposit volumes in the banks beyond state-ownership. It is also possible that the SBV data deduct the foreign reserves held in the BFTV. The World Bank figures obviously originate from the SBV, although the credit volume deviates from the SBV figures in 1992 and 1993. The SBV made major revisions of their data on several occasions, which could explain why there are differences in the World Bank and the SBV figures. The statistical publication reports lower total *credit* throughout the period - except for 1992 which is most likely a misprint. Possibly these volumes of working and fixed capital (short-term and long-term credit) refer to credit allocated to the state sector exclusively, which thus partially explains the lower figures.

[2]Due to inconsistencies in the data it is hard to say anything about how proportions between individual and enterprise clients have changed in the BFTV. The BFTV was particularly secretive about any data in interviews in 1991 and 1992, while the situation and attitude was significantly altered in 1993 when, for example, a balance sheet was produced (which was however somewhat hard to understand).

significant. As mentioned above, the main source of funds in the BIDV is state budget funding.

Table 6.2 does not give any evidence that household savings made up an disproportionally small share of total deposits in the ABV and in the ICBV, or that the deposits of the economic units were comparatively insignificant - corresponding ratios in other countries vary depending on the type of financial system and other factors. Nevertheless, the banks' deposit volumes were altogether small throughout the period under study, compared to the total money supply in the economy (as discussed in Chapter V). Hence, the question is why the banks failed to mobilize resources to any greate degree. Which coordination difficulties and incentives have caused the relatively limited deposit volumes in the banks?

Table 6.2: Main sources of funds in the state-owned commercial banks, 1989-1992 (billion Vietnamese *dong*, end of year);

	1989		1990		1991		1992	
	bn VND	(percent)	bn VND	(percent)	bn VND	(percent)	bn VND	(percent)
ABV								
- deposits from economic units			268	(13)	412	(13)	616	(17)
- savings from the population			836	(40)	1,037	(32)	1,515	(42)
- SBV borrowing	766	?	984	(47)	1,792	(55)	1,507	(41)
ICBV								
- deposits from economic units			637	(23)	[1]781	(21)	-	-
- savings from the population			1,264	(46)	[1]1,907	(51)	-	-
- SBV borrowing	337	?	827	(30)	[1]1,087	(29)	-	-
BFTV								
- deposits from economic units in VND	277	(8)	454	(9)				
- foreign currency deposits	2,406	(69)	3,057	(60)				
- deposits for LCs	311	(9)	970	(19)				
- government deposits	81	(2)	179	(4)				
- due to customers					6,926	(58)	10,391	(78)
- current accounts					4,842	(40)	2,843	(21)
- SBV borrowing	404	(12)	426	(8)	187	(2)	129	(1)
BIDV								
- deposits from economic units	194	(10)	134	(5)	291	(7)	534	(7)
- funds from the state budget	1,594	(85)	2,510	(90)	3,753	(89)	6,508	(91)
- SBV borrowing	77	(5)	141	(5)	174	(4)	135	(2)

Note: [1]September

Sources: the banks balance sheets (1992); IBRD (1991); SBV;

Household and enterprise deposits

In most modern financial systems, banks treat all depositors roughly equally: regardless of whether you are an enterprise or a private person, you can keep your money in different types of accounts on different conditions, at your convenience. From

a macro perspective, there is nonetheless an important distinction between business and households: households are the net providers of financial resources, while the business sector (along with the government) is the net recipient of these resources. Both groups contribute to the total volume of deposits in the banks: households by keeping their net savings there, enterprises by parking their liquidity in the banks in between various transactions.

In Vietnam, the distinction between business and household deposits extends further. The two groups of clients are treated quite differently. Banks differentiate very carefully between deposits from economic units and saving from the population. Both groups may keep demand deposits (which may be withdrawn on demand), or time deposits (of three or six months) with the banks. Interest rates vary between the two types of depositors, however (further explored in section two below). The calculation and payment of interest rates also vary between demand and time deposits. Interest rates on demand deposits qualify for interest rate payments from the first day. The rules for time deposits are such that depositors who withdraw funds prematurely would receive no interest rate at all. Savers keep a savings book, which at each installment and withdrawal is signed and stamped by the bank office, and also registered in the bank office. Enterprise deposits are registered in the bank office as an account. Until September 1993, private companies were only allowed to keep time deposit accounts (not demand deposit accounts) with the banks.[3]

In the traditional socialist system, banks were not important to the individual citizen: "Not even the rich would deposit their money in the banks", a Vietnamese observer noted.[4] The increase in the real interest rates on households' time deposits in 1989, and the subsequent growth in the deposit volume, sent two messages to the Vietnamese banking authorities:[5] Firstly, interest rates matter - people respond to interest rate incentives. This idea seems to have been successfully transmitted - in fact there has been a tendency towards an exaggerated reliance on high interest rates as a means of absorbing liquidity, which has acted as a disincentive for the banks to mobilize such deposits. Secondly, there *are* financial resources in the population. The general evidence of domestic financial resources in developing countries, the discussion on the Vietnamese savings potential, and the existence of a well developed informal financial system support this idea. This message seems to have had greater difficulties in getting through. Looking at the situation from the bankers' perspective, it is easier to understand why. Household savings have made up an important share of deposits in

[3]*Far Eastern Economic Review*, 16 September, 1993.

[4]CIEM in Hanoi, October 22 and 29, 1991.

[5]"Banking authorities" vaguely consists of commercial banks and SBV management, and the various government ministers with command over the banking system.

the ABV and in the ICBV, but the overall size of these deposits was not impressive. Furthermore, the bankers probably knew that not all the household deposits really came from individual households. The difference in interest rates between households and economic units was quite dramatic; there were thus an incentive for the enterprises to disguise their liquidity as household deposits, which has also happened.[6] The extent to which this occurred is impossible to assess, although the likelihood of such behavior helps to explain why deposits in 1989 increased (in response to positive real interest rates), while most Vietnamese whom I encountered in 1991 and 1992 exclaimed that "nobody [i.e. no individual] wants to save in the banks!" If a substantial share of the allegedly household deposits really was cash from the enterprises, the Vietnamese could possibly remain generally skeptical towards banks, and there would still be an increase in household deposits. Consequently, if household deposits in the banks were really concealed enterprise deposits, the Vietnamese authorities would be right in not catching the message about considerable resources in the population.

Savings from the population

There is no reason to believe that all household savings were really disguised enterprise deposits. The high interest rates on household deposits must have also motivated individuals to put their money into the banks. However, the same high interest rates would discourage banks from accepting these deposits. Other institutional conditions inhibit both the coordination of savers and banks, and the motivation for them to seek each other's services.

The banks cannot formally deny people the opportunity to deposit money in the banks. However, there are circumstances which make depositing difficult. Among other things, it is a question of accessibility. For banks to be accessible, they need to be physically present. On the rural scene, where the majority of the Vietnamese live, the ABV is predominant. Beyond branches and sub-branches, the ABV keeps so called "saving tables": an officer from the local bank branch establishes a small temporary office in a village or a hamlet, where the villagers can deposit their money, and apply for credit. The ABV has continuously expanded activities and opened new branch offices. It is also heavily engaged in various rural credit projects with funding from foreign aid organizations. Still, reaching out to the large number of Vietnamese villages is a gigantic task which will not be completed overnight.

The physical presence of banks is less problematical in the urban areas. There are branch offices for all the state-owned commercial banks in the larger cities, and in the four cities where my interviews took place, there were also one or several share-

[6]Fforde (1993), p. 56.

holding banks present. The branch networks are also in the urban areas poorly developed. Banks are largely concentrated in certain central districts, and less accessible to potential clients in the suburbs. In the tourist centers of Hanoi and Ho Chi Minh City, banks in 1992 and 1993 opened small foreign exchange offices. Yet, the banks have a long way to go before they can match the frequency and the opening hours of the many gold shops, where foreign currency can be easily exchanged, and gold can be bought and sold.

Physical access to banks is a necessary but not sufficient condition for people to use the banks. Many Vietnamese observers reported on the problems depositors faced in their relationship to the banks. The rules surrounding deposit accounts - whether they are deposits from the enterprises or from individuals - has created tedious bureaucracy. Bureaucracy is a trademark of the socialist system. When private fortunes were banned, the origin of an individual's money had to be carefully investigated, or else it was assumed that the money had been earned illegitimately. These procedures for controlling deposits remained in the state-owned commercial banks in the 1991-1992 period, according to several Vietnamese observers. In addition, withdrawing funds was complicated; the clients had to carefully report on how the money was going to be spent etc. Up until 1991, the obstacles to the withdrawal of funds were related to severe cash shortages. As a by-product, bank deposits became unattractive. Irksome bureaucracy lives next door to corruption. Many banks regularly - contrary to rule and legislation - charged extra fees when customers wanted to withdraw their funds or cash cheques; five percent of the withdrawn sum was the common standard.[7] Apart from the disincentive to the acceptance of deposits created by interest rates, the prevailing cash shortages explain a discrepancy between the official policy of the banks and their actual functioning. The interviewed bankers often stressed that in the new system, in order to face competition, the banks must begin to provide attractive services. The bank staff, though, might have had little choice but to stick to old rules when there for example was no cash in the bank. While the management at the head offices and the branches assured that the banks were now performing their tasks differently, the behavior of their staffs lagged behind.

Apart from stressing the lack of motivation of the banks to the mobilization of expensive household saving, most bankers in the interviews also seemed to doubt the saving potential of the Vietnamese households. The bankers often explained that because Vietnam was a poor country, and the Vietnamese were poor, their ability to save and provide funds from their own sources was limited. An ABV banker at the head office claimed that "idle money in the population is not very plentiful", although he

[7]These fees were reported in informal conversations with Vietnamese observers, as well as discussed in the newspapers; see, for example, *Far Eastern Economic Review*, 1 July 1993.

recognized the necessity to change the interest rate structure in order to increase the attractiveness of depositing money in the bank. But deposits mobilized by the banks could only be one-third of capital sources for loans to farmers, the banker said.[8] "Low incomes make it difficult to mobilize savings from the people", a banker at the head office of the ICBV confirmed.[9] This view did not prevent the bankers from regarding the US dollars floating around in the economy as an important potential source of funds; an ICBV banker explained that the bank was prepared to start mobilizing US dollars from the population, as soon as all banks were permitted to open foreign deposit accounts.[10]

Indeed, the faith of bankers in the saving potential of the Vietnamese people appeared ambivalent. A general impression was that the interviewed bankers had problems in assimilating two different views on what was happening in Vietnam. On the one hand, the bankers were well aware of the dynamics created in the new market system, and the existence of considerable surpluses earned in various market activities: many people were making a lot of money; people had savings which they were presently busy putting into house constructions if they were not to be used for highly profitable trade transactions etc. Some bankers were probably personally involved in these kinds of activities. On the other hand, as bankers in the state bank system, they preserved the outlook on Vietnam as a poor country with no resources to mobilize. Since the state banks' main clients largely consisted of loss making state enterprises and deteriorating agricultural cooperatives, the banks were not wrong. Their main clients were fairly poor. Interest rates and other institutional features helped to preserve this structure, in which banks and state enterprises were forced to keep each other floating. The earnings generated by other segments of the population were not absorbed into the banks.

The propensity to save in banks also depends on confidence. Periods of dramatic inflation, along with the socialist system of meticulous control of the individual is not the best ground for cultivating confidence about the willingness of the banks to serve the people. Confidence increases with time-consistent rules and adequate enforcement mechanisms. Vietnamese rulers do not score very highly in these respects. Recent Vietnamese history is burdened by episodes of confiscation of private wealth, and the formal banking system has in many ways been an instrument of the Vietnamese rulers. Inflationary expectations and negative interest rates, the lack of an adequate payment system, and the fear of taxation, all add to the distrust in banks. Confidence in banks, weak as it has always been, was further hit by the credit cooperative crash in 1990.

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[8]Head office of ABV, January 3, 1992.

[9]Head office of ICBV, January 6, 1992.

[10]ICBV in Hanoi, November 22, 1991.

Money was lost in this crash, but also a general trust in banks, as reported by many observers.

SBV borrowing

In the monobank era, the role of the State Bank was to allocate government credit. Partly as a legacy of this tradition, SBV credit in the early 1990s constituted an important source of funds for all the banks. Probably an even more decisive reason for this borrowing was the low costs associated with this source of funds compared to deposits mobilized in the population. A Vietnamese observer noted that banks were profitable because they borrowed from the SBV to such a high degree.[11] A head office banker of the ABV explained that "Without borrowing from the SBV, we would be loss-making".[12] Many bankers claimed, however, that resources should be mobilized as deposits. "Our source of capital is deposits", an ICBV banker said.[13] Judging from Table 6.2 above, the SBV was up until 1991-1992 still providing large proportions of credit to the ABV and the ICBV (and to a lesser degree to the other two banks). Banks also deposited quite large volumes in the SBV. Hence, we need to assess the magnitude of the flows between the SBV and the commercial banks.

Table 6.3 shows the bank deposits in the SBV and total flows of credit from the SBV to the banking system as a whole for the 1988 to 1993 period. Despite the considerable reserves that are kept in the SBV, the SBV has provided the commercial banks with net funding throughout the period. Any trend regarding whether SBV credit is gaining or losing in importance over the period is not observable. The rate of 2.4 percent of credit measured as a share of GDP in 1993, after a reduction from 3.3 percent in 1991 to 1.4 percent in 1992, suggests that credit from the SBV remains an important source of funds to the banks. Table 6.3 also shows the credit flows from the SBV to the government. Although these flows have been substantial, their importance has gradually diminished. Measured as a share of GDP, the flow of credit to the government culminated in 1990 at a level of 9.4 percent. It has subsequently tapered off, down to 3.0 percent in 1993. This confirms that inflationary pressure in the early 1990s came from credit expansion in the banking system, parallel to a reduction of freshly printed money directly channelled into the state budget.

Banks are required to keep ten percent of their deposits in the form of non-interest bearing reserves in the SBV, and in addition the SBV receives extra reserves of some twenty percent. These extra reserves earn a low interest rate, and constitute in

[11]Department of Banking at the NEU in Hanoi, November 7, 1991.

[12]Head office of ABV, January 3, 1992.

[13]ICBV in Danang, December 3, 1991.

essence a liquidity requirement that act as a substitute for the lack of other supervisory tools.[14] Table 6.3 relates the required and extra reserves to the banks' total deposit volumes, and shows that neither the required nor the extra reserves kept in the SBV ever reached the stipulated levels. In none of the years, not even when the comparison is made with the SBV figures on deposit volumes,[15] have required reserves constituted ten percent of total deposits (they varied as much as between 0.7 and 7.0 percent). The extra reserves reached close to 20 percent in 1989 and 1990, but only between seven and twelve percent in the two following years. Taken together, however, the required and the extra reserves in each year exceeded the reserve requirement of ten percent with the exception of 1991, when severe cash shortages in the banks were also reported.

Since the reserve requirement is used as a monetary policy instrument, the fluctuations in the total reserve volumes are thus not necessarily problematic. Varying volumes of reserves in the commercial banking system could be in line with the desired monetary policy, although not in accordance with the stipulated level. The extra reserves would also appear to have substituted for the required reserves. Perhaps the

Table 6.3: Banks' deposits in the SBV and major recipients of SBV credit, 1988-1993 (billion Vietnamese *dong*, end of year);

	1988	1989	1990	1991	1992	1993
i) commercial banks' deposits in the SBV	370	1,056	2,069	1,125	3,427	3,540
of which						
required reserves	-	119	356	98	1,148	1,458
extra reserves	-	947	1,713	1,027	1,933	2,083
ii) SBV credit to the commercial banks	534	1,615	2,741	3,640	5,004	6,792
iii) net SBV credit to the banks (ii-i)	164	559	672	2,515	1,577	3,252
(iii as share of GDP)	(1.2)	(2.1)	(1.6)	(3.3)	(1.4)	(2.4)
iv) net SBV credit to the government (credit minus government deposits in the SBV)	669	2,428	3,958	3,904	4,547	4,025
(iv as share of GDP)	(5.0)	(9.1)	(9.4)	(5.1)	(4.1)	(3.0)
v) SBV credit to state enterprises	46	120	84	80	89	0
vi) total deposits in the banking system according to SBV (see Table 6.1)	-	5.068	7,622	13,882	16,305	18.071
(required reserves as percent of vi)		(2.3)	(4.7)	(0.7)	(7.0)	(8.0)
(extra reserves as percent of vi)		(18.7)	(22.5)	(7.4)	(11.8)	(11.5)
memorandum item: GDP	13,266	26,723	41,955	76,707	110,535	136,571

Source: SBV; GDP: IBRD (1995)

[14]IBRD (1993), p. 59.

[15]This being the lower deposit volume in Table 6.1 above.

banks managed to negotiate a smaller deposit of required reserves (earning no interest), against a larger volume of extra reserves (which do earn some - although low - interest). Perhaps it is just a question of highly misleading data. In any case, the required reserves have to be kept in the SBV at all times (contrary to practice in other countries). Hence we can at least exclude the possibility that we have accidently come across the data at a time when the banks are temporarily making use of their reserves in the SBV. Since the interest rate paid on the extra reserves is very low compared to the cost of these funds to the banks, the reserves constitute an additional tax on the banks (more about taxation in Section five below).

The pattern of net borrowing from the SBV varies between banks. Table 6.4 shows that the ABV was a net borrower from the SBV throughout the period - in this case 1989 to 1992. The ABV, which is the main provider of credit to the agricultural sector, has a larger share of individual clients (farmers) than the other banks. Many ABV bankers stressed that their clients were poor and incapable of savings - thus justifying the credit from the SBV. However, given the high proportion of household clients in the ABV (at least compared to the ICBV), along with high interest rates on savings, it would in any case be costly for the ABV to rely on their clients for deposits

Table 6.4: Credit and deposit flows between the banks and the SBV 1989-1992 (billion Vietnamese *dong*, end of year);

	1989	1990	09/1991	12/1991	1992
ABV:					
Deposits in the SBV (i)	278	609	274	345	556
Borrowing from SBV (ii)	[1]766	[2]1,329	2,011	1,792	1,507
Net SBV credit to the bank (ii-i)	488	720	1,737	1,447	951
ICBV:					
Deposits in the SBV (i)	406	499	446	-	-
Borrowing from SBV (ii)	[1]337	827	1,087	-	-
Net SBV credit to the bank (ii-i)	-69	228	641	-	-
BFTV:					
Deposits in the SBV (i)	225	529	311	-	-
Borrowing from SBV (ii)	404	427	277	187	129
Net SBV credit to the bank (ii-i)	179	-103	-34	-	-
BIDV:					
Deposits in the SBV (i)	161	303	394	411	715
Borrowing from SBV (ii)	77	141	196	174	135
Net SBV credit to the bank (ii-i)	-84	-162	-198	-237	-580

Total net SBV credit to the banks according to the above	514	683	2,146	-	-
Total net SBV credit to the banks according to SBV data	559	672	2,063	2,515	1,577

Notes: [1]SBV data, not reconcilable with annual reports or information provided by the banks - see further IBRD (1991) p. 28; [2]SBV data;

Sources: The banks' balance sheets; SBV; IBRD (1991);

(if the farmers were in fact capable of saving), and this motivates the extensive borrowing from the SBV. Next, the ICBV was in fact a net depositor with the SBV in 1989, although it became a net recipient of credit in the two following years (for which there is data). The reverse situation holds true for the BFTV: in 1989 it borrowed larger sums from the SBV thanit deposited with the bank. During the following two years, the BFTV kept more deposits in the SBV than it borrowed. Net deposits in the SBV would imply that banks could not advance loans for various reasons. The BIDV was throughout the period a net depositor with the SBV. However, given the substantial state funds provided to the BIDV, it is less strange that this bank had in each time period excess funds deposited in the SBV for future distribution to various investment projects.

The borrowing of commercial banks from the SBV was up until 1991 quite inexpensive and apparently generously provided.[16] Until 1991 the banks also deposited large volumes of funds in the SBV. It is not completely clear whether the considerable extra reserves were kept in the SBV only because the SBV so required, or if there were also motives for the banks to do so. If for various reasons the banks have problems in advancing credit, the expensive saving deposits would become less expensive for the banks when deposited against at least some interest rate in the SBV. These deposits were in all circumstances happily received by the SBV, since it helped to absorb some of the liquidity in the economy, thus reducing the inflationary pressure, while also stabilizing the banking system. Changes in the interest rates in late 1991 and in 1992, along with the tighter monetary policy, reduced the banks' incentives to deposit money in the SBV. On the credit side, a more "Western" refinancing system was introduced. Banks could obtain short-term funding credit (one to ten days) from the SBV at interest rates higher than the original loan contract for which the funding was required. At least until 1993 there was in addition a possibility of long-term funding which was apparently quite advantageous to the commercial banks. As well as a lender of last resort, the SBV was certainly one of first.[17] Several bankers claimed that in 1992 the system of borrowing money from the SBV had ceased, although Table 6.3 shows that credit from the SBV remained an important source of funds for the banks even in 1993.

[16]The interest rate for credit within quota was in 1990 (and possibly also in 1991) 1.5 percent per month, and beyond quota 2.4 percent per month. Bankers in the interviews in the fall of 1991 claimed the interest rate on credit from the SBV to be 1.8 percent.

[17]The banks received credit for 45-180 days at interest rates of 85-95 percent of the original loan contract, according to IBRD (1995), p. 29.

Bonds and bills

Before turning to the credit side of bank intermediation, a few words on a recent development in the financial market: the growing importance of bills, bonds and other securities. In late 1991, the Ministry of Finance began disbursing treasury bills, although only on an experimental level. The bills were issued at a rate of five percent per month in order to absorb cash holdings in the population and to help finance the budget deficit. Meanwhile, the commercial banks were limited to maximum interest rates of 3.5 percent per month on saving deposits. Bankers in regions where the introduction of the bills had begun, complained about their inability to compete with these bills.

In December 1991 the commercial banks also began on a limited scale to issue their own bonds in collaboration with enterprises in so called participation funds. The objective was to absorb excess liquidity from the enterprises by offering more attractive interest rates on these instruments than on ordinary enterprise deposit accounts. By 1993 the market had developed. The Treasury issued bills on short-, medium- and long-term, as well as gold-indexed and foreign exchange bonds. In addition, the SBV issued its own promissory notes - as a monetary instrument. The issue of Treasury and SBV securities did not seem however to be well coordinated. An SBV official complained about the Treasury being allowed to set their interest rates on bills freely, while the SBV promissory notes were subject to the interest rate regulation. Hence, the Treasury could always successfully compete with the SBV.[18] In all circumstances, securities of various kinds had, by 1993, become an important part of the domestically mobilized resources. Interest rates on these bonds were higher than those on deposits of the same maturity, as opposed to the practice prevailing in most other countries. In 1993 bankers also complained about the situation which made their own instruments of mobilization unattractive.

1.2 Credit Allocation

The purpose of commercial bank operations is to make active and independent decisions on credit allocation, based on profitability criteria and risk estimates. The problems of the Vietnamese banks when it comes to providing credit is a fundamental issue throughout this work. This section concentrates on how credit was allocated in the

[18]SBV official in Hanoi, December 11, 1993. There are many reasons why it is unfortunate to use two parallel systems of this kind: Central bank securities as a monetary instrument are a burden to the central bank, which might build up articifical financial deficits as it issues bonds to absorb excess liquidity in the economy. The competition between the Treasury and the SBV may furthermore endanger the consistency of monetary policy.

early 1990s, and discusses how information problems influence the banks in their role as lenders.

Table 6.5 gives an idea of credit disbursement in the four state-owned commercial banks for the years 1989 to 1993. The figures are incomplete, not fully comparable between banks, and possibly unreliable. Nevertheless, some basic features may be identified. The first is the strong focus on short term credit in the ABV and the ICBV (and the maturity of the BFTV loans is also predominantly short-term, although this does not show up in the table).[19] The concentration on short term credit is natural in light of the inflationary experience and the general uncertainty in the economy. There is probably also an element of tradition involved. The working capital provided by the socialist bank was short term in nature - it supplied the enterprises with liquidity for wage payments and purchases of input material from other enterprises (in accordance with the plan document). Longer term funds were allocated through other organizations, in Vietnam through the BIDV. It might seem paradoxical that the share of long-term credit from the BIDV, according to Table 6.5, *grew* from 37 percent in 1989 to 77 percent in 1993; this is however due to an increasing share of BIDV funds being allocated as commercial credit rather than as direct funding of various projects. The bankers confirmed the short-term focus on loans. As a banker at the ABV head office put it: "due to the lack of long-term and medium term credit, we consider ourselves a commercial bank, specializing in short-term credit".[20] The situation is however subject to gradual change. By 1993 the ABV and the ICBV had somewhat increased the proportion of long-term lending. The main element of long-term funding in most of the banks was foreign exchange lending.

The second main feature observable in Table 6.5 is the dominance of the state enterprises as clients to the banks. In the ICBV, around 90 percent of total credit went to state enterprises. In the BFTV and in the BIDV (although not shown in the table) state enterprises were almost completely predominant. In the ABV, the state sector played a somewhat less significant role, although in 1990-1991, the share was still close to 80 percent. Credit to households increased in the ABV, in particular between 1991 and 1992. In the ABV figures, 'households' are separated from 'private enterprises', which are instead gathered under the same heading as 'cooperatives', and 'joint-ventures'. The latter group reduced its share of credit in the 1990-92 period. This coincided with the general abolition of agricultural cooperatives. It could very well be that credit to cooperatives diminished while credit to private clients increased, but we do not really know.

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[19]Short-term credit means credit for three or six months.

[20]Head office of ABV, January 3, 1992.

In the ICBV and the BFTV there was hardly any increase in lending to the private (enterprise) sector between 1989 and 1991. The pattern changed in 1992 and in 1993. An ICBV banker explained in an interview in late 1993 that the state-owned enterprises received by that time only 36 percent of total outstanding loans, as compared to the situation in 1991 when these state enterprises received 70 percent.[21] These figures are not consistent with those in Table 6.5, which shows that the state enterprises received 92 percent of the ICBV credit in 1991 and 67 percent in 1993. However, even though the share of state enterprise loans in 1993 was higher than the 36 percent

Table 6.5: Major allocation of credit in the state-owned commercial banks, 1989-1993 (billion Vietnamese *dong* and percent);

	1989		1990		1991		1992		1993	
	bn VND	(%)	bn VND	(%)	bn VND	(%)	bn VND	(%)	bn VND	(%)
ABV										
Credit	1,271		1,542		2,847		3,456		6,127	
per maturity										
- short-term	1,197	(94)	1,436	(93)	2,714	(95)	3,292	(95)	5,117	(84)
- long-term	74	(6)	106	(7)	133	(5)	174	(5)	1,010	(16)
per ownership										
- state enterprises	-	-	1,203	(78)	2,204	(77)	1,809	(52)	1,950	(32)
- cooperatives, joint-ventures, private units	-	-	244	(16)	287	(10)	230	(7)	253	(4)
- households	-	-	95	(6)	356	(13)	1,417	(41)	3,924	(64)
ICBV										
Credit	1,126		1,759		3,032		4,190		6,189	
per maturity										
- short-term	1,103	(98)	1,653	(94)	2,908	(96)	3,915	(93)	5,420	(88)
- long-term	23	(2)	106	(6)	124	(4)	275	(7)	769	(12)
per ownership										
- state enterprises	{1,081	{(96)	1,601	(91)	2,797	(92)	3,600	(86)	4,140	(67)
- cooperatives			88	(5)	133	(4)	182	(4)	432	(7)
- private	45	(4)	70	(4)	102	(3)	408	(10)	1,617	(26)
per economic sector										
- industry, construction	405	(36)	563	(32)	939	(35)	-	-	-	-
- agriculture, forestry	45	(4)	88	(5)	107	(4)	-	-	-	-
- trading	507	(45)	791	(45)	1,261	(47)	-	-	-	-
- other	169	(15)	317	(18)	376	(14)	-	-	-	-
BFTV										
Credit	1,248		1,779		2,192		3,619		4,976	
per ownership										
- state enterprises	1,247	(>99)	1,772	(>99)	2,118	(97)	3,533	(<98)	4,665	(94)
- cooperatives	1	(<0.1)	2	(<0.2)	74	(3)	84	(2)	217	(4)
- private	0	(0)	5	(<0.3)	0	(0)	2	(<0.6)	94	(2)
BIDV										
Credit	321		731		1,422		2,024		3,725	
per maturity										
- short-term	202	(63)	294	(40)	370	(26)	499	(25)	873	(23)
- long-term	119	(37)	437	(60)	1,063	(74)	1,525	(75)	2,852	(77)
Development financing	1,325		2,276		3,547		5,352		-	

Sources: SBV; interviews in the banks; the banks' balance sheets (1992); IBRD (1991) and (1995);

[21]Head office of ICBV, December 11, 1993.

claimed by the banker, the reduced importance of state sector credit from the ICBV is indisputable, as is the growth in lending to the private sector, in particularly in 1993. In 1991, however, the ambition to treat "all kinds of ownership equal" was still only under consideration, as one banker pointed out.[22] A Vietnamese observer remarked that the responsibility of the state-owned commercial banks to provide credit to the private borrowers was not fulfilled; instead the state-owned enterprises received the credit.[23] In 1991 a large proportion of the state-enterprises credit remained subsidized.[24] All throughout the early 1990s, however, the banks were gradually phasing out the provision of subsidized credit to the state-sector.

As for the proportion of credit to different economic sectors, Table 6.5 only provides information about the situation in the ICBV in 1989-1991. In this bank, the proportions of credit to four different economic sectors - industry and construction, agriculture and forestry, trading, and other sectors - remained largely constant between 1989 and 1991. As could be expected from a bank of industry and commerce, the two principle sectors which received ICBV credit were industry and trade. Approximately about 35 and 45 percent respectively of the total credit volume went to the above two sectors. Due to the lack of aggregate information on credit disbursement to different economic sectors in the other banks, we must turn to the interviews to gain some insights into the pattern of credit in these banks. The most worthwhile information was gathered from the different branches of the ABV.[25]

In summary, the information provided by the four branches indicates the following general pattern in the ABV: in the 1989 to 1991 period, credit was advanced mainly to agriculture and the food industry. The comparatively large share of credit to the food industry diminished, however, by 1991 (coinciding with the overall decline of credit in state-owned enterprises in ABV, as shown in Table 6.5). More credit went to agriculture (i.e. not the food industry) in 1991 than in 1989 (presumably reflecting the increase in credit to households in Table 6.5) although the shares of credit to sectors such as industry, construction, and trade also grew, with variations in each of the four ABV bank branches visited (increases in "trading" were signficant in Ho Chi Minh City, while it was the construction and industry sectors which received increasing shares of credit in Hanoi, for example). There is a peculiarity in the data provided by the two southern branches - Danang and Ho Chi Minh City - in that they report a considerable decline in the share of credit to private households between 1989 and 1991 (strangely

[22]ABV in Hanoi, January 7, 1992.

[23]Institute of Economics in Hanoi, November 16, 1991.

[24]Around 80 percent of total bank credit, according to IBRD (1991), p. 84.

[25]ABV in Haiphong on November 12, 1991, in Danang on December 3, 1991, in Ho Chi Minh City on December 9, 1991, and in Hanoi on January 7, 1992.

enough included as yet another economic sector in these two banks). In Danang, credit to private units and individuals declined from 42 to 27 percent, and in Ho Chi Minh City from 41 to 15 percent. This does not fit with the aggregate trend in the ABV in Table 6.5, where household credit increased from six percent in 1990 to 13 percent in 1991. Either credit to households did actually diminish in the South (or at least in these two branches), while credit to private households grew in the other branches. Alternatively there is simply a mis-match in definitions and in the way credit allocation was categorized.

The interviews in the other state-owned banks' branches did not provide the basis for a similar analysis of their credit disbursement. This is also less relevant. In particular the BFTV concentrated on trade - on export and import enterprises (and then predominantly state-owned). The interviewed BFTV bankers often stressed their ambition, however, to reduce the proportion of credit to the state sector in the future. Nontheless, the figures from 1993 do not suggest that the proportion of credit to private borrowers had increased very much in the BFTV. Likewise, investment funds from the BIDV, while going to all kinds of economic activities, were very much a concern for the state sector alone.

The bankers talked about the general difficulties in finding interesting investment projects. An ABV banker explicitly said that his bank had concentrated on providing credit to the trade sector, since industrial and agricultural production was at a standstill.[26] Bankers also talked about gearing more credit to private enterprises and households - as part of their new role as commercial banks. Still, except from some expansion of the ABV credit to rural households, fairly little had happened even up until 1993. Despite the disincentives created by subsidized interest rates, the state-owned enterprises remained the main clients of the state-owned banks. The close bonds between the banks and the state sector are probably due both to the legacy of the socialist banking system, as well as the public ownership of the banks. Public ownership creates linkages between the state-owned enterprises, the government and the banks, which put the latter under more or less explicit pressure to keep servicing the state industry. Informally, both SBV officials and other observers confirmed this behavior, although the exact extent to which such pressure occurred is impossible to assess.

Borrowers and risks

Tradition and public ownership are not the only explanations behind the state sector domination. There are also features of the emerging private sector which make

[26]ABV in Ho Chi Minh City, December 9, 1991.

it difficult to coordinate their credit need with the lending capacity of the banks, and which provide disincentives for the two parties to seek each other out. The bankers often mentioned the riskiness in lending to the emerging private sector. Until 1992 private borrowers were charged higher interest rates than borrowers belonging to the state sector. The higher rates include a risk premium, although this may not have been sufficient to cover potential losses: when banks cannot fully appraise or monitor their clients, adverse selection and moral hazard make the banks reluctant to lend. The problems of bad debt and repayments are indeed a central feature for the Vietnamese banks. Section four below takes a closer look at the magnitude and effects of repayment problems and bad debt. Arrears arise partly because of inadequate enforcement possibilities, which, in turn, relate to the functioning of the legal framework (or the missing legal framework). We return to this in Chapter VII. Risks also depend on the banks' ability to acquire adequate information about potential clients or projects.[27]

Information problems in Vietnam have several causes. One is the short-comings of the infrastructure - of tele-communication networks, of postal services, as well as the lack of computers and other such technology in the banks. Several of the Vietnamese bankers stressed the lack of computers as a major problem. "We need at least three to four computers at each of our 500 branches", one ABV banker pointed out.[28] Like most developing countries, in this field Vietnam is a blend of several eras. While adequate infrastructure is often obsolete or absent, segments of the society are developing rapidly. Electronic equipment is increasingly available, mainly imported from not so distant Korea and Japan. The banking system is gradually computerized, which indeed means an improvement of administration, payment transfers and information exchange. Nevertheless, insufficient computer facilities are hardly the main source of information difficulties. Computers will not solve information problems without an accurate input.

There is an absence of appropriate and reliable accounting systems in Vietnam, as well as financial statements - with respect to both bank clients and the banks themselves. The banks have difficulties in evaluating loan applicants' capacity to honor a loan contract. Cost benefit analysis and project appraisals are new concepts in Vietnamese business. Moreover, data on which such analysis could be based is often lacking or misleading. Both the Vietnamese and the foreign bankers complained about the obsolete or missing accounting practices in the Vietnamese enterprises. Absent or misleading financial statements are also relevant problems in the banks themselves. My difficulties in obtaining proper data about the banks is a case in point. Both banks and

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[27]The focus is on information problems from the perspective of the banks. However, it should be noted that information and risk aspects work in two directions: Banks need information about clients and clients need information about banks.

[28]Head office of ABV, January 3, 1992.

enterprises have problems in producing and providing financial information for lack of competence. In the socialist system, the accounting methods and objectives were different. The plan documents focused on real output performance; financial flows were only oil to grease the production process. Financial measures such as profitabilty and rates of return were largely irrelevant to any decision making - the whole system was based on administered prices which did not reflect scarcities in the economy. The Vietnamese reform process has considerably altered this situation. However, there are still oceans of knowledge and practices to be introduced and assimilated regarding relevant methods for accountancy, auditing and analysis. Consequently, banks have problems in determining the feasibility of a potential project or making relevant comparisons between alternative projects.

Secrecy, particularly pronounced in the field of banking and finance, is another legacy of the the socialist system. Secrecy is a means of avoiding criticism. Revealed failure is bound to bring explicit or implicit demands for change, which might disrupt power. In contrast, the market system, without exaggerating its virtues, honors free information to a larger extent. Internal information needs to flow to make the organizational agents alert to the current performance, and external information - including auditing reports - must be available to create confidence among potential clients and financiers. Secrecy makes information a scarce resource, and scarce resources have a value. If access to previously hidden information becomes general, some agents may fear losing power and control. Their access to exclusive information had so far provided them with a merchandise which they could trade. Consequently, the desired information might not become immediately accessible when the banks (and the enterprises) become commercial entities.

In the absence of public and formalized information, informal knowledge, personal relationships and contacts become important. The banks obviously possess such information about their clients. A BFTV banker said that credit was granted based on the existence of import licenses, the client's past performance with the bank, and the potential market for the good.[29] One of the urban credit cooperatives described their method of evaluating borrowers: the cooperative staff would visit the applicant's stall in the market place and get an impression of his or her business; they would furthermore check with the management of the market and with the tax bureau to see whether the client had paid his fees and taxes or not.[30] An ABV banker in Ho Chi Minh City explained that a project evaluation consisted of verifying the legal state of the loan applicant, evaluating its financial standing and appraising the project proposal's profitability and technical feasibility. It happened, said this banker, that enterprises

[29]BFTV in Danang, December 4, 1991.

[30]Urban credit cooperative 1 in Ho Chi Minh City, December 16, 1991.

attempted to manipulate their financial statements. In that case the bank had several information sources at its disposal. The SBV was one reference, which presumably could give an account of the (state) enterprise's past performance. The banker also gave an example of a woman who wanted credit to develop a fish pond. Her sister in Chicago would send additional money for the investment, and photographs were shown of the pond. But the lady was a well known impostor and the pond turned out to belong to somebody else.[31] Apparently, the banks in various ways try to compensate for the lack of standardized and easily accessible information. Nevertheless, the difficulties in carrying out project evaluations were confirmed by many bankers. An ABV banker mentioned price changes, agricultural risks (such as climate problems), and lack of knowledge (about the clients and the market) as three reasons why it was hard to assess the creditworthiness of farmers.[32]

In a society with limited access to open and precise information, gossip and rumors become important. An example is the misfortune of one of the share-holding banks visited in northern Vietnam. The bank was in crisis because of a miscalculated investment project. The strenuous situation worsened, according to the banker herself, when rumors where spread that she had fled the country. People's confidence in the bank deteriorated, and depositors withdrew their funds. Clearly, the bank's trouble in the first place could certainly justify the distrust. The example gives, however, an insight into the kind of rumors circulating. It probably also shows that the public, in this period, was highly sensitive towards anything that pointed to banking failure, given the relatively recent experience of the credit cooperative collapse.

Secrecy is not total, though. Banks could be very open with certain types of information. When asked about the competition the banks were facing, many bankers stressed that the banks should compete but that they also should help each other. Different banks would talk to each other and exchange information about potential clients and projects. Foreign observers noted that this open attitude sometimes seemed too liberal; many of the banks would be so open with each other that they risked spreading exclusive information, which it would be in their commercial interest to keep secret. Information exchange in Vietnam also changes - previously top secret information is increasingly made public. The banks, when visited in 1991-1992, were often very reluctant to provide any kind of written information (although with differences between banks, and clearly less so in South Vietnam); in 1993, most of the banks eagerly provided me with annual reports and photocopies of documents.

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[31]ABV in Ho Chi Minh City, December 9, 1991.

[32]ABV in Hanoi, January 7, 1992.

1.3 Concluding Remarks

Both formal and informal constraints affect the ability and the willingness of the banks to function as financial intermediaries. Formally and informally the decentralization of the dominating state banks is still incomplete. Although separate units on paper, the banks are still closely linked to the central bank and the government, which influence banking activities. Moreover, legacies of the socialist system persist, which further emphasizes the state banks' position close to the state apparatus. Banks are solely the interest of a small segment of society. Credit to state enterprises is largely financed by cheap central bank funding. This creates disincentives for the banks to mobilize deposits on their own. Adding to this lack of motivation are the high costs for mobilizing household deposits, and a traditional view in which households are not supposed to have such resources. Although households would receive a fairly high return on their deposits in the banks, the banks' inaccessibility, the illegal fees charged, and the general lack of confidence in the banks motivate a skepticism towards the formal banking system from the part of the potential providers of financial resources.

The legacy of the socialist system affects information exchange. The difficulties in obtaining necessary and reliable information is a product of inadequate changes in the formal constraints (i.e. in the information systems and routines), and slowly changing informal constraints (the norms concerning which kind of information should be available to whom). The situation makes it difficult for the banks to coordinate their interests with those of new and unknown clients, and the information difficulties along with weak enforcement imply considerable risks for both parties. This, in turn, discourages the banks from seeking clients in the private sector. Confidence both in the private sector and in the banks is low.

On several occasions in this section awkward interest rates have been mentioned. The current interest rates constitute a formal constraint for the banks, central for their lack of motivation to behave in a commercially viable way. The reasons behind the structure of the interest rates will be further explored in the next section.

2. Interest Rates

A bank's business is to advance credit out of deposits, profiting from the interest rate difference between lending and saving. Interest rates provide the basic incentive for accepting and depositing funds in the banks, and advancing and borrowing credit. Interest rates are an incentive mechanism and thereby also a policy instrument. This is

a new concept in Vietnam. In the socialist banking system, interest rates played a subordinate role. Credit allocation was determined according to plan, and enterprise deposits were likewise a product of the planned credit flows. Since the bank belonged to the State and served as a passive accounting system, there was little reason why banks should make money on advancing credit. Meanwhile, the public's ability to save money and their willingness to do so in the bank was largely ignored, and there was limited recognition of the effect of interest rates on economic behavior.

As a result of the commercialization of the Vietnamese banking system, a new official objective was established in relation to interest rates. They would be set at a level which would allow the banks' costs for borrowing funds to break even with their incomes from lending.[33] In practice, for a number of reasons the interest rates prevailing have prevented the banks from immediately reaching this objective. Chapter V sketched the principle features of the Vietnamese interest rate structure, such as it appeared in the early 1990s. We also saw how most of the bankers interviewed - in the commercial banks and in the SBV - considered the interest rate structure to be an obstacle to efficient banking in the 1991-1992 period.

Table 6.6 shows a selection of different interest rates for deposits and credit between 1988 and 1993. Although summarizing a much more sophisticated spectrum of different rates, the table reveals the central predicaments. Given the inflation rate (indicated at the bottom of the table), interest rates have often (most of the time) been negative in real terms, and the spread between deposit and lending rates has also largely been negative until late 1991. Household deposit rates have been substantially higher than the deposit rates for commercial ("economic") units throughout the period, and on the lending side, there is a distinction between the government and the non-government sector (the latter type of borrower generally being charged higher interest rates) until 1992 (although there is no data for non-government credit rates until 1991). In late 1991 the spread became positive (on average) and in 1992 the differentiation between government and non-government borrowers (at least in principle) disappeared. From 1992 the real rates also became largely positive.

The rise in real interest rates on saving deposits in 1989 helped to absorb excess liquidity in the economy and contributed to a reduction in the surging inflation at that time. The rates were somewhat lowered in 1990, in a period when the inflation rate again increased. This situation prevailed until 1992: the rate of inflation (an average of four percent per month during the last six months of 1991) meant that the interest rates

[33]IBRD (1991) pp. 82-83.

were hardly positive in real terms. In November 1991 a major step was taken towards a "system of positive interest rates" (bankers and other Vietnamese observers often referred to this in the interviews in 1991 and 1992), implying a system with both positive real interest rates and a positive spread. The concept seemed relatively foreign to those elaborating on it, although the bankers were clear about the benefits: the banks would now be able to be profitable. As for real rates, monetary developments eventually brought interest rates above the inflation rate, at least from the fall of 1992. As for the positive spread, the new structure stipulated that the banks' earnings from lending would (on average) be higher than their costs for deposits, although several sectors of the economy remained subsidized through a low rate of interest. Only a few non-government borrowers (which was only a small fraction) were charged interest rates of four to six percent - a rate exceeding the maximum interest rate paid on time (three months or more) deposits by households.

The new interest rate structure, determined in mid-1992, stipulated that borrowers from the government and the non-government sectors would pay the same interest rate on credit (4.2 and 3.0 percent for short-term and long-term funding respectively) while

Table 6.6: Selected interest rates, 1988-1993 (percent per month);

	1988	1989	1989 Dec	1990 June	1990 Dec	1991 June	1991 Nov	1992 June	1992 Oct	1993 Apr	1993 Oct
I Deposits											
- demand											
- households	6.0	9.0	5.0	2.4	2.4	2.4	1.8	1.8	1.0	0.8	0.7
- economic units	0.9	1.8	1.8	0.9	0.9	0.9	1.0	1.0	0.3	0.1	0.1
- time											
- households	8.0	12.0	7.0	4.0	4.0	4.0	3.5	3.0	2.0	1.7	1.4-1.7
- economic units	-	-	3.0	1.8	1.8	1.8	2.1-2.4	2.1-2.4	1.5	1.0	0.8-1.0
II Credit											
- short term										1.5-2.3	1.5-2.1
- government sector	2.2-2.5	3.1-3.7	2.3-4.0	1.8-3.7	1.8-3.0	1.8-3.0	2.1-3.7	4.2	2.7		
- non-gov. sector						3.0-6.0	3.6-4.8	4.2	2.7		
- long term										1.5	1.2
- government sector							2.52	3.0	1.8		
- under state plan allocation		0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.7	0.7	
- non-government sector							3.6	3.0	1.8		
Monthly inflation rate[1]	14.5	3.6	1.4	2.6	6.2	4.9	4.0	2.1	0.2	0.4	0.4

Note: [1]Average monthly rate for first and second half year respectively, except 1988: full year monthly average.

Source: 1988 and 1989: Vietnam Economy 1986-1991, Statstical Publishing House, Hanoi 1992, p 110; December 1989 - 1993: SBV and interviews in Vietnam 1991, 1992 and 1993;

the deposit rates varied between 1.0 for economic units' demand deposits and 3.0 percent for households' time deposits. Thus the spread could never be negative for commercial bank lending. These interest rates were minimum levels for deposit rates, and maximum levels for lending, from which individual banks could supposedly deviate. A Vietnamese observer said, however, that while banking regulations stipulated that interest rates were only minimum and maximum rates, the governor in 1991 still set the rates for each region.[34] When returning to the bankers in late 1993, they claimed that the interest rate spread was no longer a problem to the banks. Note, however, that the interest rate on long-term credit had been reduced by October 1992. At least until late 1993 this rate remained lower than some of the deposits rates, which would provide incentives for the borrowers to redeposit these funds in the banks. Lak of confidence in the domestic currency has meant that people have turned to US dollars and gold for inflation hedging. These large holdings also relate to the difficulties in obtaining the necessary foreign currency in trade transactions. As shown in Chapter V, the volumes of foreign currency deposits as a share of total deposits have been substantial throughout the period. As early as 1988 export enterprises had been able to keep foreign currency deposits in the banks. In order to absorb more of the foreign currency floating around, enterprises as well as households were allowed in 1991 to open foreign currency accounts in the domestic banks.[35] Foreign currency deposits peaked in 1991, and constituted 41 percent of total liquidity.[36]

Generally, the bankers (predominantly in the BFTV) complained about the costs of these foreign currency deposits and the difficulties in investing the funds. The bankers differed somewhat on the level of interest rates, although the following pattern appeared to have emerged in late 1991 and early 1992: Vietnamese citizens and enterprises received a comparatively high interest rate on time deposits (an annual 9.6 percent on US dollar accounts was often reported), but only a limited amount of these deposits could be advanced as credit. The interest rate on foreign currency loans advanced by the Vietnamese banks was high - US dollar loans would cost eleven or twelve percent annually. Apart from the high rates, the bankers also expressed a reluctance to lend foreign currency domestically because of the high risks involved. The banks deposited the currency in the SBV, earning an annual 3.5 percent interest. Some

[34]Department of Banking at the NEU in Hanoi, November 7, 1991.

[35]Order No 330/CT and Decision no 337/HDBT by the Council of Minister; see Nguyen Duc Thao & Pham Dinh Thuong (1994), p. 61.

[36]Table 5.1.

bankers, though, claimed that the SBV would only accept a limited amount of the resources, and the banks had to place the money in other commercial banks.[37] Vietnamese observers remarked that the reserves which were invested internationally earned only some five to seven percent per year, thus causing significant interest rate losses to the banks.[38] In late 1992, however, Vietnamese observers claimed that the practice of borrowing foreign currency and then depositing this money in saving accounts was quite common. This arbitrage was possible because of the high real rates on domestic deposits, which in turn was a consequence of the administered interest rates, that failed to keep up with exchange rate changes.

Tedious bureaucracy involved in setting interest rates is one reason why the nominal rates have often been out of phase with inflationary levels, despite the increasing awareness that the level of real interest rates matters. Decisions on interest rates were determined by the SBV in intimate collaboration with the government, and then forwarded by official decrees from the governor. Furthermore, the complex system of interest rates reflects another feature of Vietnamese banking, central for an understanding of the prerequisites for the transformation process: the mix of social and commercial considerations. In the socialist system, the state held a total responsibility for both production and subsistence. In order to meet this responsibility the government and its agencies were to pursue an active and comprehensive social and industrial policy. When interest rates began to function as a relevant price, they also gained importance as an instrument in furthering this economic policy. This is evident in the way interest rates have been set both with respects to deposits and credit rates.

2.1 Deposit Rates

There are three reasons for the high interest rates paid on household deposits. First, high deposit rates mean that excess liquidity may be absorbed into the banking system, helping to control the money supply. Second, commercial banking implies that resources for credit advancement would be mobilized from depositors - with the help of sufficiently high interest rates. A third, less obvious reason, is that the Vietnamese authorities have viewed high interest rates as a means to give depositors an extra income: "Saving by the population should be a social policy. The interest rate has to

[37]This is somewhat unclear since it *was* a commercial bank - the BFTV - which handled part of the foreign currency reserve on behalf of the SBV at this time.

[38]CIEM in Hanoi, October 22 and 29, 1991.

be high to increase the income", an ABV banker explained.[39] Other bankers confirmed this statement. One banker said that bank savers were predominantly pensioners, who through their saving accounts received an extra income. A banker at the ABV head office remarked that traditionally "savings were a burden" to the banks.[40] An SBV official said, in 1993, that savings in the banks used to be a priority of the government for the purpose of ensuring the old people's welfare. Gradually, these rates must now fall.[41]

Because of this attitude to savers, one may assume that a reduction in the savings rate could be politically complicated. Enterprises, on the other hand, have been paid relatively low rates on their deposits. An argument in favor of such low rates was that enterprises would not be encouraged to keep excess reserves in the banks: "Enterprises should invest, not save", an SBV official explained.[42] By offering a meager return on deposits, it was hoped they would. A Vietnamese observer gave the example from the initial reforms, when deposit rates were drastically raised (in 1989): "People stayed at home. The enterprises thought of money, not of production."[43] The weapon to fight this undesired behavior has been low rates for enterprise deposits. Commercial units (largely the state-owned enterprises) were hardly compensated for the inflation rate on demand deposits at any time throughout the period. Only in 1992 did time deposits yield a positive real return.

The large differences in deposit interest rates mean that the banks, which have little incentive to mobilize deposits from the population, would be eager to receive the cheaper enterprise funds. An ABV banker stated that savings (i.e. from the population) was an expensive source of funds, and that his bank was concentrating on increased mobilization of enterprise deposits, primarily by improving services.[44] Yet the comparatively low return on these deposits meant that enterprises have been less motivated to deposit their funds with the banks. The low rates have instead encouraged lending between enterprises. In addition, as mentioned in the previous section, incentives are given to the enterprises to camouflage their deposits as household

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[39]ABV in Hanoi, January 7, 1992.

[40]Head office of ABV, December 11, 1993.

[41]SBV official in Hanoi, December 10, 1993.

[42]SBV official in Hanoi, December 11, 1993.

[43]Department of Banking at the NEU in Hanoi, October 23, 1991.

[44]ABV in Ho Chi Minh City, December 9, 1991.

savings.[45] The high cost of mobilizing funds from the population also motivates the banks to borrow from other sources, primarily the central bank.

Even with enterprise rates lower than rates for savings from the households, deposits in general proved costly to the banks. A Vietnamese observer noted that the extensive deposit mobilization in 1989 was not reallocated to profitable projects, and this produced losses for the banks.[46] For the share-holding banks, the high deposit rates limited their opportunities to expand banking activities, since they did not have access to state bank funding. In the fall of 1991, a share-holding banker in Haiphong explained that if his bank would be mobilizing resources through deposits it would go virtually (if not legally) bankrupt.[47]

2.2 Credit Rates

The interest rate data available can inevitably not be regarded as comprehensive. In Table 6.6 above, for example, it is quite possible that somewhat higher interest rates were charged from non-government borrowers prior to 1991, but I have no data on this - an omissuib which in itself indicates the insignificance of this type of borrower in the 1988-1990 period. Another thing is that long term lending was a matter solely for the BIDV, predominantly providing credit according to state plans, and charging low interest rates for this credit throughout the period. The decree on interest rates in November 1991 specified higher - more commercial - rates on long-term lending, enabling the BIDV to provide at least part of their credit on commercial conditions, and the opening up for long term funding from the other banks. As in the case of non-government credit, it is possible that a list of long-term rates for credit apart from the state-plan allocation existed prior to November 1991. However its absence in the data is a sign that such credit was viewed as insignificant and possibly non-existent.

The interest rate structure in Table 6.6 may mask further categories of interest rates for different economic sectors and regions. According to a Vietnamese observer, farms and family enterprises in the fertile Mekong delta were, for example, charged six percent per month in 1991: in the Red River delta and the central regions the rate was five percent, and in more mountainous areas in the North four percent, while ethnic minority villages in very mountainous regions were charged only three percent (still

[45]See also Dang Duc Dam *et.al.* (1991), p. 57.

[46]Department of Finance at the NEU in Hanoi, October 19, 1991.

[47]Maritime Bank in Haiphong, November 11, 1991.

quite high compared to the state enterprises).[48] The November 1991 decree on interest rates stipulated a general 15 percent reduction on interest rates on credit to production units in mountainous areas and islands, as well as in Khmer villages in the Mekong delta.[49] Moreover, the interest rates were perhaps not as uniform between banks as the decrees ruled. For example, the rates in the ABV were reported to be lower than those in the ICBV in 1991.[50] It is possible that the new 1992 rates were also subject to further differentiation, although the table claims that *all* short-term credit by June 1992 was charged 4.2 percent and *all* long term credit 3.0 percent.[51]

There is a category of short-term rates for credit to the government sector in Table 6.6. This summarizes three different headings found in published statistics for the 1988 to 1991 period. The highest interest rates were charged for credit going to "trade and tourism", the next highest for "industry and transportation" credit, while the lowest rates were charged for credit geared to "agriculture".[52] In turn, these categories are probably a condensation of different rates, similar or equivalent to those presented in Table 6.7 below, which shows different priority categories for interest rates up until 1991, and the different interest rates specified in the new structure from November 1991. Table 6.7 illustrates how interest rates have been used as a policy instrument. The lowest rate of 1.8 percent per month went to enterprises engaged in "technological improvements and rationalization of production". The middle categories comprise activities related to agriculture - such as foodstuffs, fertilizers, and forestry - as well as pharmaceutical production, teaching material, shipbuilding and machine tool industry. Less subsidized was credit to the transportation and postal services, as well as trading, tourism and services. Finally, there is a non-priority credit sector, to which credit to the private sector belongs, where interest rates were substantially higher.

The distinction between the government and the non-government sector remained after the new interest rate structure in the fall of 1991, probably reflecting a skepticism towards the private sector (partly due to the perceived and actual risks involved in

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[48]CIEM in Hanoi, October 22 and 29, 1991.

[49]SBV Decision no 202/NHQD, October 30, 1991.

[50]Department of Banking at the NEU in Hanoi, November 7, 1991.

[51]de Vylder & Fforde (1995) claim that the banks in the 1989-1991 period sometimes followed a "two-price system" when lending to state units. These could receive credit within a certain quota at the official rates, while credit beyond that was lent at rates close to those of the "free market". Although illegal, this behavior could have been instrumental in encouraging more commercial banking attitudes on the margin (p. 203).

[52]See for example *Vietnam Economy 1986-1991* (1992), p. 110.

lending to the unfamiliar private sector, mostly beyond state control, as discussed above). However the November 1991 interest rate regulation specified several non-government economic sectors. This seems to be a recognition of the private sector as a factor in the economy. Looking at the different economic activities listed in the table, some changes in the order of priority is observable. While educational material and various activities related to industry remain high on the list, agriculture is obviously considered to manage somewhat higher rates at this time. Export, import, and tourism remain the least favored priority sectors.

Although most bankers interviewed considered interest rates to be problematical, their interpretation of the problem varied. Many bankers in the state-owned commercial banks feared the consequences of changing the interest rate structure. An ABV banker emphasized that because of the low-profitability of farming, farmers could not pay

Table 6.7: Interest rates for various categories of loan-takers in 1991; percent per month

1.	Credit interest rates until November 1991:[1]		
	Priority:		
	I.	Technological improvements and rationalization of production	1.8
	II.	Food and food stuff trading, salt production an trading, books and teaching material distribution, fertilizer and pesticide production and trading, lending to economic units operating in remote and mountainous areas and islands.	2.1
	III.	Lending for medical and pharmaceutical production and trading, shipbuilding, and machine tool industry.	2.3
	IV.	Agriculture, forestry, fisheries, mining industry and construction.	2.4
	V.	Transport and post	2.7
	VI.	Trading, including imports and exports.	2.9
	VII.	Tourism and services.	3.0
	Non priority:		4.5
2.	Credit interest rates after November 1991 (until June 1992):[2]		
	Government sector:		
		Publishing enterprises, educational material	2.1
		Engineering enterprises, ship building	2.25
		Metallurgy, mining	2.4
		Fertilizers, pesticides, domestic foodgrains, assembly	2.7
		Export, import, commerce, material supply, construction, tourism and services	3.7
	Non-government sector:		
		Salt production and business	3.6
		Agriculture, industry, transportation, construction	4.0
		Commerce, tourism services	4.8
	Fixed capital in government sector:		2.52
	Fixed capital in non-government sector:		3.6

Sources: [1]Dang Duc Dam et.al. (1991), p.56; [2]SBV Decision no 202/NHQD, October 30, 1991

excessively high interest rates.[53] Another ABV banker confirmed that interest rates had to be changed gradually in order to allow the state-owned enterprises to survive.[54] An SBV official drew a similar conclusion: "It is difficult to change the interest rate structure", he said, "since only a few factories are making profits". The enterprises would have to pay the new interest rates, but the loss makers would still receive subsidized credit, he concluded.[55] Taking this social policy argument to its limit, another SBV official claimed that low interest rates were necessary in order to reduce starvation.[56] The bankers expressed concern about their ability to enforce the new rates and also talked about the consequences of the interest rate structure for the banks themselves, although they drew differing conclusions: "If we charge higher interest rates, nobody will be able to borrow", an ABV banker said, fearing to lose clients.[57] A banker at the BFTV head office complained that competition was impossible with interest rates determined by the SBV. However "changing interest rates is a major task", he explained: "It is difficult to change from negative to positive rates, since depositors want to make a lot of money, and borrowers want to pay a little".[58] An SBV official remarked, however, that the social issue and the issue of interest rates should not be confused.[59]

2.3 Concluding Remarks

Once again we see the interaction of formal and informal rules in confining financial intermediation. In the early 1990s, the administered interest rate structure (a product of the persisting linkages beween the banks and the bank authorities) constitute a firm formal constraint for the banks, which cause motivational problems. Low rates on credit to the state sector means that such credit is in high demand and must be rationed. The higher rates charged for loans to the private sector mean, on the other hand, that only relatively risky projects are able to pay these rates. Hence the banks

[53]ABV in Danang, December 3, 1991.

[54]ABV in Haiphong, November 12, 1991.

[55]SBV official in Danang, December 2, 1991.

[56]SBV official in Hanoi, September 28, 1991.

[57]Head office of ABV, January 3, 1992.

[58]Head office of BFTV, January 7, 1992.

[59]SBV in Hanoi, September 28, 1991.

have limited incentives to expand lending. Meanwhile, high deposit rates on household savings discourage banks to mobilize resources.

The structure of the interest rates is related to the prevailing norms. The ruling idea is that banks should be controlled by the authorities, which may thus pursue the social and industrial policies that are believed to be necessary. However, weak enforcement also motivates the strictly regulated interest rates. If interest rates were set free, banks may take on excessive risk while triggering the credit rates to unbearable levels. Enforcing repayments from defaulting borrowers would be difficult. From the point of view of the depositors, liberalized interest rates could also be costly if the banks were to set interest rates at levels that threatened the soundness of banking. In the event of a crisis the depositors would have problems in enforcing any deposit guarantee (the Vietnamese have indeed experienced the drawbacks of such liberalization in connection with the credit cooperative crash). Given the rudimentary state of banking at this time, it is perhaps not the administered interest rates as such which is the biggest problem, but the level of the different interest rates.

The deposit interest rates *are* high and would in principle encourage depositors to put their money in the banks. Apart from the general lack of confidence in banks, the poorly functioning payment system however discourages them from making such deposits.

3. The Payment System

Banks provide a payment mechanism, facilitating exchange in the economy, and are thus important coordinators of economic activity. Not only is the banking system the source of cash used in financial transactions, but checking accounts and clearing systems between banks also ease various payment transfers, thus reducing transaction costs and increasing efficiency. If the payment system functions, the public - and notably the business sector - will conduct their payment transfers through the banks; the deposit volumes in the banks will grow and banks will have more resources to advance as credit. The credibility of banks as reliable borrowers of people's savings is central to the maintenance of an efficient payment system. The Vietnamese payment system does not function in this ideal way. Individuals and organizations alike largely avoid the banks' payment services because they are slow, bureaucratic, and inflexible. Payments through the banks may also involve extra (often illegal) charges.

The interviewed bankers in the 1991-1992 period confirmed the problems of the payment system. A BIDV banker claimed that it would take about four to six days to

transfer payments from one enterprise to another. Even transfers between enterprises in the same city would require several days.[60] Transfers between different bank offices of the same bank was somewhat easier than transfers between different banks, an SBV official claimed, although the transfers were all the same slow.[61] The payment systems of the banks are of little use to individuals. They largely receive their wages in cash; transfers to and from the government (such as education fees and health charges, as well as pensions and child allowances etc.) are made directly through a number of tax departments headed by the Ministry of Finance at district and provincial levels (which also administer state lotteries - a fairly important source of revenue to the state). Other payments for public services (such as telephone, electricity, water etc.) are either paid to special collection offices or collected directly in people's homes. Inter-regional transfers of money between individuals are made predominantly through money orders via the post.

3.1 Reasons Behind the Weak Payment System

The poor performance of the payment system has several causes. Physical deficiencies contribute to slow transfers. The lack of communication infrastructure is important. Postal services are slow and the telephone network has severe limitations. The absence of a well functioning interbank clearing system also inhibits rapid transfers. Excess funds in one bank or one part of the country will thus not be transferred to other banks and regions which could make use of the money. Other mechanisms that were lacking in the early 1990s were giro systems to handle transfers between different organizations, and a Vietnamese connection to SWIFT, the telecommunication network for international payments.

More fundamentally, the payment system has functioned poorly because of the traditions inherited from an era where money and financial transactions had little relevance for the (official) activities in the economy. The banking system was not primarily organized to conduct rapid payments. The initial bank reforms worsened the situation. With the establishment of the two-tier banking system, enterprises were allowed to use cheques. Some enterprises abused the system by writing cheque in excess of the available funds. Lack of appropriate enforcement mechanisms, and the enterprises' influential contacts with powerful people, meant that they could successfully

[60]BIDV in Hanoi, January 3, 1992.

[61]SBV in Danang, December 2, 1991.

refuse to pay the banks, and the banks made losses. To curtail the abuse, the SBV restricted the use of enterprise cheque and interregional bank payments. Different SBV branches had to be involved in all the interbank transfers between provinces. As a result cheque transfers at this time could take up to six months. Consequently even state enterprises would increasingly rely on cash transfers for payments.[62] Stories were told in 1991 of trucks loaded with cash driving from Ho Chi Minh City to Hanoi to settle business deals. The inefficient system, along with the low trust in the domestic currency, contributes to the deteriorating confidence in the banking system. In turn, the lack of confidence reenforced inefficiency. There has been limited pressure on the banks to improve their payment services since nobody trust the banks anyway.

The transfer system in the early 1990s obviously needed reform. In mid-1991 a new cheque system was created, and other payment mechanisms were made eligible for enterprises.[63] Several different types of cheques were introduced - either local or national in terms of circulation. There are so called 'transfer cheques' and 'guaranteed cheques', which may be deducted from the buyers' account upon transfer or already upon the date of registration, whereas so called "quoted cheque books" [*sic*] may be sold directly to "risky clients who are not worth to a/c [account] transfer checks"[64] There are cash transfer cheques, and payments through authorization, i.e. money transfers through the banks. For international payments, the letter of credit remains the basic instrument. In the early 1990s, Vietnamese banks, and especially the BFTV, tried to rebuild their international reputation; the experience of international companies' and banks in the 1970s and 1980s was that they did not fulfill their payment obligations.

Cheques and other transfer procedures require a considerable amount of documentation. Given the experience of overdrafts, and the general riskiness of the Vietnamese business environment, it is not surprising that the banks try to limit their risk exposure. Yet the bureaucracy involved creates disincentives for clients to use the banking system. At least until 1992 a persistent cash shortage worsened the problem. As reported in Chapter V, cash shortages were mentioned as a problem by many bankers. The banks lacked cash, and were thus reluctant to provide clients with cash. If enterprises wanted to withdraw funds from their accounts, they were required to come up with confirmed specifications of the reason for the need of cash at this point etc.

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[62]IBRD (1991), p. 64.

[63]SBV decision no 101/NH QD, July 30, 1991.

[64]Nguyen Duc Thao & Pham Dinh Thuong (1994), p. 104.

The cash shortage was partly a result of monetary policy. The authorities (read the Council of Ministers) had in this period become aware of the relationship between monetary expansion and the inflation rate. The main policy instrument was - and still is - control of the money supply. An SBV official explained how the SBV forecasted the expansion in the money supply based on growth projections for the economy and the estimated volatility of money (in line with the quantity theory of money). When this forecast was presented to the government, it wanted to know how much of the planned monetary expansion referred to cash and how much was credit in the banks. The decision was then made to cut the cash expansion in half, i.e. restrict the SBV's issuance of currency, thus signalling a resolute and ambitious monetary policy. The result was a reluctance on part of the banks to pay out cash to their clients. In 1993 the bankers claimed that cash shortages were no longer a problem. Reports on current events in the banking system suggest, however, that there is a cash shortage in the economy due to the government's ambition to control inflation.[65]

Cash shortages and a powerful bureaucracy are prone to cause corruption. The pressure on the banks to hold on to cash opens up the possibility of discriminatory treatment of clients depending on their willingness to provide bribes to individual banking staff. Banking services in the shadow-land between legal and illegal procedures are reported by many people, and noted previously in this chapter. Slow payments may not only be due to inefficient administration. Observers claimed that individual bankers conducted private banking on the side. By borrowing money for a few days and lending it as "hot credit" on the private market, bankers could compensate themselves for their meager official wages.

The bankers in the interviews talked about the weaknesses in the payment system and the cash shortages. However the fact that the Vietnamese relied so heavily on cash transactions seemed to be less of a problem. This is related to the general impression (at least in the 1991-1992 period): that bankers did not seem to primarily think of a banking system as an infrastructure for the smooth operation of the economy, or as an intermediary for resources; banks were not believed to be the concern of ordinary people. "People have the cash habit", one banker put it. He complained about the cash dependency, though, because of the costs of keeping a large part of the staff busy in counting money.[66]

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[65]For example in *Far Eastern Economic Review*, August 25, 1994.

[66]ICBV in Ho Chi Minh City, December 11, 1991.

The costs of handling money arose because of low currency denominations. Due to periods of dramatic inflation, the highest note available until 1993 was 10,000 Vietnamese *dong*, equivalent to about one US dollar. The most common notes were however those of 2,000 and 5,000 Vietnamese *dong*. The low confidence in the currency (offset recentlly by steady improvements in inflation control) and the difficulties in dealing with the domestic currency has created a tendency towards dollarization of the economy. Banks are avoided due to tedious bureaucracy and illegal costs. The currency is avoided for the fear of returning inflation but also because it is such an impractical payment instrument. Measures have been taken to resolve the denomination problem. From late 1992 the banks offer a payment voucher as an additional instrument for transfers. These have a fixed denomination of 100,000, 500,000 or one million Vietnamese *dong*, and have a limited time period for circulation. The vouchers have apparently been quite well received, although enterprises have complained that the denominations are still too small (one million Vietnamese *dong* being equivalent to 100 US dollars), while farmers often find them too large. It has also been common albeit illegal practice to discount the face value of the voucher.[67] In 1993, a 50,000 Vietnamese *dong* note was introduced.

The payment system is a prime target for reform. It is however now gradually improving. Some of the worst examples of slow payments (for example, several months delay in inter-city cheque clearing) are gone. A new inter-bank clearing system has been introduced. Payments may take only half a day within a city and one day between cities. Payments to more remote areas could still take longer. If the pressure on the banking system grows, the present facilities for clearing might not be sufficient.[68] The innovative payment instruments also tend to be developed locally, such as the credit cards introduced in July 1993 by the BFTV in Ho Chi Minh City. By December 1993 they had been was accepted as a payment instrument by some 100 shops in the city.

The dollarization of the economy is also being dealt with - more or less successfully. As early as 1991 clients were allowed to open foreign exchange accounts in the banks in order to absorb some of the foreign currency circulating in the economy. In late 1994 the government banned the general circulation of US dollars. All foreign currency earned must be deposited in the banks, and all payments must be made in Vietnamese *dong*. Reducing the use of US dollars would undoubtedly be beneficial to the Vietnamese economy, but it is questionable whether the authorities could actually

[67]ICM/Crown (1993), p. 14.

[68]IBRD (1993), p. 61.

enforce the new regulation. The introduction of these kinds of authoritarian rules may also negatively affect confidence in the economic reform process, especially from the standpoint of foreign investors.[69]

Which ever way the government turns, it faces credibility problems. Making the Vietnamese *dong* a more attractive currency in transactions, requires either a currency reform (where, for example, 1,000 Vietnamese *dong* becomes equal to one new Vietnamese *dong*) or the introduction of additional notes of higher denomination. If such measures are taken, the public might fear that old notes in their possession will be worthless (or perhaps costly to exchange). This is something of which the Vietnamese have fairly recent experience. During the currency reform in 1985, only a limited amount of old notes could be exchanged for new ones, while the rest had to be deposited in the banks. People thus increasingly fled to foreign currency and gold.[70]

3.2 Concluding Remarks

In socialist Vietnam, the banking system was a control mechanism for the real economy rather than an efficiency enhancing motor for economic interaction. This tradition has inhibited the smooth coordination of payment transactions. The payment system has also worked poorly because of inadequate infrastructure, and a weak confidence in the domestic currency and in the banks.

The institutions that have created these problems are under constant revision, although this has not always led to improved payment facilities. The increased reliance on markets brought about a need for cheque payments, although the abuse of the new system forced forth the introduction of stricter and time-consuming control, and accordingly more cash reliance. The market economy required a new type of monetary policy. The government interpreted this to mean a firm control of the cash supply, which has brought about additional cash shortages. Hence the banks were encouraged to hold on to cash, which meant that they were not offering an attractive service to their clients. The confidence in banking, including its payment services deteriorated. These problems reenforce each other. When the banks are not trusted, the banks have less motive to improve their payment efficiency.

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[69]See *Far Eastern Economic Review*, August 25, 1994, and *Financial Times*, October 12, 1994.

[70]Tran Hoang Kim (1992), p. 37.

4. Debt and Repayments

The Vietnamese state banks are in many ways products of the past. We have already touched upon the socialist legacy with respect to dominance of the state sector dominance, interest rates, and the deficiencies in the payment system. Another central characteristic is the heritage of bad debt. Upon formation, each new state-owned bank took over a share of the asset portfolio from the old State Bank. A large proportion of these assets were loans made to loss-making state enterprises, incapable of servicing their debt; it may very well be that these banks were insolvent from the outset.[71]

The debt problem has been further aggravated by the state enterprises' continuous arrears to the reorganized banks. In order to maintain production, the banks have, for various reasons, softened the budget constraints of the state enterprises by bailing them out with additional, subsidized - and often unrecoverable - credit. Some of the state-owned enterprises have, moreover, ceased their operations. They have been liquidated and the work force expelled. Credit to these enterprises has been lost. In addition, bad debts in the banks relate to inter-enterprise debt, which to a large extent is a consequence of insufficient banking services and an inadequate payment system. When enterprises have problems in receiving short-term credit or using the banks for payment transactions, they increasingly rely on bilateral debit and credit arrangements. One enterprise's failure to fulfil its payment obligations thereby causes domino-like effects in several enterprises, when these in turn become unable to service their debts to other enterprises and banks. The debt problem becomes important for an understanding of the banks' motivation, or lack of motivation, to advance credit.

4.1 The Magnitude of Bad Debt

In order to evaluate the extent to which debt and repayment problems influence the state banks in the transition, we need, first of all, to assess the magnitude of the phenomenon. As in previous sections of this chapter, we begin by looking at the few figures available, predominantly SBV data and figures reported by the World Bank. The state-enterprises have by far been the the most important clients to the state-owned commercial banks. It is the state-enterprise debt situation which determines the portfolio quality of the banks. A recent World Bank study concluded that "although in any transitional economy it is difficult to determine accurately the extent of bad debts, it

[71]Pointed out by IBRD (1991), p. 31.

seems clear that they [in Vietnam] are on a far smaller scale than in other transition economies."[72] The major reason for this is that the industry - and thus the state-owned enterprises - overall constitute a relatively small sector in Vietnam, compared to other transforming countries. Moreover, Vietnamese state-owned enterprises have apparently been more disciplined at the firm level, where wages, for example, have been fairly closely tied to performance indicators etc. Thus, arrears have not accumulated to the same extent as in several other transition economies.[73]

The World Bank study draws on the findings of the so called *National Debt Resolution Committee* which was formed in March 1991 and dealt not only with the banks' share of bad debt from state enterprises, but with all interfirm credit in Vietnam. The committee estimated the amount of interfirm credit in relation to the large proportion of state-owned enterprises that were still in operation in June 1991.[74] Total gross debt was about 9,000 billion Vietnamese *dong*, or approximately 13 percent of GDP.[75] Some 2,500 billion Vietnamese *dong* of this debt was cleared. The net "hole" of unrecoverable debt was estimated at about 3,000 billion Vietnamese *dong*, of which more than 1,000 billion Vietnamese *dong* was owed to the banks in mid-1991. By 1991, this unrecoverable credit constituted around eleven percent of the total outstanding loans in the banking system.[76]

As showin in Table 6.8 the total volume of bad debt among the state-owned commercial banks in 1991 was, according to data obtained from the SBV in early 1992, 1,118 billion Vietnamese *dong*, or around 10.5 percent of total credit in 1991 (the numbers refer to principal only). The World Bank and the SBV thus agree on this rough

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[72]IBRD (1993), p. 60.

[73]Net interfirm credit and bad debt in the banking system is roughly estimated to be around five percent of GDP, compared to some 25 percent in for example Russia and Romania, according to IBRD (1993), p. 12.

[74]The *Debt Resolution Committee* surveyed about 10,000 out of a total of 12,000 enterprises; the committee members claimed that the sample included the biggest debtors; see IBRD (1993), p. 61.

[75]According to IBRD (1993) p. 61, total gross debt of 9 trillion *dong* represents nine percent of GDP. However their own (low) estimate of GDP in 1991 was 69,959 billion Vietnamese *dong* (p. 235). 9,000 as a share of 69,959 is almost 13 percent.

[76]In Table 6.1, total credit in 1991 was 10,681 billion Vietnamese *dong*, which refers to the *end of the year*, while the unrecoverable debt figure in the text refers to the *mid-year*. 1,000 billion dong constitute 9.3 percent of 10,681 billion dong. However, total credit in the banking system in *September* 1991 was about 8,800 billion Vietnamese *dong* (according to SBV data), of which 1,000 billion Vietnamese *dong* constitute around 11.3 percent. No figures are particularly exact, and the purpose is to indicate the magnitude of the bad debt problem.

number, a possible explanation being that the National Debt Resolution Committee fetched its estimate of unrecoverable bank debt from the SBV. A more recent World Bank study claims that the percentage of overdue loans as a share ot total loans in 1991

Table 6.8: Volume of bad debt by different causes; total and in each state-owned commercial bank in September 1991 (billion Vietnamese *dong* and percent);

	ABV		ICBV		BFTV		BIDV		TOTAL	
	i)	ii)	i)	ii)	i)	ii)	i)	ii)	i)	iii)
a) State-owned enterprises; liquidated:	311.1	(50.6)	148.6	(39.3)	24.2	(42.6)	13.2	(19.1)	497.1	(44.4)
b) State-owned enterprises; ceased operations; renegotiation:	112.7	(18.3)	189.8	(50.2)	32.6	(57.4)	26,8	(40.3)	362.2	(32.4)
c) Collapsed cooperatives:	151.2	(24.6)	-	(-)	-	(-)	-	(-)	151.2	(13.5)
d) Private economic units:	39.9	(6.5)	36.1	(9.5)	-	(-)	24.8	(36.0)	100.8	(9.0)
e) Natural damages (storms, floods etc):	-	(-)	3.5	(0.9)	-	(-)	3.2	(4.6)	6.7	(0.6)
Total volume of bad debt	614.9		378.0		56.8		69.0		1,118.6	
- percent of total credit in the banking system according to Table 6.1:		(5.8)		(3.5)		(0.5)		(0.6)		(10.5)
- percent of each bank's total credit according to Table 6.1:		(21.6)		(12.6)		(2.0)		(4.8)		

1991: Overdue loans as percent of total credit in each bank in 1991 according to other SBV data and Table 6.1:		(24.6)		(15.7)		(3.7)		(8.0)		(12.6)
1990: Overdue loans as percent of total credit in each bank in 1990 according to other SBV data and Table 6.1:		(41.5)		(12.6)		(4.5)		(7.8%)		(16.2)

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i) = billion Vietnamese *dong*;
ii) = percent of total bad debt in each bank
iii) = percent of total bad debt in all four banks;

Source: SBV

was 20 percent (a figure which by 1994 had fallen to twelve percent).[77] Some of the overdue loans may be recoverable, so eleven percent of (bad) unrecoverable debt may not be inconsistent with twenty percent of overdue loans in 1991. Other SBV data claim, however, that overdue loans amounted to 1,343 billion Vietnamese *dong* by 1991 or only some 12.6 percent of total credit (as shown in Table 6.8).[78]

To sum up, the bad debt figures are uncertain, although they may provide an indication of the magnitude of the problem: bad debt in the state-owned banks was in the region of ten to twenty percent of total outstanding credit in 1991, but has probably subsequently fallen. One may add that the way in which bad debt is calculated does not accord with international accounting standards. The latest World Bank study claims that if such measures were used, non-performing assets would perhaps amount to some 25 percent of outstanding loans, or twice the capital and reserves of the banks.[79]

Table 6.8 shows not only the total figure for bad debt, but also indicates how bad debt was distributed between the different state-owned commercial banks in 1991. Overall, the ABV had a heavier burden of bad debt (some 21 percent of the bank's total outstanding credit) than the ICBV (with around twelve percent of total credit being unrecoverable). In the BIDV, the figure was close to five percent, while only two percent of credit in the BFTV was reported unrecoverable. This is a small figure, not least compared to reports on the BFTV's considerable repayment problems to foreign creditors, and BFTV losses due to exchange rate developments.

Looking at the causes behind repayment problems, the main reasons for unrecoverable debt in the state-owned commercial banks in 1991 was, firstly, that state-enterprises had been liquidated, i.e. the enterprises had been dissolved or merged with others.[80] Secondly, some state-enterprises had ceased operations but were involved in some kind of renegotiation with the authorities, including the full or partial cancellation of old debts. These two causes dominated the bad debt burden of all the individual banks. According to Table 6.8 they were the only reasons for bad debt in the BFTV, while they accounted for close to 90 percent in the ICBV, and around 60 and

[77]IBRD (1995), p. 19.

[78]This is also principal only: if overdue interest payments are included, total overdue loans may have amounted to as much as 20 percent of outstanding credit.

[79]IBRD (1995), p. vii.

[80]The background to and procedure of state-enterprises' liquidation is further discussed in Chapter VII.

70 percent respectively in the BIDV and the ABV. The ABV had also lost money because cooperatives had collapsed, due to the changes in the agricultural sector.[81]

From Chapter V, we know that the bankers in the state-owned commercial banks did frequently mention repayments and arrears as a problem. Nevertheless, the interviewed bankers did not often seem overly worried. A banker in one of the ABV branches claimed that the repayment quota was 102 percent, since late payments were included in the present payment volume.[82] An ICBV head office banker said that repayments were not a major problem. Bad loans constituted only ten percent of total overdue loans, and only 0.2-1.5 percent of outstanding credit.[83] Likewise, the ICBV Hanoi branch claimed a comparatively small share of unrecoverable debt: one third of total overdue debt or only about two to three percent of outstanding debt.[84] These figures are much lower than the bad debt proportion of 12.6 percent of total credit in the ICBV, reported in Table 6.8. Nevertheless many bankers admitted to the problems of unrecoverable debt.

The ICBV banker in Ho Chi Minh City explained that the bank was thinking of starting a department for real estate, in order to handle all the buildings that it had recovered as collateral, when borrowers had defaulted.[85] The banker at the ABV head office stressed that losses due to loss-making state-owned enterprises was the most urgent problem for the bank.[86] The interviewed bankers in the BFTV indicated that the bad debt problem was significant. The representative at the head office said that arrears amounted to some 40 percent of total credit.[87] The banker in the Danang

[81]According to Table 6.8 only the ICBV and the BIDV had problems related to natural damages. BIDV credit, which goes largely to infrastructural investments, could quite possibly be jeopardized by frequent periods of bad weather. Similarly, since a small share (six percent) of the ICBV credit was also long-term, this could partly explain why this bank was hit by natural catastrophes. What is more surprising is that the ABV has no records on the underlying causes behind the repayment problems: floods and typhoons are obvious threats to agricultural production, and every year there are reports on damaging monsoons in some part of the country; accordingly, the ABV in Danang explicitly referred to the weather as a reason why small farmers had problems of arrears. Why the ABV, with its bulk of credit geared towards household farms and enterprises within the agricultural sector, did not report problems related to climate is difficult to understand.

[82]ABV in Ho Chi Minh City, December 9, 1991.

[83]Head office of ICBV, January 6, 1992.

[84]ICBV in Hanoi, November 22, 1992.

[85]ICBV in Ho Chi Minh City, December 11, 1991.

[86]Head office of ABV, January 3, 1992.

[87]Head office of BFTV, January 7, 1992.

branch, however, claimed that repayments were a small problem to the bank, but he was apparently referring to loans in the domestic currency, of which only about three percent were not repaid. Regarding loans in foreign currency, the default rate was about 50 percent, due to the exchange rate changes, said the banker.[88] The BIDV banker at the head office did not seem particularly worried about repayments: "Sooner or later enterprises will pay back", he said, with reference to their state-ownership.[89] The same banker claimed that repayment was also in the Hanoi branch a minor problem, although a banker from the branch itself said that one of their problems was indeed repayments.[90]

4.2 Bad Debt and Transition

To what extent does bad debt constitute an obstacle to financial reform? On the one hand, the banks' inheritance and accumulation of bad assets threaten the stability of the financial system. A large proportion of highly risky or unrecoverable loans require banks to keep considerable capital to cover for losses. The current debt/equity ratio stipulated in the Vietnamese legislation (20:1), is most likely inadequate given the true quality of the banks' portfolios. If the banks were autonomous units, their weak position would make depositors hesitant to use the banks. There would then be a risk of bank runs and bankruptcies. This would cause severe losses to depositors as well as a further deterioration of the already weak confidence in the banking system. On the other hand, the banks are not autonomous units in the current situation. By being state-owned they have an implicit guarantee of their survival, regardless of their portfolio quality and the way in which they are run. Yet costs also arise in this situation, since the banking system functions poorly. For instance, if management competence and portfolio quality do not directly determine bank survival, bankers are not given incentives to adapt to commercial banking procedures that are adequate for the market economy. Moreover, to the extent that banks not only maintain their weak portfolios but also continue to advance credit on non-commercial grounds (to clients who cannot repay, resulting in continuous arrears etc) resources are wasted. The credit could have found better use.

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[88]BFTV in Danang, December 4, 1991.

[89]Head office of BIDV, November 28, 1991.

[90]BIDV in Hanoi, January 3, 1992.

To establish how portfolio quality and arrears affect bank behavior, we need more knowledge about the trends. Is bad debt in the banks increasing or is it a gradually diminishing problem? Unfortunately, we do not have much data on this. In Table 6.8 there are some SBV figures for *overdue* debt in 1990 and 1991. Total overdue loans as a share of total outstanding credit for all the banks diminished slightly from some 16 percent in 1990 to 12.6 percent in 1991. Only in the ABV, with its much higher level of overdue loans, is there any significant difference between the two years: 41 percent of outstanding credit was in 1990 overdue, while in 1991 the percentage had diminished to some 25 percent. Overdue loans increased somewhat from 1990 to 1991 in the ICBV and in the BIDV, while they diminished in the BFTV, although the changes were not dramatic.

These figures do not really lead us to any firm conclusions about the growth of bad debt. We could claim that there seems to be some increase in repayment discipline from 1990 to 1991, since there is a total decline in overdue loans between the two years. This decline is, however, caused by a reduction in the ABV alone - in the rest of the banks, the volume of overdue loans increased as a share of outstanding credit. On the other hand, in both these years, the debt resolution program had merely begun. Bringing the situation (almost) up to date, the most recent data indicate that by September 1994, non-performing assets of the banking system, attributable to the state-owned enterprises, were around 2,100 billion Vietnamese *dong*.[91] As a share of total bank credit, this constitutes only some seven percent, compared to the approximately eleven percent bad debt share of total credit in 1991 (which was almost entirely due to the defaults state-owned enterprises). Judging from this, the bad debt problem seems to have been shrinking, since the state-enterprises have been increasingly servicing their credit and/or loss-making enterprises are now out of the game. This does not mean, however, that the problem is under control.

Private versus state sector repayments

The riskiness of the private sector influences the banks' willingness to provide credit to private borrowers, and thus to expand commercial banking. Going back to Table 6.8, in 1991 a share of the bad debt, although quite small, refers to loans to the private sector in three of the banks (the ABV, the ICBV and the BIDV). From section two (and Table 6.5) we know that the private sector has played a minor role as

[91]IBRD (1995), p. 59.

borrowers from the state-owned banks at least up until 1992. Although the banks' focus on state-owned clients is partly due to tradition and the common state ownership, an additional reason could be that private borrowers defaulted to a higher extent than state enterprises. Then the banks' incentives to lend to this sector would have been limited. Interviews in the SBV provided some support of this idea. For example, an official reported that of the roughly five to ten percent of total outstanding credit in the banking system going to private enterprises, some 27 percent were defaulting.[92]

To examine the issue further, we would want to look at the proportion of bad debt incurred by private units in relation to the proportion of total private sector credit in each bank. Again, the scarce data make this difficult: Starting with the ABV, Table 6.5 singles out household borrowers, while private units, cooperatives and joint-ventures are gathered under one heading. It is uncertain whether the defaulting private units in the ABV in Table 6.8 were household farms or private enterprises. Therefore it is not easy to compare these figures. Nevertheless, the proportion of bad debt due to private borrowers (6.5 percent) is smaller than both the private units' and cooperatives' share of total credit in 1991 (ten percent) and the household share (13 percent), which suggests that private borrowers among the ABV clients were not extremely risky. On the contrary, if the ICBV figures are truthful, they support the hypothesis. Private units borrowed some three percent of total credit in 1991, while the share of bad debt incurred by private units amounted to close to ten percent in the same year. The BFTV, according to Table 6.8, had no default problems with the private sector in 1991. However, private borrowers received then less than 0.8 percent of total outstanding credit that year.

A surprisingly high proportion of bad debt in the BIDV originates from private economic units: 36 percent. Regrettably, there is no data on credit advancement per ownership in the BIDV. In the interviews, the BIDV bankers generally stressed that their banks' task was to provide long-term funding for state-owned enterprises. A BIDV banker in Hanoi, however, gave some more details on his bank's relationship with the private sector. Three years earlier (i.e. in 1988 or 1989) the bank had provided some 500 million Vietnamese *dong* to private enterprises, but the bank had not been repaid. Since the private sector could not provide adequate collateral it was too risky a borrower, the banker continued. The reason for this was that there were no real capitalists in the country.[93] If similar costly lending mistakes to an unreliable private

[92]SBV official in Hanoi, September 28, 1991.

[93]BIDV in Hanoi, January 3, 1992.

sector were made in many of the BIDV branches, this could explain the high proportion of bad debt due to private borrowers. This, in turn, supports the hypothesis that the high risks of private borrowers made the banks reluctant to advance credit to this sector.

Generally, the bankers emphasized the risks involved in lending to the private sector. Credit to private enterprises was only provided against a hundred percent collateral, according to most bankers, as this was stipulated by an SBV resolution from 1989.[94] The ICBV in Hanoi said that the joint-stock companies - like the cooperatives, had many employees but were poorly managed, and were accordingly not reliable clients.[95] The ICBV in Ho Chi Minh City, however, claimed that in pinciple they had no reluctance about lending to the private sector. The only problem was that this sector was still so small, and that there were some ownership problems that had consequences for the banks' ability to take on collateral.[96] This banker seemed annoyed with the way banks were assumed to be principally biased against the private sector.

Soft budget constraints

The 1989 reform program implied tougher constraints on state-enterprises, by phasing out subsidized credit and a more consistent enforcement of budget limits. It seems, however, that the bargaining behavior, typical of the old system, continued in the post 1989 economy.[97] The bankers' statements provided evidence of this pattern, from their perspective. The state-banks regarded the state-enterprises as safer borrowers than the private. Not necessarily because they always paid back their loans on time, but rather because the banks assumed an implicit pardoning from the government if banks were making losses due to the state enterprises. The bankers often stressed that enterprises might be making losses, and that this would require additional credit from the bank to resolve the enterprises' problems. A banker at the BIDV head office claimed that all the economic units could pay back their long-term loans. Some products could perhaps not be sold, but then the bank would change the maturity of the loans. This did not mean that the unit could not repay. Most state entities could pay off their

[94]See further Chapter VII, Section 2.2.

[95]ICBV in Hanoi, November 22, 1991.

[96]ICBV in Ho Chi Minh City, December 11, 1991.

[97]As discussed by de Vylder & Fforde (1995), pp. 198-199.

loans and did quite well, while most of the private units were unable to repay, the banker said.[98] The ICBV in Ho Chi Minh City was not overly anxious to be repaid from the state-enterprises since, according to the banker, they would not be able to operate without these loans. These enterprises are themselves waiting for payments, but they will repay, he confidently claimed.[99]

The enterprises received additional loans if they were operating but for some reason or other encountered difficulties. "If enterprises have difficulties but can be successful in the future, they may receive new credit", an ICBV banker in Danang claimed.[100] The BFTV in Danang said that credit was not given to clients that had overdue debt, although if the arrears were "normal and not due to insolvency", and if there was a market for the project, the client might receive credit anyway.[101] The banker at the head office of the BIDV said that loss-making enterprises may have profitable projects. It should rather be the prospects for the individual projects which determined the bank's decision. This had been the experience of the bank since it had given credit to loss-makers which were now profitable.[102] An SBV official explained that enterprises received visits from SBV staff who investigated their business, but no enterprise was refused credit. "If they have support, they have support," he said.[103]

Bankers were not all unaware of the dilemma of bailing out loss-makers while running a commercial bank. A BFTV banker in Ho Chi Minh City explained that "in the old mechanism, debt was the debt of the government. Subsidies to the enterprises were all right, because enterprises were the children of the government". The situation was now changing, since the state enterprises were exposed to competition; some enterprises, about 30 percent, consequently turned out virtually bankrupt, while some 70 percent were profitable, according to this banker. This meant that some of the bank's clients were having problems with repayments. Still, the banker explained that "when the enterprise once has entered you have to be calm and discuss with the enterprise. You have to be human, not a wolf."[104] The BIDV Hanoi branch banker

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[98]Head office of BIDV, November 28, 1991.

[99]ICBV in Ho Chi Minh City, December 11, 1991.

[100]ICBV in Danang, December 3, 1991.

[101]BFTV in Danang, December 4, 1991.

[102]Head office of BIDV, November 28, 1991.

[103]SBV official in Danang, December 2, 1991.

[104]BFTV in Ho Chi Minh City, December 9, 1991.

explained that their borrowers were used to the subsidy system. Thus, they used loans inefficiently and the bank had problems with repayments.[105] The head-office of the BFTV claimed that the state-owned enterprises had no collateral and were highly leveraged. Few customers were able to repay their debts, this banker claimed, explaining why the bank was afraid of lending.[106] The BIDV in Ho Chi Minh City said that they did not have problems with repayments, since the owners (presumably the state enterprises and thus the state) guaranteed the credit, and hence the loans were repaid. There was some ambiguity here, however, since the banker also said that the enterprises must be responsible for the loans - the government could not guarantee them.[107] The ICBV banker in Ho Chi Minh City said that a bank had to take on some risk. In a situation of arbitration, the court would only allow the bank to recover the principal, the banker claimed, and thus the bank was always exposed to interest rate losses.[108]

Looking beyond the state-owned commercial banks, the newer share-holding banks were generally less burdened by legacies of bad debt. However, share-holding banks were also drawned into the default problem, a Vietnamese observer claimed.[109] The share-holding bankers stressed that they focused on the private sector, although many of their clients often were part of the state sector: "Most of our customers are state-enterprises", a share-holding banker in Ho Chi Minh City explained: "With the guarantee of the government, it is the government who is responsible for the payments, and we thus have no fears." When elaborating on this, he said that the bank at least got the principal back. They would like to be get the outstanding interest rate as well, but the SBV forced them to cut these demands. "The state-enterprises are indebted to us but fail to repay", the banker said. "When we are waiting for the debt, we have no choice: we issue more loans for the state-enterprises".[110] The urban credit cooperatives, finally, explained that they had many problems with repayments. If the cooperative had taken physical collateral (presumably

[105]BIDV in Hanoi, January 3, 1992.

[106]Head office of BFTV, January 7, 1992.

[107]BIDV in Ho Chi Minh City, December 12, 1991.

[108]ICBV in Ho Chi Minh City, December 11, 1991.

[109]Department of Banking at the NEU, November 7, 1991.

[110]SBIT in Ho Chi Minh City, December 3, 1991.

in the form of gold, cars, bicycles etc) it could sell it, but papers and documents, the banker explained, were worthless.[111]

The bankers' statements confirm that soft budget constraints persisted in Vietnam in the early 1990s. The government bailed out the commercial banks (by providing additional credit from the SBV), and the commericial banks bailed out the loss-making enterprises. Of course there might be occasions when credit contracts need to be modified, without this being an expression of a soft budget constraint. In the transition period, there may be some confusion between support of unprofitable activities, which only prolongs the industrial restructuring, and a unique episode of "softness" towards those entities which really have a potential of future returns. Some bankers did refer to the future potential of these enterprises. It is, however, doubtful whether their assessment of profitable potential projects was always accurate. Most of the bankers expressed considerations beyond commercial interests behind the banks' decisions to provide additional credit or prolong the maturity of loans.

Information and opportunism

When trying to assess the magnitude of the repayment problems we have come across a wide range of categories: In the statistical data there is overdue debt as well as bad (truly unrecoverable) debt; there are volumes of defaulting principal as well as interest payments overdues etc. Moreover, the bankers reported varying and often incomprehensible estimates of their arrears. When measurement is non-standardized, the information contained is difficult to interpret. It also gives room for opportunism in financial statements. Enterprises as well as banks may have reason to stress either their short-comings or their achievements.

To understand this point, consider the role of information in the socialist system. Socialist enterprises often benefited from stressing failure in their contacts with the banks. Enterprises obtained more credit in times of trouble. In Vietnam the soft budget constraints - although perhaps harder than in some other transforming countries - obviously prevailed in the time period under study. The transition may, however, create a peculiar ambivalence both for enterprises and for banks. Should the enterprises stress their weakness and seek relief with the state banks, relying on the old mechanism? Or should they emphasize their strength and seek finance from the state banks, or the emerging private financial market, relying on commercial banking criteria?

[111]Urban credit cooperative 2 in Ho Chi Minh City, December 16, 1991.

The same ambivalence applies to the state banks themselves. The different banks seemed to chose somewhat different strategies: The BFTV and the ICBV were beginning to face increasing competition - from each other, from the share-holding banks, and from the foreign banks. The management of these banks did not exactly claim that there weren't any remaining problems to resolve, but they stressed their bank's relative success and competence. The ABV bankers, on the other hand, were more pessimistic. Their clients were poor, the bank did not have enough resources to serve them etc. To an extent, this was of course true. The ABV *was* heavily burdened by the reorganization of the system. It took over an extensive branch network that had an administratively costly group of clients. The ABV was, in addition, the bank through which the government and various aid organizations are most prone to distribute credit to peasant farmers etc. It is thus fairly logical that the ABV chose to expose its weaknesses in order to get outside support, while the other banks must instead emphasize, in order to create confidence for their business, that they are survivors in the financial market.

The absence of relevant information might inhibit action and decision making of various kinds. Coordination in the transformed organization is impaired. The extent to which such mechanisms prevail in Vietnam, and in the banks in particular, is impossible to assess. The general difficulties in obtaining information, testified by most observers, along with repeated complaints by Vietnamese authorities and observers as well as foreigners about corruption and inefficiencies, suggest that the phenomenon is of importance.

4.3 Concluding Remarks

The banks carry a burden of bad debt. Borrowers continue to default on their loans. The banks appear to have little formal guidance as to how to treat the problem. How should they account for the arrears in their financial statements, and how should they behave towards the clients? The magnitude of the problem is thus difficult to assess, while the bankers report a fairly pardoning attitude towards the debtors.

The banks are not completely decentralized units. Hence they are not required to take full responsibility for the quality of their loan portfolios. Neither are the state enterprises (the main bank clients) fully independent. The banks, the enterprises and the bank authorities are in the same boat, and continue to help each other. Meanwhile, the private sector appears to be as much of a credit risk for the banks as the state sector, without the latter's implicit state support. The banks' reluctance towards the private

sector is thus in the given situation well motivated, albeit damaging for the expansion of banking.

5. Profitability and Competition

If the banks keep advancing credit which is not repaid, surely the banks cannot be doing very well. This study concerns the features of bank transition, and how the banks interpret and act under the present conditions; whether the state banks in the longer run will and should survive on the financial market is not the issue. Moreover, the lack of adequate financial data makes any attempt to ascertain the financial soundness of these banks a demanding (if not impossible) endeavor, which is again outside the scope of the study. Yet, the agents' opinions about bank performance affect their actions. Hence, a few remarks on the financial performance of the banks are necessary - remarks which lead into a discussion of the banks' attitude towards competition.

5.1 Bank Profitability

Banks and bank clients strive to reach profitable agreements. Otherwise they would have little motivation to be in business. Assessing a counterpart's profitability is also a signal, which may help banks and clients to coordinate their interests. Only a bank (or an enterprises) which has shown reasonable profits in the past would be a worthy companion for future profitable cooperation.

If we were to seriously consider financial performance, we would want to examine bank earnings, bank liquidity and capital adequacy.[112] Bank earnings, or profits, provide internal capital and contribute to the general confidence in a bank. Liquidity levels affect a bank's ability to face market disruptions, which in turn also influences the public's and the authorities' confidence in the bank. Regarding capital adequacy, it is a bank's capital resources which determine the bank's ability to cover for bad loans and remain solvent. The greater the proportion of a bank's portfolio that is of poor or doubtful quality, the more capital is required. The relevant capital to be considered consists of equity, retained earnings, and general reserves allocated to cover for unexpected losses.

In Vietnam, the situation in the early 1990s with strongly regulated interest rates, and where the bulk of credit went to state-controlled enterprises, makes any talk of bank profitability quite premature. According to the banks' balance sheets, most of the banks were making profits in 1991 and 1992. It is, however, very unclear how these profits

[112]See Barltrop & McNaughton (1992) for an overview of financial statement analysis.

are calculated, what provisions for doubtful assets are made, or how administrative expenses are accounted for. Again we encounter the problems associated with the weak accounting system. As for liquidity, we know from section three above that cash shortages, and other difficulties for depositors to withdraw their funds, caused liquidity problems and a generally low confidence in the Vietnamese banks. A problem which to some degree was provided for, however, by the requirement to deposit extra reserves in the SBV.

Capital adequacy is also difficult to establish. In broad terms we know that the banks have problems with bad debt, which requires a relatively high level of capital. To properly assess the capital situation one would need to perform a detailed screening of the value of the banks' loan portfolios, in order to estimate the adequate capital requirements. This is impossible, since the banks lack a loan classification system, and the measurement of their capital base is likewise unclear.[113]

The need to maintain adequate capital reserves is not ignored in the new banking regulation. The banking law stipulates that "credit institutions" should create a general reserve fund by setting aside an annual five percent of net profits up to a maximum, and a special reserve fund for risk provisions by annually allocating ten percent of net profits until reaching a hundred percent of the initial capital.[114] The regulation furthermore addresses capital adequacy by requiring a ratio of 20:1 of mobilized funds (debt) to capital and reserves.[115] This rule seems, however, fairly generous and indeed lax. It does not allow for any differentiation of the capital requirement with respect to the risk characteristics of different bank portfolios. Meanwhile, the interviewed bankers hardly mentioned problems of capital resources or reserves to cover for risky assets. It could be because my questioning bypassed the issue, but it could also indicate that the bankers, at the time of these interviews, were not overly concerned. As mentioned earlier, the state-owned bankers, in the early 1990s, seemed to assume the implicit protection from the state, which meant that profitability and solidity were of subordinate importance to them.

When external inspection of the soundness of the banks is complicated or impossible, the banks' ability to become sound and surviving commercial entities hinges

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[113]Upon formation the state allocated 200 billion Vietnamese *dong* as initial capital to the state-owned commercial banks (while the capital requirements for urban share-holding banks' has been between 3 and 53 billion Vietnamese *dong*, and substantially less for so called rural share-holding banks). A Vietnamese observer, however, claimed that of the own capital provided, the banks only received half. Thus the bankers could not increase their reserves since they did not receive them in the first place (Department of Banking at the NEU, December 27, 1991).

[114]*Decree law on banks, credit cooperatives and finance companies* (Decision no 37, May, 1990), Chapter II, Article 14.

[115]*Decree law on banks, credit cooperatives and finance companies* (Decision no 37, May, 1990), Chapter IV, Article 23.

on their level of self-regulation.[116] In principle, banks would be motivated to regulate themselves if banking were sufficiently profitable. Then the banks would have incentives to maintain an adequate risk exposure and maintain suitable capital volumes etc. Profitability in the present Vietnamese situation is an obscure concept. Nevertheless, if the Vietnamese government's attempt to establish a commercial banking sector is serious, the *potential* profitability of the banking sector will constitute a basic factor in determininig the future development of the sector.

Taxation

The level of taxation has an important bearing on bank profitability. Transition to a market economy means that tax revenue replaces the enterprises' direct transfers to the state budget. In Vietnam, as in most transforming countries, the development of a tax system is a long-term project. The absence of adequate information- and control systems makes it difficult to collect taxes from the rapidly expanding private sector, as well as from the growing numbers of citizens with personal incomes of some magnitude. More accesible - but not without problems - is the state-sector, including the state-owned commercial banks.

The Vietnamese banks are subject to heavy taxation.[117] The banks have to pay turnover taxes of some four to 15 percent. Turnover taxes are rarely applied for commercial banks elsewhere because of the disincentives they create: the costs would almost automatically be translated into lower deposit rates, and higher rates of interest on loans, reducing the attractiveness of financial intermediation through the banks. The Vietnamese banks are also to pay profit tax: 50 percent for the state-owned commercial banks, and 25 percent of profits for the share-holding banks.

Possibly, this discrimination against the state banks is due to the same mechanism as described above, i.e. the tax authorities try to get the money from those who cannot escape. The development of the banking system requires new and independent banks; in order not to discourage their growth they need to be able to retain some substantial share of their profits. The state-owned commercial banks, on the other hand, are already there, and their survival is within the authorities' control (and thus in less need of profit incentives). Furthermore, collecting profit taxes from the state-owned banks may be regarded as a quick way to get hold of the return on the state's own assets. A commercial banking system would, however, instead require that all banks could compete on equal terms - at least with respect to the legislated rules of the game. What is worse, perhaps, is that the profit taxes are to be paid on net income, prior to any

[116]As discussed by IBRD (1993), p. 59.

[117]The figures for banking taxation in Vietnam is based on IBRD (1993), pp. 59-60.

deductions for specific or general provisions have been made. The banks have thus little reason to make the necessary provisions, nor to take measures against potentially unprofitable loans. In addition to these taxes, the reserve requirement on banks implies an implicit taxation. Compulsory reserves earn no interest rate from the SBV, and the interest rate paid on excess reserves is substantially lower than the average cost of funds. The result is squeezed margins for the banks, substantially reducing the incentives to mobilize deposits and allocate resources, or expanding the banking system.

The taxation level of banking is surely an obstacle to the future development of the Vietnamese banks, although it is difficult to ascertain how much it affects the banks' behavior. The interviewed bankers rarely talked about taxation. A couple of bankers mentioned the lack of tax policies as a problem of the legal framework. Few bankers, however, seemed concerned with profitability or with tax burdens. It is my impression that quantifiable performance measures were not very important to the Vietnamese banks, at least not in the 1991-1992 period. So much of the banks' options depended on bargaining and government discretion, as in the case of bad debt and additional credit from the SBV, that figures in a financial statement hardly played a decisive role for banking operations. Such an attitude is of course flawed for commercial, competitive banks.

5.2 Competition

Ultimately, the commercial banks' profitability depends on their competitive capacity in mobilizing resources and identifying suitable borrowers. Competition is a fundamental driving force in the market economy. Competing agents are motivated to improve and expand in order to survive in the market. There are reasons, however, to limit entry into the banking industry. From the discussion in Chapter II, we know that competition may force banks to squeeze margins and take on a damaging level of risk, provided that there are deposit insurances and/or an ignorant public which allows the risky banks to keep getting depositors. Risky banking also threatens the stability of the financial system. There is, therefore, a trade-off between a healthy and an unhealthy level of competition in banking. In Vietnam, the authorities seem to have been aware of this trade-off, and new banks have had to fulfil therequirements of the banking decree, and await licensing from the SBV. The expansion of the banking sector has accordingly been fairly slow compared to many other transforming countries. Whether the present licensing policy is too conservative or too permissive is hard to say. What we can examine, however, is how the people in the state banks (the former departments of a bank monopoly) as well as the new-comers on the market regarded the competitive situation in the early 1990s.

Note, first, that this study habitually considers the state-owned banks as a group, facing similar difficulties and expressing similar points of view. Such clustering is for the most part adequate, since the study tries to capture a general picture of the banks' abilities and disabilities in the period. Yet there are substantial differences between the banks. From section four above, we know that the extent to which the individual banks are (and were) burdened by non-performing assets and repayment problems varies. The scope of activities also differ between the banks. Each state-owned commercial bank is often a monopolist in its respective line of business and/or region, and this affects both competitiveness and survival of the individual banks. The bulk of business in the BIDV, for example, is state-budget financed long-term investments. This makes the bank as much an instrument for state investment projects as it is a commercial bank. Consequently, a relatively high level of government protection could be expected.

The role of the ABV, to continue, is also distinct. The bank branch network covers the vastly populated rural regions. The ABV is involved in aid associated rural credit projects which are part of different aid programs. The state takes an active interest in the bank, and not only profitability will determine the banks' survival. "The ABV has the first priority in the country", a banker at the head office said: "All leaders recognize that it is the ABV which has the most difficult situation."[118] The BFTV is different again. It had a monopoly position as the sole bank for foreign trade transactions in the old system. The monopoly is gradually disappearing as other state-owned commercial banks as well as new share-holding banks and foreign bank branches have begun operations in this field. The BFTV, in addition, carries the burden of severe repayment problems from the old system. The legacy of the past has also provided it with a bad reputation which weakens its competitive position, and the viability of the BFTV has indeed been questioned.[119]

Given these qualifications, only the ICBV seems to remain the pure commercial bank envisaged in the banking reform. In spite of this, the goal of all the state banks has been to become (at least partly) commercial banks in a market oriented system. The interviewed bankers all explicitly confirmed this intention. However, the view on whether and how the banks should - and could - compete varied. The new competitive role was accepted and stressed by some bankers. "We compete, we accept customers from other state-owned commercial banks", an ABV banker said.[120] Thus, the banks now had to change their behavior in order to attract customers: "We should serve customers as quickly as possible", a BFTV banker explained, and continued: "In the past we never had to invite anybody to have dinner with us, but now we are considering

[118]Head office of ABV, January 3, 1992.

[119]By the World Bank in 1991 - see IBRD (1991).

[120]ABV in Haiphong, November 12, 1991.

it."[121] On the other hand, many bankers stressed that banks should cooperate and learn from each other. The "aim is to encourage activity, not to kill each other", an ABV banker explained.[122] It is not clear, however, whether the bankers who emphasized cooperation referred to the relationship between the different state-owned commercial banks or included also the new share-holding banks. The Danang branch of the BFTV, for example, claimed that other banks were considered their brothers, although competition with the private banks was possible. Besides, in Danang these banks were no real threat, the banker confidently added.[123]

The state-owned commercial banks are discriminated against with respect to tax rates. In most other respects it is the share-holding banks that have come out short. Due to the restrictions on interest rates, while access to cheap SBV funds has been limited for the share-holding banks, it has been difficult for them to compete. A share-holding banker who complained about this situation, hoped for a future in which the state banks' monopoly position would vanish, and positive and equal interest rates would apply to all the different banks.[124] The BFTV banker in Ho Chi Minh City did not seem too worried about competition with the share-holding banks: "Other banks are too new", he said.[125] And a Vietnamese observer explained that "tigers and mice cannot compete".[126]

Beyond the locked position of the interest rates, the share-holding bankers often stressed *their* competitive advantages. Primarily, they claimed their better services.[127] "The working style is our advantage", a share-holding banker explained, while government subsidies were what the state-owned banks could offer.[128] A share-holding banker in Ho Chi Minh City remarked that the ICBV was a very big bank, which did not need to care about their customers. When the ICBV received customers, their white-collar officials could exercise their power. This behavior was all right in the former monopoly situation, the banker implied, but it would eventually turn out to be devastating for the state bank in the new competitive situation. On the other hand, his share-holding bank warmly welcomed these customers, the banker said, since the bank staff knew that their existence depended on their clients.[129] When it came

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[121]Head office of BFTV, January 7, 1992.

[122]Head office of ABV, January 3, 1992.

[123]BFTV in Danang, December 4, 1991.

[124]Danang National Bank, December 4, 1991.

[125]BFTV in Ho Chi Minh City, December 9, 1991.

[126]Department of banking at the NEU, November 7, 1991.

[127]Maritime Bank in Haiphong, November 11, 1991.

[128]HSB in Haiphong, November 11, 1991.

[129]SBIT in Ho Chi Minh City, December 18, 1991.

to the foreign bank branches which were about to establish offices in Vietnam, the state bankers again stressed learning and cooperation. "First of all they are potential agents with whom to cooperate", one ICBV banker said.[130] The share-holding bankers agreed: "The foreign banks' presence means that the banks can learn about banking", one of them explained.[131]

One may add that in general the visited bankers in the state-owned commercial banks (and in the share-holding banks) in the South were quite confident about their banks' prospects, when they compared themselves to the banks in the North. Not only was business better in the South, but the banks in the South were also better organized, they claimed. A Vietnamese observer in Hanoi agreed: the South never fully moved to the socialist economy, and the degree of monetization was greater.[132]

Cooperation

The bankers held different views on the necessity of competition and on their competitive advantages. Often the state banks underlined cooperation. Partly this may be a facet of culture. Reaching consensus and stressing collaboration is important in Vietnam. Nonetheless, stressing cooperation is not solely a Vietnamese cultural phenomenon. It may also be part of a rhetoric to facilitates business. The foreign bankers whom I encountered were keen on stressing that their presence was a way to open up the Vietnamese economy, to help the "new-born" Vietnamese businessmen and bankers to take their first trembling step on the market, i.e. to cooperate. But nobody can doubt that the long-run reason for the foreign banks' presence was and is the prospect of future profits.

As for the Vietnamese bankers themselves, i.e. in the state banks, it is likely that an element of shrewdness lay behind their want for cooperation. Judging from what several share-holding bankers' said, the state banks (and also the SBV) were not always cooperative nor eager to exchange experiences with the private share-holding banks. Again this points to the state banks being more or less motivated to underline their weaknesses depending on the situation. Towards the private banks, one can imagine that the state banks would want to mark their superior position in order to reduce the success of these competitors and retain the protection from the authorities. In contrast, the state banks (as well as the share-holding banks) may consider the foreign banks, with regard to banking practices, far beyond the Vietnamese banks in skill and resources. Thus, the Vietnamese have motives to emphasize their lack of resources, of

[130]ICBV in Hanoi, November 22, 1991.

[131]Eximbank in Ho Chi Minh City, December 19, 1991.

[132]CIEM in Hanoi, October 22/29, 1991.

knowledge and of competitive advantages, in order to be cared for by the foreign banks, and obtain the necessary information.

While some bankers were keen to stress cooperation, other state-owned banks were also from other state banks happily winning clients over. To a degree these attitudes followed the pattern of relative success of the different banks. Bankers who thought (or claimed) that they were doing quite well, tended to be the ones who emphasized that their particular state-owned commercial bank was a separate entity which competed with the others (and note that this could be the view of a banker in one branch office of a particular bank, which was, however, not necessarily shared by his colleague in another city). Others, who were less optimistic, tended to stress the importance of moving slowly towards the new situation, so that the old problems could be gradually resolved, while cooperating with the fellow banks along the road. But there is also another element in play.

It is not clear that the state-owned commercial banks were, at the time of this study, regarded as four separate banks. For one thing, several Vietnamese observers, although perhaps not with first-hand information on the elements of banking reform, explicitly said that the Bank was one unit that had different specialities.[133] The close linkages between the SBV and the state-owned banks remained. Quite possibly, some bankers still viewed their bank rather as a department of the State Bank, with a particular field of activity. If that is true, it is more understandable that some state bankers would think of the private share-holding banks as their true competitors, while their fellow state banks were their colleagues. After all, they had - and have - the same owner.

A final aspect of competition is the degree to which the formal financial system competes with the informal financial sector. Experiences in many developing countries show that informal finance both substitute and complement the formal sector. In Vietnam, the role of gold shops is clearly a substitute for poorly functioning public banks. Instead of depositing money in the banks, people buy gold, or save in *huis*. But these activities, and those of private money lenders, so long as they are better informed about clients and projects, are also complements to the formal financial system.

In many of my interviews with the bankers, I asked about the informal financial sector. Did the bankers know about it? What were the interest rates charged? What kind of lending occurred? etc. Most bankers gave some answers, but explained that loans in that market were very risky. No responses suggested that the bankers saw the activities of informal financial agents as a potential market for the state banks. What lies behind those replies is hard to tell. Bankers have been reported to participate themselves in the "hot credit" market - thus the delays in transfer payments. Perhaps some bankers for

[133]Department of finance at the NEU in Hanoi, October 19, 1991.

this reason did not want to dwell on the subject in order not to reveal too much familiarity with it. At times, surely, the interviewed banker did not know nor care about informal finance. And, as noted earlier in this chapter, the state-owned commercial bankers sometimes did not seem to think of individuals as their clients: The (state) banks were the partners of big enterprises. Big enterprises were the important economic agents in the country, and banks could not be bothered with small shop-keepers or traders or with people's individual savings (with the exception of the ABV, that is). For this reason, as well, the activities of all these messy and highly personalized relationships of informal finance would appear a far cry from the bureaucratic and important activities of the state banks.

5.3 Concluding Remarks

Commercial banking was in the early 1990s in an embryonic state. It is too early to talk of profitability or competition in the way such concepts are discussed for more mature banking systems. The banks were burdened with poor quality portfolios, suffer from heavy taxation, and had little means to profit maximize because of the interest rate regulations. At the same time, the incomplete decentralization made these commercial issues less of a concern for the state banks. Old mechanisms persisted, where it was rather the banks' negotiating power and relationship to authorities that determined survival.

The lack of relevant financial accounting creates room for varying interpretations of how well the banks were - and are - doing. There are not sufficient formal rules to base evaluations on, and informally competing norms develop as to how banks should behave towards clients, competitors and authorities. At times the norm is to stress weakness and thus seek support, at others to stress relative strength and thus out-match any competition.

Such a situation is not stable. As time goes by, the formal and informal constraints develop and become more uniform. The banks must adapt or become out-dated. But so long as the rules remain opaque, the banks are motivated (and may have no choice but) to rely on their own interpretaion of the situation. The development of commercial banking moves on slowly.

6. Summary

The Vietnamese state-owned commercial banks are to a high degree a state sector concern, although there is some variation between the different state-owned banks. The ABV, for example, is increasingly winning clients from the private (and household) sector, in line with the development in agriculture.

The banks differentiate between households and economic units, and this relates both to differences in interest rates, in accounts available to the two types of clients, and the attitude to the two groups. High interest rates on household deposits discourage the banks from accepting these funds, but there is also a prevailing ignorance of the potential deposit volume in the economy. In the view of the bankers, the Vietnamese are too poor to have any money to save. The depositors' confidence in banks is meanwhile low, and this discourages them from saving in banks. The banks substitute the lack of deposits with cheap credit from the SBV.

The financial market is increasingly developing financial instruments other than deposit accounts. Various types of bills and bonds are offered by the Treasury, the central bank as well as the commercial banks. The issuance of these instruments does not seem well coordinated, however.

Credit from the Vietnamese state banks is predominatly short-term and geared to the state sector. A modest growth in credit to the private sector is observable in the ICBV, and more significantly in the ABV. Apart from the close bonds between the banks and the state sector, the riskiness of the private sector discourages bank credit beyond the state. Risks have to do with the poorly developed information systems. The infrastructure for communication is inadequate, while financial statements and auditing practices are non-standardized and difficult to interpret. In addition, there is a tradition of secrecy, which is not easily altered.

The perverse structure of the administered interest rates seems partly to be due to the ambition to conduct monetary, industrial as well as social policies through the banks. Household saving rates are high to absorb liquidity, but also because depositors are to receive an extra income from their savings - a view which emantes from the old system. Economic units are not supposed to earn money on financial assets, but on productive investments. The large difference in the rates between these two groups provides incentives, however, for the enterprises to conceal their money as household deposits. The banks are not particularly willling to accept these expensive funds, although they cannot formally refuse. Instead various bureacratic measures as well as illegal charges discourage the households from using the banks.

Credit interest rates have been subject to detailed differentiation, where priority has been given to state-sector borrowers and to certain types of economic activities within this sector. The rates are increasingly becoming more uniform, particularly with respect to ownership, but the ambition to subsidize certain economic activities seems to remain.

The payment system functions poorly; money transfers are lengthy and involves considerable red tape. The reliance on cash transactions persist. The difficulties are partly a result of the economic and bank reforms themselves. As financial transactions gained importance, new payment instruments were introduced, but the system and the

enforcement mechanisms were poorly developed and were hence misused. Improvements are under way, but cash shortages and the low denominations of the currency are bottle-necks in the process. The present situation gives rise to discretionary treatment of clients and is prone to cause corruption. The confidence in the banks remains weak.

Although not as severe as in some other transforming countries, the banks are burdened with bad debt. The magnitude of the problem is, however, difficult to assess due to the short-comings of financial statements and the lack of accurate loan-classification systems. The bankers did not seem overwhelmingly worried about the problem, however. Even if budget constraints have hardened, the state affiliation of the banks and their clients seems to presuppose an implicit pardoning of the bad debt. The reported riskiness of the private sector, and thus the reluctance to advance credit to this sector supports that notion.

The difficulty in accurately assessing the problem of arrears seems to create room for opportunism. Sometimes it is in the interest of the enterprises (and the banks) to stress their weakness to gain support from the state. Sometimes they rather emphasize their surviving potential.

The present state of Vietnamese banking makes it premature to talk about bank profitability. Furthermore, the information problem makes it virtually impossible to assess. Still, the potential profitability (given a different interest rate structure and a solution to the problem of arrears) may be obstructed by the present heavy bank taxation.

The state banks' competitive advantage in the financial market seems to be their implicit state protection. Whether they in a situation with more equal terms for all the financial agents can compete with the newer share-holding banks and the foreign bank branches is questionable. Meanwhile, the bankers stress the necessity to cooperate and learn from each other (and in particular from the foreign banks).

CHAPTER VII

BANKING IN THE EARLY 1990s: THE INSTITUTIONAL ENVIRONMENT

Two features of Vietnamese banking stood out strongly from the analysis in Chapter VI. Firstly and most fundamentally, there is the incomplete decentralization of the state banks, which remain heavily influenced by their socialist heritage. This affects most of their banking activities, from ideas of savings to profitability criteria. The socialist legacy also contributes to the considerable information problems. The non-standardized routines and undeveloped information systems complicate day-to-day banking activities and create room for opportunistic behavior. The second feature was how opaque rules prevail in a system under transition. The official objectives regarding reform clash with details of regulation and common practice. Moreover, the interpretation by different agents of the official objectives sometimes vary. All these problems frustrate coordination of banking activities, which in turn impedes the coordinating function of banking in the economy. The problems also cause motivation costs, since the incentives created by the prevailing system may conflict with the objective of commercializing the banks.

This chapter continues to examine the Vietnamese banks and their environment. While Chapter VI dealt with "financial intermediation" *per se*, this chapter is more about the "institutional environment", although the contents of the chapters overlap. The following three areas are examined: aspects relating to the organizational structure and

competence of the banking staff in the state-owned commercial banks, the regulatory framework, and finally the role played by the bank authorities - the central bank and the government.

1. Organization and Banking Skills

The institutions governing Vietnamese banking are currently undergoing rapid change. The social capital accumulated under the previous system is in many ways obsolete and needs to be replaced. In the transition phase, there is uncertainty regarding the new rules and norms, and how they would need to be changed in order to make banking function smoothly. The efficient coordination of the activities of the various agents together with the motivation underlying efficient behavior would require a consistent, uniform set of banking rules able to be understood by everyone. This is undoubtedly above all a question of training.

Increasing the competence of the people in the commercial banks, in the SBV, and others engaged in the financial market is central for the development of efficient financial intermediation. From Chapter V we know that untrained staff was mentioned as a problem by most of the interviewed bankers, and the general lack of relevant skills in the Vietnamese banks was emphasized by Vietnamese and foreign observers. Hand in hand with the introduction of new banking methods comes substantial reorganization of the banks. Training and reorganization takes time. Efficient banking will not come about over night. Some of the difficulties facing the banks in these respects are explored below.[1]

1.1 Organizational Change

For two reasons, Vietnamese banking has traditionally been a very labor intensive activity. Firstly, the bureaucratic control function of the former state banks required a lot of manpower to conduct all the necessary book-keeping. In the new era, the state-owned commercial banks have continued to rely on cumbersome accounting methods, although the procedures are mostly inadequate for the new information requirements. High inflation and the inadequate denominations of the currency have also meant that a considerable proportion of the bank employees have been engaged in the physical handling of money. Secondly, the life-time employment guarantee implicit in the socialist system has allowed the number of bank employees to swell.

The Vietnamese situation might have been different from other centrally planned countries in that the formal state sector was small. It did not explicitly guarantee state

[1]See also Hainsworth (1993) on human resource development in Vietnam.

employment for a very large share of the population. The pattern was nontheless the same: once you were in the system, you stayed there. Labor productivity in such a system, as discussed in Chapter III, is low. Individual performance has little impact on material rewards and job-security. In Vietnam in the early 1990s, deteriorating real wages in the state sector led, furthermore, to a point where virtually nobody could live on his official wage. People would instead engage in economically more rewarding activities on the side. During the field-work for this study, this behavior was easily observable both in the banks, in state-enterprises and in other state organizations. Whether people engaged in income-generating activites during or after regular working hours, the formal place of work seemed to be a place of rest and possibly of social interaction. Of course, most people in the banks did have some proper work to do. However, it did not often demand a full time effort, although some people have indeed been fully occupied and hard-working. The few key people with the relevant competence have been in heavy demand and certainly busy.

Hence from their very inception, the new state-owned commercial banks were generally over-staffed, and inefficient organizations. In Chapter V it was seen that in 1989, the state banks alone employed some 50,000 people. The reorganization of the banks implied the abandonment of the implicit employement guarantee, and by 1992 the numbers of employees had shrunk to some 38,000. The largest organizational changes, and the only net reductions in the number of employees have been limited to the ABV, the bank which inherited most of the old bank branches and offices. The banker at the head office in Hanoi explained in early 1992 that the district offices were to be transformed into sub-branches, and that the staff was to be reduced. The goal was a reduction of the total number of employees by one third. The banker noted that the reductions were difficult to make; it was partly a "human rights" problem.[2] The remark illustrates the tension between the old norms of guaranteed employment, and the new requirements of a more efficient organization. The banker in the ABV Hanoi branch also touched upon the organizational structure of the bank. He explained that the bank had now eight different departments, although this was soon to be reduced. A theme familiar from the previous chapter recurred in that the banker said that the reorganization of the Hanoi sub-branches aimed at centralizing the branches to the more viable economic centers - away from the rural areas.[3] As we have seen, the ABV, in particularly in the North, often referred to their difficulties in providing credit to poor farmers or trying to mobilize resources from this group of clients. The ABV banker in Ho Chi Minh City, on the other hand, seemed quite content with the organization of his

[2]Head office of ABV, January 3, 1992.

[3]ABV in Hanoi, January 7, 1992.

bank. He favored the small size of the branch, which was easier to manage in terms of closer contact with the clients, when compared to competitors in the city.[4]

The head office banker in the ABV claimed in early 1992 that the staff reduction was a four to five year project. Judging from the employment figures in Chapter V, however, this goal was almost reached already by the end of 1992. The exact procedures and consequences of the substantial reorganization in the ABV is unknown to me. Although the threat of rising unemployment is one feature of the economic reforms which counter-balance the impressive achievements, it is likely that former bank employees are not the ones most severely hurt among people losing their state employment. Some of the staff reduction has been achieved through retirement. The new share-holding banks as well as the new foreign banks have absorbed some of the staff. Indeed, the head office banker whom I met with again in late 1993, explained that the reorganization had come about quite smoothly, despite the dismissal of more than 7,000 people. The problems had not been transferred to society, he claimed, since the bank was able to provide the staff with good alternative employment and good pensions.[5] This is, however, a single statement on this issue.

Decision structures

Has the reorganization led to changes in decision structures in the banks? The general impression of Vietnamese state organizations in the early 1990s was that cumbersome hierarchic structures seemed to force even the simplest daily decisions to be transmitted to management at the highest levels. The hierarchical tradition is a legacy of Confucianism as well as Marxism. The creation of new independent state-owned commercial banks implies a loosening of the close linkages between these units and the central bank as well as the government. As already discussed on several occasions, this decentralization is still incomplete both formally and informally. We will return to the extent to which the SBV and the different government bodies still interfere with the commercial banks in section three below. Let us briefly examine here the decision structures that appear to apply to the state-owned banks themselves.

While the state banks, arguably, have gained some additional independence towards the banking authorities, some of the interviews suggested an increased tension within the banks, between the head offices and the different branches. This was most noticable in the case of the ICBV. The banker at the head office, when discussing the future of the bank, stressed the necessity of acquiring proper equipment in order to improve information exchange and to reduce the number of branches and sub-branches.

[4]ABV in Ho Chi Minh City, December 9, 1991.

[5]Head office of ABV, December 11, 1993.

The head office would then be able to directly connect to the sub-branches, and thus increase the general director's control. Paradoxically, the head office banker also said that the branches ought to be given increasing independence.[6] Possibly, his talk of control refers to better communication within the bank, and not necessarily to firm control and ordering from the head office. On the other hand, the ICBV banker in Ho Chi Minh City complained about too much interference from the head office. Prior to the 1987 reforms, his branch (then a branch of the State Bank) had more authority and could, for example, refuse payments to clients. As a commercial bank, prior to the 1990 decrees, the bank was also more independent. After that, the head-office had begun interfering much more, and the present situation was costly to the branch. The branch had, for example, to keep deposits with the head office against a low interest rate. To settle transfers from other banks it had to use deposits which cost them a much higher rate.[7]

In short, the southern banker was irritated that northern bureaucrats interfered in a business which the bankers in the South knew better.[8] This banker, as well as others in the South, often stressed their experience of finance prior to reunification in 1975. Throughout the post-1975 period, the South has been more commercialized and economically advanced than the North. To an extent, the branch banker was probably rightly concerned that the head-office might confuse information exchange and tight control, thus preventing the bank from making relevant and timely decisions. The branch banker's appreciation of more authority to deny clients the opportunity to withdraw their deposits is, however, not in line with commercial service-oriented banking, even though in late 1991 the cash shortages did motivate such behavior from the banks. Possibly, the southern banker somewhat overestimated his bank's superior knowledge of commercial banking compared to colleagues in the North. During a considerable time period, Southerners have also lived in and adapted to the rules of the socialist system. Meanwhile commercial banking in the rest of the world has rapidly developed. A share-holding banker in Ho Chi Minh City made exactly this point, noting how much banking had changed between 1975, when he was the director of a bank, and 1987, when he was allowed to return to this profession, after having worked as an English teacher in the intervening period.[9]

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[6]Head office of ICBV, January 3, 1992.

[7]ICBV in Ho Chi Minh City, December 9, 1991.

[8]The type of deposits to which the banker refers here is unclear. It is possible that it concerned the extra reserves which the head office in turn had to deposit in the SBV. Whether the banker's irritation on this issue was justified is however not the point. The point is his complaint about head office interference.

[9]Saigon Bank for Industry and Trade in Ho Chi Minh City, December 18, 1991.

The interviews did not provide any consistent pattern regarding possible tension beween the head offices and the branches. More bankers complained about interference from various government bodies, than from the head offices. The BFTV banker in Ho Chi Minh City, for example, did not seem too worried about their relationship with the head office. The southern branch was the more active and prosperous one, the banker claimed, but "when the son is more intelligent than the father, that is the happiness of the family."[10] Leaving the North - South dichotomy, there were some other examples of disputes between head-offices and branches regarding their relative independence. The banker at the BIDV head office explained that all the payment activities must come through his office, and that foreign exchange transactions must be decided by the head office. He added that it was just as well to talk to him about matters concerning the Hanoi branch, since it was the head-office which engaged in mobilization and credit advancement, while only payment transfers were the concern of the branch office. On the other hand, the same banker said that the "the head office is the head of a body, while the branch offices are the arms and the legs. The head cannot touch the arms and the legs, but they can touch the head".[11] As I understand this statement, it implies that the branches, somewhat contradicting the banker's first remark, maintained some independence, while the head office was some kind of coordinator. When I finally got to talk to the bankers in the BIDV, they indeed claimed their independence, and explained that they themselves decided on credit allocation, and that neither the head office nor the political authorities could interfere.[12]

One should not exclude the possibility that there are other reasons why the banks might fear too much interference from the head-office. Certain banking practices, which do not perhaps fully follow official procedures, would no longer be possible under the increased control. Some rumours claimed, for example, that a former director at the BIDV in Hanoi had been fired and put in jail because of illegal transactions - something which might motivate the BIDV head office to take a firmer hold on the branch.

Based on these few statements, one might at least hypothesize that the perception of what the internal relationships between head offices and branches were and should be varied between the agents. The different origins of the state-owned commercial banks may also be a factor to consider. An official at the SBV in Danang claimed that the BFTV and BIDV were directed by their head offices, while the ABV and ICBV were directed by the SBV in Hanoi.[13] The ICBV and the ABV have gone through more profound organizational change, following their separation from the former state

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[10]BFTV in Ho Chi Minh City, December 3, 1991.

[11]Head office of BIDV, December 23, 1991.

[12]BIDV in Hanoi, January 3, 1992.

[13]SBV in Danang, December 2, 1991.

bank, and the new decisions structures in these banks would necessarily take time to establish. The BFTV and the BIDV have always been independent units, although part of the state system. They have not experienced substanial alterations of the old structures, although the banking methods have changed. If the SBV offical is right or wrong in her assessment about who is ruling the ABV and the ICBV is less relevant. The statement suggests that even in late 1991, at least some people believed that there were close linkages between the SBV and two of the banks. At the same time, the head-offices of these banks believed that they were actually running the banks. The point is that the decisions structures within the state-owned commercial banks were unclear. Moreover, the unclear decision structures in the frequently archaic bureaucratic organizations also complicate retraining of the banking staff. It is difficult to implement the new skills acquired in organizations which in many respects still function according to the old rules.

1.2 Training and Work Incentives

Although the state banks have been over-staffed, there is a shortage of competent people. Foreign bankers consistently remarked on the absence of management competence and knowledge in the Vietnamese banks. One foreign banker specifically pointed out the lack of middle management.[14] Another foreign banker said that his Vietnamese colleagues were fairly knowledgeable in foreign trade finance, but they did not know how to handle risk, i.e. to analyse and evaluate investment projects.[15] The interviewed Vietnamese bankers also stressed the absence of relevant skills among the staff as a major problem in the transformation process. The SBV joined in the chorus; an SBV official stressed the need of training both the younger staff, as well as the managers at higher levels.[16] In contrast to this general trend, the ABV banker in Ho Chi Minh City claimed that his staff was indeed competent. He noted in particular their expertise in micro-computers.[17] As observed above, the bankers in the South generally claimed to have greater ability in banking. Nevertheless, the lack of banking knowledge was also stressed by the southern bankers.[18] There is, in short, an intense need of training the bank employees at each and every level. Training programmes in

[14]Indovina Bank in Ho Chi Minh City, December 17, 1991.

[15]Credit Lyonnais in Ho Chi Minh City, December 19, 1991.

[16]SBV in Hanoi, September 21, 1991.

[17]ABV in Ho Chi Minh City, December 9, 1991.

[18]In fact, in Table 5.6 in Chapter V, four out of six branch bankers who noted the problem with the untrained staff came from the South (Danang and Ho Chi Minh City).

commercial banking include new accounting procedures, new criteria for credit advancement, new service skills etc.

Training programmes

Learning about commercial banking is an ongoing process, taking many different forms over a long time period. Ever since the restructuring of the old State Bank, the managers and the staff have been informed about the new policies and methods through decrees, circulars, short courses and meetings, as well as through articles, for example in the SBV bank review. Some of this information was reflected in the interviewed banker's presentations of the bank reforms and the new role for their bank. Many of the bankers also appeared to be fairly knowledgeable about the principles of project appraisals and creditworthiness (although with large variations). Applying these new skills is, however, difficult when, for example, accurate accounting and auditing systems do not exist. The banks are still in many respects reduced to the old-fashioned principles and methods, since retraining on a large scale does not happen over night.

Most of the staff who have college degrees have their training from the two banking colleges, one in Hanoi and one in Ho Chi Minh City, run by the SBV. The studies generally take four years, and at least up until 1993, the old curriculum (from the monobank era) dominated training. A director at the banking college in Ho Chi Minh City explained already in early 1991, that they were working on rewriting the lectures in accordance with the new requirements, but that resources were scarce and they had mostly to use old books and old material.[19] In addition to the banking colleges, there are other colleges and universities of finance and/or economics, which presumably also supply some people to the banks. The extent to which bank staff has been recruited from these universities is, however, unknown to me.[20]

The necessity of retraining the bank personnel on a larger scale has been recognized by foreign aid donors, which has led to substantial technical assistance in this field. The most comprehensive assistance to the bank sector has been a World Bank initiated project, mainly funded by the Swedish aid agency, *SIDA*, consisting of several components. Apart from comprehensive management courses, the programme also consists of a project to revise the payments system, and assistance to the SBV etc. The implementation of the project began in 1993. In addition, other countries and organizations have contributed in management and other training projects. The *Asian Development Bank* (ADB) has provided some assistance, and there has also been

[19]Banking College in Ho Chi Minh City, March, 1991.

[20]An SBV official claimed that some 70 percent of the banking staff was recruited from the banking colleges; SBV in Ho Chi Minh City, December 13, 1991.

German as well as French involvement in various ways. The foreign banks have also offered courses and work-shops to the Vietnamese bankers. There has been a fairly large involvement of foreign donors in the field of rural credit, where the assistance has been mainly channeled through the ABV.

It is beyond the scope of the present study to dwell on the content and progress of all these training projects. These efforts are definitely desirable, and the results, at least in the longer run and on average, surely beneficial to the banks. Nevertheless, there are a few things to note concerning the conditions for implementing the training programmes and introducing new ideas in the Vietnamese banks. The old decision structures, as mentioned above, in combination with all the other problems of old-fashioned accounting methods, administered interest rates etc, might hinder the implementation of new ideas and methods. It is easy to imagine situations where, for example, enthusiastic students return to their banks with fresh ideas regarding how to appraise potential loan applicants by advanced analysis, only to discover that the reality does not permit either appraisal or the eventual advancement of a loan.

The hierarchical traditions also influence who will have access to the training courses. The Vietnamese' banks are in a situation where the banking staff largely consists of people either too young to have any experience of banking, or too old, in the sense that they were trained in an outdated system. Age before ability is a blunt way to describe the Vietnamese' respect for seniority. Sadly, in a period of rapid change, old age might not be an advantage when it comes to learning new skills and new ideas. A share-holding banker explained that he preferred the young and inexperienced staff to the older.[21] The old people still retain the executive functions in the state bank hierarchies. An SBV official said that people with the old training had high positions. They did not know what to do, however, while those who knew did not have these high positions.[22] The remark makes sense to me. A frequent observation during the interviews was that the assistants to the bankers, who were sometimes engaged as interpretors, seemed more knowledgeable and alert than their superiors. Senior positions still often served as the selection criteria for various courses. An ABV banker exemplified with a project appraisal seminar funded by the ADB, in which only directors had been the official participants.[23]

Another question is the type of training provided. What skills are important for the competitiveness and efficiency of the banks? Several bankers stressed the necessity of improving the employees' language skills. Surely, knowing a foreign (read Western) language would in many instances be valuable, not least because so much of the training

[21]Maritime Bank in Haiphong, November 11, 1991.

[22]SBV in Ho Chi Minh City, December 13, 1991.

[23]ABV in Danang, December 3, 1991.

is provided by foreign teachers, and the documentation in relation to these courses is more readily available in foreign languages (there are few Vietnamese translations of literature in banking and economics, and the Vietnamese vocabulary in this field, as mentioned in Chapter I, is not yet well established). The Vietnamese bankers probably also find language skills important to be able to gain market shares in the profitable trade sector and in dealings with foreign business - something which had a high priority in the 1991-1992 period with most of the banks. One may still put a small question mark regarding the preoccupation with language skills, in that it might be part of a superficial view on what is required for competence: if only English is spoken, then banking knowledge becomes automatic (as if one could become a good skier simply by learning to speak Norwegian).

Another aspect of training is that these programmes have primarily been geared towards the state-owned commercial banks. The share-holding bankers have complained about this arrangement. People from the state-owned banks had greater chances to participate in courses and would even get to travel abroad, while the share-holding bankers were often excluded from conferences and seminars. The bankers explained that if a foreign bank arranged a conference and had not specified that participants should come from a specific share-holding bank, this bank would not be invited.[24] The remark suggests the element of discretion prevailing in decision making in the banks, as well as the strong hegemony of the state banks *vis-à-vis* the share-holding banks.

Work incentives

Just teaching what to do is not sufficient to ensure that things will be done. Material incentives such as wages and promotion opportunities are definitely important in determining work effort and commitment. The hierarchical organizations may also in this respect work against the advancement of efficient banking. From what was noted above, powerful positions are not always held by the most able people, and the honoring of seniority would make it difficult to rapidly change the established promotion schemes. One can also easily imagine the potential tensions involved in promoting young executives to positions where they were to give orders to people previously senior to themselves.

The state bank salaries, in the studied time period, remained extremely low: in 1991 they averaged about 150,000 Vietnamese *dong* per month in the North (about 15 US dollars) and in the South somewhat higher. Given these low wages, work effort could not be expected to be very high for the reasons mentioned above (the limited incentives to make an effort in the banks, and the high incentives to find complementary

[24]Eximbank in Ho Chi Minh City, December 19, 1991.

income sources). The share-holding banks paid higher salaries. The average salary in a bank in Haiphong was, for example, 50 US dollars per month. This was the highest in the city, the banker explained, and thus the staff would stay in the bank office the whole day.[25]

The wage problem is not unfamiliar to the Vietnamese. When debating corruption, for example, it is often pointed out that low salaries promote such behavior. The relationship between productivity and wages is also recognized, and there is an awareness of the risk of a "brain drain" to private or foreign enterprises which offer higher wages to qualified people. What is surprising, however, is that the interviewed state bankers rarely talked about wage problems (in fact never, judging from Table 5.6 in Chapter V). The only time any salaries were at all mentioned was when I explicitely asked about the average salaries in the banks.[26] For this I believe two reasons may be put forward. First, state employment has traditionally been accompanied by numerous fringe benefits (housing, education etc). Hence the cash wage has up until recently not been a major concern for the employees (partly also because the shortage economy meant that it was not primarily the lack of cash that constrained consumption). In the early 1990s, salaries have indeed become important, however, because of reductions in many of the state subsidies, while the consumption opportunities have grown. Nevertheless, it seems that the bank managers lagged behind in regarding wages as a determining factor for the performance of their employees.

The second reason for the bankers' silence on this issue relates to this "lag". The bankers, like many Vietnamese managers within state organizations, often failed, in the era of the new born market economy, to recognize the importance of incentive mechanisms. This has to do with a general tendency due to the socialist legacy. The socialist ideology contains an idealistic view about human motivation. Along with the oppression necessary to maintain the power structure, this has stifled the ability of many agents to analyze the operation of their society. Incentive effects, and other mechanisms put in motion by various policies have been ignored. One has relied on moral suasion (moral incentives if you like) and decided on the final targets rather than the means through which one possibly could reach these targets. Certainly (and as noted in Chapter III), moral incentives are necessary for a society to function. Socialism relies, however, too heavily on this aspect of motivation and ignores people's self-interest and material desires. An example of this is the ABV banker in Ho Chi Minh City, who talked about creating a feeling of belonging among his staff, and the necessity of the

[25]Maritime Bank in Haiphong, November 11, 1991.

[26]One could claim that a typical Vietnamese feature in this type of interview with people in their official positions, is that you will only get information in response to explicit questions. Remember, however, that I explicitely asked about problems for the banks in the transformation process, to which the bankers never mentioned any problems with salaries.

employees being devoted to their jobs. Meanwhile, the average salary was 250,000 Vietnamese *dong* per month (some 25 US dollars).

The Vietnamese reform process has nevertheless in many instances been characterized by an early recognition of individual incentives for economic performance. What has been said above is only one tendency, not necessarily the most dominating one. Indeed, ignorance of wage incentives is not a sufficient explanation for the low salary levels. Salaries are low in the state banks, just like everywhere else in the state sector, because the state has no money. The banks, just as most of the state-enterprises, were loss-makers in this period, and consequently the banks could not start to raise wages. A share-holding banker in Danang noted exactly this dilemma, when he explained that the problem of the low salaries was recognized, but that the lack of profits in the banks, hindered any wage increases.[27] One could, however, argue that since the state banks were making losses and were still not liquidated, they might as well improve their future prospects by paying decent wages. The staff in general would be motivated to make an effort, and the most competent staff would have a reason to stay on.

1.3 Understanding the Market Economy

Two themes run through most of these analytical chapters. The first one is the clash between old structures and new requirements, which I refer to as incomplete decentralization. In this section we have already noticed the phenomenon in several ways. The ability of the banks to reform their organizational structures and improve their competence is constrained by the close linkages to the central bank and the bank authorities, the hierarchical traditions, and the lack of relevant incentives. The second theme is that of unclear rules during the transition. This also affects retraining and reorganization, and is associated with the understanding of the market economy. Uncertainty about the new situation, and accordingly the new rules, creates uncertainty about how to act in various situations. This causes problems of coordination and motivates passivity which reduces efficiency.

A foreign banker claimed that the Vietnamese bankers did not really understand banking; they did not, for instance, respect contracts.[28] Another foreign banker complained about the absence of common concepts and of unity among the Vietnamese banks, and that they lacked policies as well as management as well as knowledge.[29] The governor of the SBV stated in 1992 that "rudimentary economic thinking prevailing

[27]Danang National Bank, December 4, 1991.

[28]Credit Lyonnais in Ho Chi Minh City, December 19, 1991.

[29]BNP in Ho Chi Minh City, December 11, 1991.

in the society constitute one of the major obstacles and sources of risks for the banks".[30] Understanding banking and the market economy is certainly a training project. The problems will be resolved when everybody has learned, when legislation has been adapted, and everything works better. One should, however, be very clear about the immense task in this respect. It is not just learning a new way of calculating the cost-benefits of an infrastructural investment, or of understanding how one should clear a payment to another bank when there has been a change in routines. *It is about understanding the whole context in which the banks are to operate.*

Chapter II of this study outlines the role of banks and a financial system in the market economy. One could claim that it is not necessary to know all that in order to be a good banker (rather one needs a lot of other knowledge which Chapter II never mentions). Yet one definitely needs to have some idea along these lines. To have such idea, one also needs some sort of notion of how the market economy at large works, at least in those respects relating to banking. For example, one should be aware that enterprises have business ideas which they implement in order to make profits. Similarly, one needs to know that enterprises may need financing in the initial phases of their projects, but only to the extent that their ideas are actually profitable. Moreover, it is important to note that the parallel activities of numerous enterprises ensure a sufficient supply of goods to meet people's demand for consumption etc. The problem is that these ideas about banks and the economy contradict socialist ideology, where the state takes on the responsibility to ensure the sufficient supply of goods etc, and where the banks follow orders and plans when deciding on how to advance financial resources. There is thus a large cognitive problem embedded in the transformation process for the many agents in Vietnam, who have worked in a different environment, and learnt different theories regarding the functioning of the system. They are now confronted with the need to reprogramme themselves. And the understanding of the new system has to be brought back to day-to-day activities, where decisions and actions are to work in accordance with the new role.

The southern bankers often claimed they had the necessary knowledge. A shareholding banker in Danang explained: "We, the businessmen in the South, we understand and rely on the free market."[31] To the extent that they do, their problems of commercial banking originate in the other constraints provided by the given institutional structure. However, it is difficult to implement commercial banking in a business-wise sterile environment, where, for example, other criteria than profitability determine whether (state) enterprises may survive etc. A Vietnamese observer noted the obscurity of the concepts applied to the new situation. He referred to the idea of the "the market

[30]Cao Sy Kiem (1992), p. 21.

[31]Danang National Bank in Danang, December 4, 1991.

economy under government control" (another popular phrase has been the "macro regulated market mechanism"). The concept suggests the prevailing uncertainty as to whether the state should - and would - interfere in the market mechanism. "We do not even know what the market is", the observer said.[32]

1.4 Concluding Remarks

Transition implies reorganization and retraining. For the banks to play their new role in the commercial banking system, they need new internal organizational structures and a more complete decentralization *vis-à-vis* the bank authorities. The state banks are engaged in reorganization, although their heritage as large state bureaucracies makes the process cumbersome. Meanwhile, old structures persist. Notwithstanding the necessary staff reductions that take place, hierarchical traditions slow down the accumulation of new ideas and routines. Due to a lack of resources the banks cannot provide proper wage incentives to motivate efficient bank management. Old ideas also blur the recognition of incentive mechanisms.

The central problem of unclear rules in the transition phase is particularly apparent when discussing retraining and reorganization. In order to successfully adapt to the new commercial requirements, these must be properly understood. The state of knowledge regarding banking still belongs to the monobank era and the socialist system. The market economy induces a different perception of the role of the banks. As long as the old organizational structures remain it is, however, difficult for the agents to assimilate these new ideas in the environment in which they are to act. This creates a coordination problem. The agents have difficulties in acquiring, and interpreting the relevant information, and exchange this information between each other, and thereby reaching agreements.

2. Rules and Regulation

The difficulties in matching new ideas about banking with old knowledge and the realities of the economy in transition, creates uncertainty about the rules of the games. In Chapter VI we saw how the Vietnamese banks in many respects faced unclear or contradictory rules about their activities. Deficiencies and ambiguities in the formal and informal rules cause high coordination and motivation costs. This section looks a bit deeper into short-comings in the *formal* legal system, which affect the banks' ability to do their business. Some of the legislation of concern to the banks has already been discussed. Chapter V presented the content of the two banking laws of 1990, for

[32]Department of Banking at the NEU in Hanoi, November 7, 1991.

example, and in Chapter VI we saw how the absence of adequate accounting principles and auditing systems affected the banks. The ambition here is not to give a comprehensive account of the structure and the short-comings of the legal system, but rather to point at some central features of the formal legislation and how these influence bank behavior in practice.[33]

2.1 The Legal Framework

The legal tradition in Vietnam rests on several legacies. In the pre-colonial era, the neo-Confucian ethic dominated rules of conduct. In the colonial period, French inspired legal codes were applied, and the South was up until reunification also partly influenced by U.S. common law. After the 1945 revolution, socialist legislation ruled in the North, and spread to the South after 1975. In the present period of economic transition, the legal system is again undergoing change. From a system where the central authority largely ruled by discretion, the country has now to establish a legal infrastructure to ascertain the smooth operation of the market economy. Naturally, the legal framework is so far both incomplete and partly inconsistent. To quote a Vietnamese scholar: "Our economy is undergoing structural changes, many new economic relations are taking shape or have been formed; meanwhile, lawmaking and organizations have not kept pace with these changes. It is our delay and shortcomings in legal and procedural matters that have created loopholes in business operations and other activities, allowing speculators, smugglers, tax evaders and corrupted cadres to make use of the dereliction in state management, to embezzle properties of the state and the people".[34]

New laws are continuously promulgated, and existing regulations are revised. The legislation has significantly improved, even since the 1991-1992 period, although the country has a long way to go before a functioning legal system exists, is well understood, and respected amongst most of the citizens. "A long way" and "slow transition" are, however, relative concepts. Vietnam officially declared the intention of moving towards a market economy in late 1986, and began comprehensive policy changes to that effect from 1989. As this is being written, less than ten years have passed since the first of these important dates. Given the immense task of economic systemic change, the time period could surely not be considered to be very long. But then again, the process is by no means yet completed.

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[33]See Thayer & Marr (1993), and IBRD (1993) for more thorough discussions on Vietnam's legal system, as well as Burke & Howell (1993), and Lichtenstein (1994) for more condensed accounts of the laws existing.

[34]Ngo Ba Tanh (1993), p. 87.

The constitutions

Since independence, Vietnam has had four constitutions. The first one was promulgated in 1946, inspired by the US Declaration of Independence and French law. Since then there have been revisions in 1959, in 1980 and in 1992. The constitutions briefly established the general socio-economic structure and objectives of the nation, and distinguished the nominal separation of power between legislative, executive and judicial branches of the government. The 1946 constitution guaranteed the right to private property. The 1959 constitution emphasized the focus on central planning and collective and state forms of property (private property was permitted if it did not undermine the socialist system). The 1980 constitution drew up the new common objectives for the reunited country. It limited private property to the individual's income, saving and housing, and to the means essential for private activities permitted under law. Moreover, it explicitly ascertained the superior power of the country to the communist party.[35]

Quite possibly, constitutions have played a different role in socialist societies compared to their function in Western, capitalist countries. Briefly, a "Western" constitution serves to establish fundamental power relationships and property rights, which are instrumental in maintaining the basic economic mechanisms. Western constitutions have thus been comparatively stable documents, respected throughout changing conditions. In Vietnam, as in other socialist countries, the constitutions have been instruments for "preserving the dictatorship of the proletariat", and in order to serve that purpose the constitutional framework has been subject to alterations in accordance with changing economic and social conditions.[36] They have thus been less stable over time than the Western kind. The constitution as the legal foundation of society has also been less central. The socialist economic mechanism is based on planning, and thus the plan documents have been the important legal documents, along with other decisions made by the centralized leadership - in Vietnam the National Assembly, the Council of State and the Council of Ministers. The constitutions have played a secondary role; they have served to formalize what has already become the practice, for instance in the case of confirming the dominant role played by the communist party.

The extent to which the 1992 constitution will have a different position is difficult to know today. The constitution in itself affirms the new direction of the economy. For example, that "in the private individual and private capitalist sectors people can adopt

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[35]Nguyuen Van Canh (1983), pp. 50-52, Beresford (1988), pp. 100-105, and Lichtenstein (1994), p.4.

[36]Beresford (1988), p. 98.

their own ways of organizing production and trading", or that the "lawful property of individuals and organizations shall not be nationalized".[37] The 1992 version appears at a time when a whole set of laws, especially concerning economic relationships, are introduced for the first time in the country. Possibly the constitutional rights will become a more active and fundamental prerequisite for development of the legal relationships in the country. Although this latest version introduces radical amendments, the history of recurring revisions of the constitutions gives them a bias towards instability, which must contribute to (or reflect) an uncertainty regarding the consistency of reform measures and legal rights. Moreover, one cannot avoid observing certain ambiguities in the phrasing of the new constitution. For example, "the State promotes a multi-component commodity economy functioning in accordance with market mechanisms under the management of the State and following a socialist orientation".[38] As discussed in Chapter III, the combination of markets and socialism is neither a very clear concept, nor a very stable economic system. There is another form of instability inherent in the contradiction between "democratic centralism" which is the governing principle, and the role of the communist party which continues to be "the force leading the State and society".[39] One may add that the constitution does not confirm development in all respects, but is rather ahead of events. There is, for example, a paragraph on the citizen's unrestricted freedom of opinion and speech, which has yet to be matched by reality.[40]

2.2 Laws Relating to Banking

The constitution establishes economic relationships which are of immediate concern to the banks. The rules on property rights and in particular land ownership have, for example, a direct bearing on the opportunities available to the banks to take collateral and mortgage on real estate. The constitution also determines who has the authority of appointing people to various key positions, including the governor of the SBV. In the 1991-1992 period, however, the new constitution was not yet promulgated, and in several respects there was much more ambiguity regarding the rules in various areas that were relevant to the banks. Moreover, the constitution is by no means the only relevant legislation for the banks. The banks as organizations are subject to the banking law of 1990. In addition, the government and the SBV issue a number of decrees and decisions (for example on foreign banks) which determine how the banks

[37]Constitution, 1992, articles 21, and 23.

[38]Constitution, 1992, article 15.

[39]Constitution, 1992, articles 6 and 4.

[40]Constitution, 1992, article 69.

are to operate. In the broader context, banking is also dependent on the general regulations of the business environment, e.g. the laws from 1990 on private business and on companies, which protect individuals' and legal entities' rights to invest resources in economic activities.[41] Two other sets of laws and regulations are of particular relevance for the banks: the rules on collateral, and the legislation concerning bankruptcy.[42]

Collateral

As we saw in Chapter VI, the banks have difficulties in enforcing payments from clients if loans are overdue. The banks' response to this problem has been largely to extend the loans, but there is also the possibility of accepting collateral. If a lender completely collateralizes a loan, his risk exposure shrinks to zero - given that there is appropriate enforcement of the collateral. The Vietnamese legislation has taken this risk reducing mechanism to its extreme for borrowers beyond the state sector. In 1989, an SBV resolution declared that all borrowers (except state enterprises) must offer collateral whenever applying for a loan.[43] Mortgage on real estate is one kind of collateral, and in addition, there is cash collateral, chattel mortgages on personal property, and third party guarantees. The predominant forms are real estate mortgages and cash collateral. Collateralizing personal property seems rare in the formal banking system. The formal ownership of cars or machines or other types of suitable property is not easy to prove, and the alternative for the banks is thus to store these items, which is quite impractical. Third party guarantees are not accepted as such since they have to be backed up by mortgage or cash collateral in turn.

The bankers in the interviews in the 1991-1992 period confirmed their reliance on collateral for borrowers from the private sector. "He who has collateral can borrow", explained an ABV banker.[44] And one of his colleagues said that the rural households could borrow money only if they had collateral.[45] Naturally, the collateral requirement thereby restricted the private sector's access to funds. A BIDV banker

[41]Law on Private Business, and Law on Companies, December 1990. The difference between the two laws refers to differences in ownership, where there is a distinction between state ownership, and other types of ownership (Lichtenstein, 1994, pp. 6-7).

[42]The section is largely based on Lichtenstein (1994), IBRD (1993), and IBRD (1995).

[43]SBV Resolution No 156/QD-NH, November 18, 1989.

[44]ABV in Haiphong, November 12, 1991.

[45]ABV in Hanoi, January 7, 1991.

claimed that the private enterprises could not receive any loans, because their assets were too small to serve as a collateral.[46]

The use of cash collateral was confirmed to be a frequent practice. When advancing loans in foreign exchange, for example, the clients had to deposit the equivalent sum in Vietnamese *dong* in the banks, a share-holding banker explained. "Importers have to cover credit in foreign currency by 100 percent deposits in the bank," he said. "At the same time as our reputation is enhanced, our risk is diminishing".[47] The reversed pattern also appeared. A share-holding banker explained that it accepted foreign exchange as collateral when advancing credit to its customers. The problem was, however, that this foreign exchange had to be stored in the share-holding bank until the client had repaid the loan, and could not be efficiently placed in the market.[48]

Although the banks are required to take collateral, the rules on both how to establish the collateral contract, and how to enforce the collateral in the event of default is largely unclear. There is a mass of incoherent legislation and internal bank rules, which create vast ambiguities both for the banks and for the bank clients. One problem is that contracts between agents may be considered either as *economic* contracts or as *civil* ones, which makes them subject to two different ordinances. Roughly, a contract is either economic or civil, depending on the legal status of the two parties involved; if one of the parties is an individual without a business affiliation, the contract is civil. The distinction is however not fully clear. The status of the contract can apparently also depend on the type of activity concerned.[49]

The two ordinances differ in their specification of collateral contracts, as well as in relation to their enforcement. The civil contract ordinance (and related regulations) is quite specific both on how to establish and enforce collateral. A problem is, however, that the collateral/mortgage contract is not publicly available, which makes it difficult to determine if a specific property has been pledged as collateral. Custody of certificates of titles are therefore important for the lenders. This means that a property may not be used as collateral up to its total value, which act as a bottleneck for the banks when advancing funds. A bank may be willing to lend to a borrower, and the borrower has a collateral to pledge (part of a property). The proof of the collateralization (the certificate) has however already been taken up by another lender. If a contract is deemed an economic contract, it is under an ordinance which is much less specific on

[46]BIDV in Hanoi, January 3, 1992.

[47]Eximbank in Ho Chi Minh City, December 19, 1991.

[48]Maritime Bank in Haiphong, November 11, 1991.

[49]See IBRD (1995), p.124, and Lichtenstein (1994), pp. 33-35.

collateral. This is particularly true regarding mortgages on real estate, but then the whole issue of real estate is quite confused.

Real estate rules (encompassing private property, housing, and land use rights) have evolved parallel to the growth of collateral and mortgage legislation. The severe restrictions on private ownership culminated with the 1980 constitution. It confirmed the ongoing communialization of rural land, while most urban land which had hitherto remained private, was nationalized. However, developments during the 1980s tended to strengthen private land use, beginning with the increased reliance on household farming. In 1988 a land law was enacted, which granted private land use rights, although land remained under state ownership. Agricultural households were granted land on fixed-term periods (mostly fifteen years). The land was not transferable nor inheritable, and thus not able to be used as collateral. Nevertheless, a market for land use rights developed, or perhaps one should say surfaced. Land transactions, especially in urban areas, had gone underground after nationalization, rather than disappeared. After the introduction of *doi moi*, these transactions became increasingly open. In 1993, a new land law, in accordance with the new constitution, considerably improved land use rights. It provided for the right to transfer, sell, and lease, as well as mortgage, inherit and be compensated in the event of expropriation of land use rights.[50]

The land law thus confirmed what had increasingly become common practice. Meanwhile, an ordinance in early 1991 recognized the full right of private residential housing, including rights to mortgage and inheritance of a property. The ownership of a house did not include the land on which the house was built, but evidently this was not a problem for the ecollateralization of the property. In practice, any borrower could thereby mortgage on his house, but not his farm land or other land that did not have a building on it. The ambiguous situation gave rise to conflicting interpretations of property rights. There have also been local variations in legal practices with regard to land management, especially the difficult issue of initial land allocation. Adding to the problems, the certification of land use rights is a time consuming process. By 1993, only about two percent of households (or 0.6 percent of the land) had been allocated official land use rights certificates.[51]

The banks are compelled to take collateral from borrowers outside the state sector, and although the rules are not fully transparent, there are formalized procedures about how to do it. The major problem seems to be the enforcement of the collateral - regardless whether the contract is deemed civil or economic. In the event of a conflict the parties tend to primarily resort to out-of-court methods. From 1990, a *Resolution Committee* was established with representatives from various ministries, the banks, the

[50]Land law, National Assembly, July 14, 1993.

[51]IBRD (1993), p. 30.

department of police and the people's committees etc, with the aim of settling conflicts of this kind. First if the matter cannot be resolved in that way, the parties turn to the judicial system, i.e. to the *Economic Arbitration Body* (replaced in July 1994 by the *Economic Chambers of the People's Court*), in the event of an economic contract, or the civil court, in case of a civil contract. Since the mechanisms outside the judicial system are preferred, there is evidently some distance between the formal structure of enforcement mechanisms, and the actual functioning of the system in case of a conflict. It is easy to imagine that the ambiguities in the legislation give room for varying interpretation by the law enforcers, which means that the outcome of an arbitration is uncertain.

From the banking problems listed in Chapter V, we know that the bankers did not mention collateral or its enforcement as a major problem. Only one banker gave some indication that the matter was not completely straightforward. The ICBV banker in Ho Chi Minh City said that the bank always required collateral such as machinery, plants or other assets, but complained that it was difficult for them to obtain the collateral in the case of default. There was no adequate legislation on property rights. Hence difficulties arose in proving the ownership of the asset.[52] This singular statement on enforcement of collateral could indicate that the problem was in practice not particularly important, or that my questioning just missed the point. On the other hand, if the banks largely relied on out-of-court negotiations to solve the problem of liquidating collateral, they might not think of this as a serious obstacle in banking, but rather as an element in their daily activities, where negotiations and discussions were common routine. In all circumstances, collateral was required only from private borrowers who constituted only a small proportion of the borrowers in the state-owned commercial banks. As discussed in Chapter VI, many bankers claimed that the private borrowers were generally risky, and sometimes the bankers (in the state-owned banks) did not even seem to think of private borrowers as potentially important clients to the banks. Many bankers might simply not regard either lending to private borrowers nor recovering these loans as an important matter.

However, the image of the banks that take collateral in order to reduce their risks is blurred by statements about a much less prudent acceptance of collateral than so far suggested. An SBV official explained that the general lack of control and regulation of the private sector, also meant that private borrowers would borrow money on the same collateral several times.[53] Rumours supported the existence of this phenomenon. Examples were given of banks that would lend to a client if he had a nice car parked

[52]ICBV in Ho Chi Minh City, December 11, 1991.

[53]SBV in Hanoi, September 28, 1991.

outside the banking building. The bank required neither evidence that the car was really the borrower's property, nor proof that it was not already pledged.

What we learn from this example of slowly evolving legislation, is that it obviously creates a lot of obscurity in how to interpret the laws and settle disputes. This gives the authorities (and the banks) room for discretionary treatment of borrowers, as well as room for corruption. A potential inefficiency also arises to the extent that not all private borrowers try to cheat the banks, or that not all the banks allow themselves to be bribed to accept inadequate collateral. The law requires the banks to request collateral from their clients. Since enforcement of this collateral is complicated, however, they may in addition select the private borrowers whom they perceive as low-risk clients. The banks would thus be strongly protected against risk (when lending to the private sector). On the other hand, certain clients who have good projects on hand and are perceived as reliable borrowers, would be still excluded from borrowing from the banks because they lack the required collateral. Given the circumstances, however, this inefficiency would probably not be successfully removed by simply reducing collateral requirements. It would require the development of better information systems and improved possibilities to enforce repayment, for example through adequate bankruptcy legislation.

Bankruptcy and liquidation

The banks' willingness to lend is strongly affected by the existence of bankruptcy laws. A well-defined and enforceable body of bankruptcy legislation is an important prerequisite for hard budget constraints in the state sector. The threat of bankruptcy gives incentives to state enterprises to run their business efficiently, since they cannot expect to receive state support regardless of their performance. When the rules are clear on the definition of enterprise failure, there is less room for the negotiations and discretion. Another important implication of a bankruptcy law is that it specifies the range of protection available to creditors. This reduces the uncertainty of the effects of defaulting clients, which may in turn affect the banks' risk calculations, and thus their motivation to advance loans.

The idea of bankruptcy is new to the banks, and to Vietnamese society at large. As argued in Chapter III, the socialist system lacks mechanisms to deal with failure. The pretense for socialist enterprises was to fulfill society's need for various goods, rather than be financially viable, or, if they were not, to go bankrupt. Until mid-1994 Vietnam lacked legislation on bankruptcy. During the transition period, when the socialist mechanisms were being abandoned, the absence of such regulations has naturally been a problem. The Vietnamese situation has however also in this context given proof of a gradual adaption to the market economy, in which the promulgation

of the bankruptcy law was only one, although important, step along the way. As mentioned in the context of repayment problems in Chapter VI, the Vietnamese state enterprises have probably to a greater extent than in other transforming countries been ruled by financial performance criteria prior to the comprehensive market reforms. Hence the level of financial discipline has been relatively high. Thus the idea of financial performance and the risks of running losses have at least not been unheard of. Moreover, as a forerunner to the bankruptcy law, there has been legislation on liquidation of state-enterprises, which has implied a certain distance between enterprises and state authorities, and thus sent signals to state enterprise managers - and to the banks - about the fundamental risks contained in poor management of business.

The procedures for liquidation of state-enterprises were introduced as early as 1990. These regulations were applicable to those who "cannot sell their products, cannot fulfill their business purpose, have continuous losses, cannot repay their debts or cannot overcome current financial difficulties". "Large state enterprises or those providing important products or whose dissolution would have a 'bad influence' on other fields of enterprises" were excluded from liquidation. There were various forms of liquidation: "total or partial merger with other enterprises, total or partial sale of assets to other enterprises (public or private), lease or bidding."[54]

In July 1992, some 1,259 enterprises had been liquidated out of a total of some 4,000 which had ceased operations. Other loss-makers, which had not been liquidated, seeked to avoid liquidation by merging with more successful enterprises. This may not always have been an efficient solution if the merger was involuntary from the more profitable enterprise's point of view. The somewhat confusing impression is that liquidation as well as the avoidance of liquidation might lead to the merger of loss-making enterprises into more successful ones. The World Bank comments that mergers might burden the government since the weak enterprises may bring increasing debts to the stronger ones.[55] A serious problem of the liquidation procedures has also been that "government bodies have much discretion in the disposal of immovable assets, particularly land use rights".[56] Lack of transparency in this process is a source of inefficiency and corruption.

In the event of liquidation, an *Enterprise Liquidation Committee* has been responsible for enterprise operations, with representatives of the SBV and the commercial banks. The legislation contains details about orders regarding priorities between claimants. It is worth noting that in a first version, the banks were guaranteed both repayment of principal and interest (and banks had higher priority than "material

[54]Lichtenstein (1994), pp. 20-22.

[55]IBRD (1993), p. 61.

[56]IBRD (1993), p. 51.

benefit" for employees). However, in a revised version, "principal to banks" had the lowest priority.[57] Consequently, the Danang branch complained that bankruptcy procedures were unfair, since the banks were put at the end of the queue among creditors.[58] But liquidation of firms did apparently result in some recovery of assets to the banks. The ICBV in Ho Chi Minh City explained that the bank had plans to establish a real estate agency to sell out all the assets obtained because of the the state-enterprises' repayment problems.[59] Still, both bankers and Vietnamese observers in the 1991-1992 period claimed that the absence of bankruptcy laws was a problem. Indeed, an SBV official talked about the necessity of causing creative destruction through the bankruptcy law.[60]

2.3 Regulation and Reality

The discussion above indicates that the formal structure of the regulatory framework is not yet well developed.[61] Moreover, the legal bodies to enforce these laws suffer from resource shortages, both in terms of organizational capacity and competent people. There is, for example, a severe lack of qualified court personnel and lawyers.[62] Consequently, the legal practice is even less well established, as is the public's acceptance of the emerging legal structure. These difficulties have arisen because of the way in which the formal legal structure has developed - the lack of a coherent structure and the laws in general being of poor quality - and the lack of a clear division between the legislative and executive system and the general blurred roles of the party and the state.[63] A Vietnamese observer noted a threefold problem in relation to the legal system. First, the essential legislation had to be put in place; second, everybody had to understand them; third, everybody had to retrain to adapt to the new laws.[64]

Unclear rules cause coordination problems. These difficulties are obviously one reason behind the inefficiencies of financial intermediation. As shown in Chapter V,

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[57]Decree 330-HDBT, Revision of Decree 315, Council of Ministers, October 23, 1991.

[58]BFTV in Danang, December 4, 1991.

[59]ICBV in Ho Chi Minh City, December 11, 1991.

[60]SBV in Hanoi, September 28, 1991.

[61]See Gillespie (1993) for a discussion on the tensions created by the emerging commercial legislation and the heritage of the old system. See also Bergling (1995) on legal reforms and their implementation in contemporary Vietnam.

[62]See, for example, *Far Eastern Economic Review*, 29 July 1993.

[63]Fforde (1995).

[64]CIEM in Hanoi, October 7, 1991.

several bankers did point to the problems in the legal framework. The ICBV banker in Ho Chi Minh City complained that there was a lack of consistency in the implementation of the new rules. Only piecemeal adjustments were made.[65] A shareholding banker remarked on the difference between the laws in principle, and in reality. When an enterprise did not repay, the bank would present the case to the economic arbitration body. Due to the lack of a real business law, it was, however, difficult to reach any settlement.[66] The ambiguous legislation concerning mortgage and collateral was discussed above as one example of the uncoordinated rules. The problems also apply to other regulations to which the commercial banks and the SBV are subject. A web of different circulars and decisions govern the banking system. Observers and SBV officials noted informally that the mass of different legislation made it difficult to know what which rules to follow. Different departments could sometimes obey different sets of regulations.

The problems of the unclear rules are further aggravated by the short-comings of the judicial system. Enforcement problems appear between all the different agents and in all directions. Banks have difficulties in enforcing repayments from clients, and in enforcing the required behavior from the bank authorities. The difficulties in obtaining sufficient cash from the SBV is one example, where the banks appear relatively powerless. At the same time, the bank authorities may have difficulties in enforcing correct behavior from the commercial banks. If the banks allocate credit for improper reasons (beyond commercial considerations, for example), the SBV may have little opportunity to punish the banks (we will return to the short-comings of bank supervision in the next section). The bank clients may also have limited means to enforce the proper behavior from the banks. Depositors may be denied the opportunity to withdraw their deposits until the bank has managed to obtain cash from other sources. No legal procedures or political system expresses the interest of depositors in this situation. Meanwhile it remains unclear to the banks to what extent the banks should really bother to provide services to the general public. The rules are thus also unclear in this respect, which enhances the depositors' difficulties in insisting on their rights. Borrowers may also be mistreated (i.e. denied loans or requested to repay in advance) without being able to persuade the banks to behave differently.

Lawlessness, corruption and government discretion

The difficulties of unclear rules and enforcement problems seem to lead to three major phenomena which trouble Vietnam at this stage: first, the general lawlessness,

[65]ICBV in Ho Chi Minh City, December 11, 1991.

[66]Danang National Bank in Danang, December 4, 1991.

second, the problem of corruption, and third, discretionary interference or the breaking of the rules by the authorities both at central and local levels. These phenomena are to an extent interrelated.

Lawlessness is partly a matter of definition. If, in a Proudhonian spirit, property is theft, then the whole orientation towards increased reliance on private incentives and market exchange is an unlawful movement. This is not, however, the situation in Vietnam today. Almost by necessity, however, the unclear formal framework and the lack of enforcement mechanisms has permitted activities to take place which borders on the illegal - for good and for bad. On the negative side, there may be instances where contracts are broken, and borrowers simply refrain from repaying loan. It may also be instances where the self-enforcement of a contract is achieved by the threat of physical punishment. On the positive side, the breaking of the legislation may point out short-comings in the formal rules. This may provide an indication of the way in which the legislation needs to adapt to the requirements of reality. Such law-breaking is a necessary interaction between formal and informal constraints which serves to develop a functioning institutional framework for the society.

It does not demand too much in-depth study of Vietnamese law to conclude that both "good" and "bad" law-breaking exist in Vietnam (although it might be difficult to distinguish between the two in the individual cases). Some observers characterize the emerging market economies in general (and Vietnam specifically) as "Wild-West" societies, where the arm of the law is fairly short. The bankers' perception of the riskiness in lending, reported elsewhere in these chapters, indicates the problem. The sectors outside the state are unknown territory for the banks. The banks will have limited opportunities to enforce repayment from private borrowers in the event of default, while there is ample evidence of fraudulent business, experienced by the banks themselves and also frequently described in newspapers.

Lawlessness appears when enforcement is weak or there are loop-holes in the formal legislation, when the reward for honesty is small, and when the system supporting the formal rules lack legitimacy. The same mechanisms also drive the corollary of lawlessness: corruption. Corruption is an urgent problem for Vietnam. In various official statements, representatives of the government and the National Assembly declare corruption to be a major obstacle in the further reformation of the economy; campaigns against corruption are continuously launched.[67] Foreign businessmen venturing into Vietnam testify about the necessity to "grease" the palms of both government officials and business counterparts in order to get any business done. With reference to "the market mechanism", pecuniary contributions are at times

[67]See, for example, *Far Eastern Economic Review*, December 23, 1993, and Vo Van Kiet (1995), p. 19.

required in order to obtain written information or interviews with officials in ministries or other more or less public offices.

I will not attempt any evaluation of the level of corruption in Vietnam in general or in the banking system. It is an impossible task. Obviously, there are loopholes in the legislation and enforcement problems, as there are "reasons" for individuals to be corrupt: official wages are extremely low, and the hierarchical systems may discourage honest attempts to promote ones career. The fact that the country is still led by the communist party, leaving the basic political (and economic) structure largely untouched, may possibly imply a loss of legitimacy of the system and the reform process in the eyes of many individuals - in the banks, in the enterprises, and in the state administration.[68] The situation thus motivates corruption. And corruption apparently appears. Nevertheless, the extent of this corruption is problematic to estimate, as is the extent to which it hurts. A Vietnamese observer informally explained that there is a difference between positive and negative corruption; negative corruption is putting money in your own pocket, rather than investing it for the purpose for which it was meant; positive corruption is paying an official an extra fee in order to work the bureaucratic machinery more smoothly, allowing thereby, for example, an investment to be quickly implemented.

Many Vietnamese observers confirm the government's notion that corruption is well spread. A share-holding banker talked about corruption in the state-enterprises, which contributed to the poor condition of the state-owned enterprises. Their managers often did not engage in the activities stipulated for the organization. Instead they used the money for smuggling, and avoiding taxation. Nevertheless, if these enterprises were liquidated, the banker said, it would be very difficult for the banks to get the debt back.[69] "Mafia" a Vietnamese observer replied, when I asked about corruption in the banks. Others described the banks as black holes, where money just disappeared. The reason for the long delays in payment transfers, claimed other observers, was not (only) the deficiencies in the communication systems, and the awkward routines, but the fact that bankers would conduct commercial banking (with more market oriented interest rates) on the side, thus making quick profits in, for example, the lucrative smuggling sector. To the extent that it is true, the example illustrates the aspects of positive and negative corruption (or perhaps lawlessness). It is negative, where the confidence in the banking system deteriorates and the process of making banks more efficient is slowed down, but it is (perhaps) positive if money is efficiently circulated in growth promoting

[68]Such loss of legitimacy would, fundamentally, be caused by the party's and the system's recent failure to achieve promises of prosperity and happiness of the country; a failure which currently seems to be slowly reversed, but which may have profoundly discredited the present government, at least from some people's point of view.

[69]Saigon Bank for Industry and Trade in Ho Chi Minh City, December 18, 1991.

business activities (since smuggling may be another "positive" lawlessness to the extent that the trade regulations are too restrictive).

More small scale corruption was also reported to occur in the banks. As noted elsewhere, the extra fees charged when withdrawing deposits seemed to be almost routine in the banks. If clients refused to pay these fees, they would be punished. They would, for example, be asked to return later, or would be paid in extremely low denominations. An example was given of how somebody who wanted to cash a lottery ticket in a bank, but refused to bribe the clerk, would be paid in notes of 200 Vietnamese *dong* (about two US cent).

The element of discretionary treatment from the authorities should be added to these unlawful and corrupt features of banking and of the Vietnamese society at large. This is made possible through the inconsistencies in the legislation, and the difficulties in properly enforcing the rules. Some aspects of this was touched upon in the discussion above. When the system relies on out-of-court arbitration and negotiation, there is more room for the various interests groups to push their will, depending on their relative strength. The local governments may interfere in the negotiations to pursue their particular interest, for instance the protection of an indebted state enterprise. There is evidently a lot of local variation in the interpretation of different regulations, as well as variations in the respect that local party officials' show the law.[70] Local governments are frequently reported to act quite independent of central decisions.

2.4 Concluding Remarks

The legal framework for economic transactions is going through a metamorphoses similar to the transition in the economy itself. The previous ruling by party decrees and administrative acts is replaced by laws. The immense task in establishing these laws, and in making them understood and respected partly explains the yet fragmented state of the legal system. Adding to the difficulties are the ambiguities contained in the ideological constraints, due to the maintenance of the political structure. It is politically difficult for a socialist government to fully promote private enterprising and private ownership. Laws on property rights have a strong bearing on the banks' ability to take collateral, apart from playing a fundamental role in motivating economic actitvity. In particular the laws concerning land ownership are not clear. The judicial system also lacks resources to properly verify and enforce the legislation.

The mechanism, briefly, is such that the unclear legislation, and the lack of respect for the legislation, create an arbitrariness in the way laws will be followed and enforced. The situation paves the way for corruption and for discretion on the part of

[70]See *Far Eastern Economic Review*, 29 July, 1993.

the authorities. This undermines the confidence in the law and creates a further lack of clarity and even greater uncertainty regarding the rules of the game. Some aspects of bank authority intervention will be further explored in the following section.

3. The Bank Authorities

Commercial banking is dependent on rules set by the "bank authorities", including the central bank, the government (at local and central levels), and the state administration. The monobank heritage and the public ownership of the Vietnamese state-owned commercial banks imply a special relationship between the banks and these authorities, referred to as incomplete decentralization. This section completes the examination of the institutional features affecting the transformation of the Vietnamese banking system. It examines, firstly, the role played by the central bank, secondly, the relationship between the government and the banking system, and finishes with a discussion of tendencies of prevailing paternalism.

3.1 The Central Bank

A two-tier banking system assigns specific roles to the central bank and the commercial banks respectively. The central bank's key function is to provide stability in the system by conducting monetary policy, serving as a lender of last resort, and supervising the financial organizations. The degree to which the SBV manages these tasks has to do with its organizational capacity: the competence of the staff, and the existing decision structures, including its degree of autonomy *vis-à-vis* the government as well as the commercial banks.

Organization and competence

The problems relating to the banking skills and organizational structure, apply to the SBV as well as to the commercial banks. It is beyond my ability to evaluate which ones of these organizations that have had (and still have) the greatest obstacles to overcome with respect to establishing new routines and efficient decision making. Many foreign observers reported extensively (although mostly informally) on the severe malfunctionings of the SBV: blurred decision making, poorly functioning information exchange, lack of competence among the staff, and far too close linkages between the SBV and the government agencies. The general lack of transparency and unclear rules give plenty of room for discretion, which foreign observers noted in the context of receiving - or not receiving - necessary authorisations, or getting appointments with key persons in the banks. Even people with the explicit mission to promote functions within

the SBV itself, for example to assist in improving the supervision function, would be met with suspicion and unwillingness to cooperate from some of the SBV staff; the fact that the mission was agreed upon by high government levels as well as the leadership in the SBV did not seem to affect the attitude.

The foreign observers commented more positively on the commercial banks' willingness to respond and adapt to the new situation. But then the observers particular concern with the poor performance of the SBV might also be a result of their greater need of interaction with the SBV; their view was perhaps a product of them having more experience with the difficulties in penetrating the SBV than coming to grips with the commercial banks. Many observers, just like me, needed to go through the SBV to get various permissions: to implement a foreign investment, to establish an advisory monetary policy function, to launch a bank retraining project, or to interview people in the state-owned commercial banks. Thus these observers (we) were much more dependent on the SBV than on other organizations, with whom they (we) merely met and had interesting exchanges of ideas. On the other hand, it is precisely because the SBV has this power position that any dysfunction in the SBV is of particular concern. Problems in the SBV hurts more, because the SBV then is a bottleneck in the system. Also, because of the powerful position of the SBV, there are particular motives for some agents in the SBV to oppose change and openness. Their key positions may be threatened, and thus they will create obstacles to change.

Nevertheless, the central bank is undergoing change. The SBV is what remains of the old State Bank, when the commercial banks (the ABV and the ICBV) were separated and granted independency. The bank reform brought a new organizational structure also within the SBV, with various new departments established (see Chapter V). In addition, attempts are made to gradually restructure and reduce the vast SBV branch network. In the initial phase of reorganization, the branches were simply cut out from the former State Bank as separate units in each district. A second step of reorganization in late 1991 closed the district sub-branches, reducing the number of branches to only one such branch in each of the then 44 provinces. In recommendations to the SBV, the necessity to further reduce the number of branches and centralize decision making has been stressed.[71] One could argue that a developing country like Vietnam, with its poor infrastructure etc, needs a larger central bank branch network than more developed countries, in order to efficiently circulate orders and maintain control from the head office. Somewhat paradoxically, the main problem with these branches seems to be, however, the high degree of decentralization of authority, although the present level of branch autonomy is somewhat less than in the intial steps of bank reform. An SBV official explained that as an experiment, the branches were

[71]IBRD (1991), pp. 62-63, and IBRD (1995), p. 17.

granted even more autonomy in the 1987-1988 period (they were, for example, self-accounting units). The SBV could thus not regulate cash flows between regions. Consequently, the branches' independence had now (in 1991) been reduced, the official said, although some of the directors in the southern branches still retained the idea of their independence.[72]

My interviews with only two southern SBV officials do not provide any sample to evaluate whether the southern bankers' indeed granted themselves more independence than what was formally established. The Danang official at the SBV branch talked about its role to implement SBV decisions on interest rates, foreign exchange circulation etc, and to report to the SBV in Hanoi and to the local government about local banking activities.[73] The SBV official in Ho Chi Minh City did not mention any contacts with the SBV in Hanoi, but stressed that commercial banking in Ho Chi Minh City was much more intense than in the northern capital.[74] Possibly he thereby implied, similar to some commercial bankers in the South, that banking was really better understood by Southerners (and thus intereference from the head office was not wanted). Such an implication is however a mere speculation. What we can note is that there is room for a power struggle between the center and the peripheries. The previous situation of extraordinary autonomy must have been fundamentally different for these bankers, compared with the present plans to even reduce the number of provincial branches.[75] Possibly, many provincial SBV bankers would perceive this as a considerable threat, and try to meet it with some resistance.

The SBV staff is subject to retraining. An SBV official explained that the managers in the SBV branches used to be deputy directors in the old structure. They had now been trained in short-term courses, been provided with written material, and gained knowledge about the new situation through meetings with the governor.[76] Most of the SBV officials' at higher levels have their background in the old system. Hence, the problems of retraining apply also to the central bank functioneers. Since banking in the socialist system was of secondary importance, the State Bank had not the highest of prestige among career eager functioneers. Thus the bank was not necessarily staffed with the most able people. That would imply that the SBV is still to some degree burdened with less competent staff; something which oberservers informally confirmed.

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[72]SBV in Hanoi, October 22, 1991.

[73]SBV in Danang, December 2, 1991.

[74]SBV in Ho Chi Minh City, December 13, 1991.

[75]According to the SBV in Hanoi (October 22, 1991), the SBV's ambition was to reduce the number of branches, but apparently this had not, by 1993 at least, happened: following the new provincial structure, there were, in 1993, 53 provincial branches, according to IBRD (1995), p. 16.

[76]SBV in Hanoi, October 22, 1991.

But there is of course great variation also in this respect. I certainly met with many knowledgable and extremely ambitious SBV people. Moreover, the SBV as an organization is undergoing constant change. Although a product of the past, it now gradually manages to transform and improve routines. I noted changes in the SBV during my different visits to Vietnam. The initial cumbersome procedures in order to arrange any meeting with whom-so-ever in the SBV in 1991, sharply contrasted with the situation two years later. An example is a staff member in a fairly subordinate position who, in late 1993, took me around the house to have improvised conversations with various executives at various departments of the SBV.

Monetary policy

Perhaps most notable among improvements made is the way the SBV has managed monetary policy. The Vietnamese central bank has indeed been comparatively successful in this respect (i.e. compared with for example Russia and several other post-USSR nations). Despite few and rather rudimentary methods for monetary intervention, the SBV has to date managed to check inflationary tendencies fairly well.

The success is even more remarkable, considering that many of the potential policy instruments have not been adequately used. For example, the control of credit expansion in the banking system - primarily achieved through interest rate regulations (including rediscount rates), reserve requirements and credit quotas - have rather functioned contrary to intentions (as touched upon in the first sections of Chapter VI). The SBV has supplied considerable credit to the banking system, and although increases in deposit interest rates have had the objective of absorbing the monetary excess liquidity, the main purpose with the interest rate structure seems rather to have been to fulfil social and industrial policy considerations. Moreover, open market operations, which are standard policy instruments in more developed economies, are by and large not applicable in Vietnam, where the security markets are in a prenatal state. The achievements made are thus largely results of money issuance control, and intervention in the foreign exchange market, along with some good luck (most importantly that declining rice prices have contributed to the slow rate of increase in the consumer price index).[77] In the 1991-1992 period the inflation combat was not yet so convincing; as shown in Chapter V, the inflation rate consequently remained the most frequently mentioned problems by the bankers at that time. The threat of rapidly expanding inflation rates created uncertainty about macro-economic stability, but the bankers' anxiety was probably also largely related to their unability to set interest rates compatible to the inflation rates.

[77]See IBRD (1993), pp. 12-15.

Bank supervision

The role of the SBV is also to supervise the financial system. Supervision of commercial banks implies new and very different tasks compared to the control function existing in the old system. That function was largely a kind of internal auditing, ensuring accounting accuracy and compliancy to regulation. The purpose of commercial bank supervison is to guarantee the stability of the banking system, by monitoring the commercial banks and other financial organizations with respect to their risk exposure and prudent management, and includes such measures as capital adequacy, liquidity management, and portfolio quality.[78] A supervisory function more in accordance with commercial banking was established in the SBV in the late 1980s. Without going into all the details of the role of supervision ideally, or how it currently functions, let me just hint at some of the central problems.[79]

Basically, many of the obstacles brought forth so far in these chapters imply difficulties for implementing sound supervision. The improper information exchange, and the weak accounting systems make it hard to evaluate the banks; the problems in properly assessing lending risks and thus the portfolio quality is one significant aspect of this. The heritage from the old system means that supervision is labor intensive and meticulous, and continues to focus on compliance to regulations and proper book-keeping. The risk is that narrow inspection substitutes for a more general, strategic evaluation of the management of the banks. Obviously, the competence problem is highly relevant in this context. Both understanding banking and understanding the role of banking must be clear to inspectors of banking. Also, wage and promotion incentives play a role, in order to attract the qualified people, and avoid corruptive tendencies which are obvious threats in this field.

Moreover, there are some difficulties for the supervision to enforce penalities on imprudent banking. Bank supervision has the authority to remove individual directors but not to issue so called cease-and-desist orders, i.e. legally binding orders that an unacceptable practice is abondoned; thus considerable losses might accrue before the decision is effected. This is thus yet a product of hierarchic decision structures, which hinders efficiency. Besides, bank supervision to a degree reports to two different heads (to an agency under the Ministry of Finance, as well as to the SBV governor), which further blurs authority.

There is also the question of who the supervision is controlling. According to the legislation, supervision should cover all financial organizations, and possibly this is by

[78]The objectives for bank supervision varies in range of specified objectives between countries: from specifications of promoting stability, competition, efficiency etc, to merely preventing bank failure and protect depositors; see Porter & Ward (1993), p. 4.

[79]IBRD (1991), and IBRD (1995) discusses bank supervision extensively.

now the case. But it has not necessarily always been so. A driving force behind general licensing and more careful inspection of credit organizations was the costly lesson learnt from the credit cooperative crash in 1990. The experience pointed to the necessity of assessing performance also of non-state and non-bank organizations. The extent to which the few remaining credit cooperatives (and the new ones recently established) indeed have been inspected by the supervision department I do not know. It is not, however, completely off the track to suggest that supervision has paid less attention to these credit organizations and to some extent also to the share-holding banks, at least in an intial period. Bank supervision has its origin in internal auditing of the State Bank complex, and the share-holding banks and other credit organizations have been regarded as step-children of the SBV, and of less importance than the state-owned commercial banks. The limits to supervision reinforce the remark made in Chapter VI, that for sound banking to develop, incentives for self-regulation among the commercial banks are important, which includes rules that allow the banks to be profitable.

The SBV and the commercial banks

The difficulties in assessing the commercial banks' performance, as well as enforcement problems in case of mis-management, indicate a control problem for the SBV. There is a limit to its ability to supervise the banks, and thus protect the depositors. It may be that awareness of the capacity restrictions in the SBV is one reason behind the cautious policy in licensing new banks. In late 1991, the introduction of the foreign banks was the hot issue. The foreign bankers at the representative offices were eager to play a more active role in the financial market, but they did give some credit to the SBV's cautious licensing policy. A foreign banker believed that the difficulties for the SBV to control the foreign banks was one reason behind their restrictive licensing.[80] Another foreign banker also pointed to the problems of the SBV in supervising the foreign banks.[81] Yet a foreign banker suggested a tension between the government, which was eager to introduce foreign banks, while the SBV remained reluctant.[82]

The need of the SBV to control the banking system is a two-faced phenomenon. On the one hand, there is the sound central bank function, that ensures monetary stability and the stability of the banking system. On the other hand, there is an unsound element of tight control of the banking sector, which hinders efficient financial intermediation. In Chapter V we saw that only two of the interviewed bankers in the

[80]BNP in Ho Chi Minh City, December 11, 1991.

[81]Standard Chartered Bank in Ho Chi Minh City, December 19, 1991.

[82]Credit Lyonnais in Ho Chi Minh City, December 19, 1991.

state-owned commercial banks reported interference from the SBV to be a major problem. The ABV banker in Ho Chi Minh City said that the SBV misunderstood its role, in his view, by questioning, for example, why the bank had not provided credit to a specific enterprise.[83] And the banker at the ICBV head office claimed that the relationship with the SBV was the main problem of the bank at the moment: "We have to go to the SBV governor when deciding about staff, financial problems and organizational structure". He stressed the necessity of autonomy for all the commercial banks - until then the banks could not properly follow the new bank regulations.[84]

Only two complaints about SBV interference does not necessarily mean that such interference was not frequent in this time period. The ABV and the ICBV experienced a fundamental reorganization when being separated from the former State Bank. It is likely that their old linkages affected the degree to which the SBV interfered in the different banks' activities. SBV interference was possibly more felt in these banks than in the BFTV and the BIDV. But in addition, the interpretation of this might have differed between the agents. Some bankers may have found the interference annoying - going against the new rules of the game - while others possibly found it quite natural, since that was what they were accustomed to.

In this context, one needs to consider the somewhat different situation for the share-holding banks. Their relation with the SBV was more independent, claimed an SBV official.[85] The share-holding bankers agreed, and some found it to their advantage. According to a share-holding banker in Ho Chi Minh City, his bank could refuse to do things which the SBV could force the competitor, the BFTV, to do. He also claimed that if his bank really needed SBV guarantees to back up loans, it would get it. "In that sense we are like the state banks", he said.[86] Another share-holding banker (in Haiphong) said that although the regulation in some respects was more strict towards the share-holding banks, he would not want to be in the same shoes as the state-owned banks. While the state banks would get more support from the SBV, they would also be more strictly controlled. For example, the state banks could not set the wages as freely as the share-holding banks could.[87] But some share-holding bankers complained about losing out *vis-à-vis* the state banks in certain respects. Yet another Haiphong banker said that her bank had to pay out interest rates on deposits every month, while the state-owned banks could pay their clients every third month.[88] And

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[83]ABV in Ho Chi Minh City, December 9, 1991.

[84]Head office of the ICBV, January 6, 1992.

[85]SBV in Ho Chi Minh City, December 13, 1991.

[86]Eximbank in Ho Chi Minh City, December 19, 1991.

[87]Maritime Bank in Haiphong, November 11, 1991.

[88]Haiphong Shareholding Bank, November 11, 1991.

a joint-venture banker explained that they were certainly ignored by the SBV, which did not, for example, circulate relevant information and decrees to them or to other shareholding banks, only to the state-owned commercial banks.[89]

In all circumstances, the SBV has a large degree of influence over the commercial banks. "The SBV is powerful: it decides on the staff, the credit policies, the interest rates, while the commercial banks are weak", explained a Vietnamese observer in 1991.[90] And some of this power is established in the banking law. It stipulates the SBV's approval in a wide range of matters. Not only is it the SBV that provides the initial licenses to the commercial banks (when it has, among other things, evaluated whether there is a "compelleing need for the banking and financial services", and whether the director has the "managerial ability"[91]). The SBV also approves matters such as a name change of a bank, the location of the head-office, or the opening or closing of branches, apart from approving issuance or transfers of shares.[92] Control and supervision of the banking system naturally need support in the legislation. Still, there are many areas where the degree of SBV authority over the commercial banks seems quite exaggerated; it is a product of the monobank tradition, and a hinder for banks to develop efficiently.

In addition to the peculiarities which the legislation gives rise to, we already know from the previous chapter that there are strong linkages, and thus power relations, between the SBV and the commercial banks in other ways. Perhaps most importantly, the way the SBV has served as a lender of first, rather than last, resort, implies a dependecy on the SBV from the part of the commercial banks, which gives a possibility for the SBV to influence the banks. Another way in which the SBV certainly maintains power over the banks, is through the regulated interest rates, which, as we have seen, leaves the banks with a very limited frame for action. Again referring to my own experience, the SBV approvals necessary for my interviews (and for other foreigners' need to seek permission from the SBV) indicate that the SBV retained, at least in the 1991-1992 period, considerable power towards the commercial banks. Note, though, that the situation (as already mentioned) appeared quite different by late 1993, when I revisited the banks.

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[89]VID Bank in Hanoi, December 1, 1992.

[90]CIEM in Hanoi, October 22, 1991.

[91]*Decree Law on banks, credit cooperatives and finance companies*, May 24, 1990, article 4.

[92]*Decree Law on banks, credit cooperatives and finance companies*, May 24, 1990, article 9.

3.2 The Government

Discussions on the ideal structure of the financial system often stress the virtues of central bank independence. To be able to pursue bank supervision and monetary policy, the central bank needs independency in relation both to the commercial banks and to the government. To be able to evaluate commercial banks, and penalize poor banking, the central bank cannot be too intimate with the banks. And a conservative central banker may hold back a government more inclined to expand state expenditures, which ultimately treatens monetary stability.

As noted above, the monobank legacy and the provisions in the bank legislation, enables the SBV to closely follow the activities of the commercial banks. The SBV is, however, not the top of the hierarchy. The intimacy with the government is also stipulated in the legislation. The constitution determines that the National Assembly sanctions the prime minister's proposals on appointments and removal of members of the government.[93] The banking law stipulates that the Governor should be such a member of the government (at the time called the Council of Ministers).[94] The close contact with the Council of Ministers is stressed by the role of a "supervisor of the government", who has to participate in SBV board meetings, although without the right to vote, and who reports to the Council of Ministers.[95] These formalized links to the government reduce the independence of the central bank. According to a Vietnamese observer, the original drafting of the banking decree, however, stipulated that the governor should not be a member of the Council of Ministers.[96]

There are obviously incentives for the government to retain a strong influence over the SBV. The government thus ensures its access to central bank funding, and, perhaps more importantly in the current Vietnamese situation, control over credit advancement to the dominating but often ailing state sector. One for the government more favorable interpretation of the situation, could of course be that the government does not (did not) rely on the competence of the SBV, and believes that it cannot be fully left on its own. The competence problem in the SBV was mentioned above, but is no proof that the level of competence is necessarily higher in the government itself. Indeed, the example given on how the Council of Ministers cut the SBV plans on cash issue in half, in order to curtail inflationary tendencies (but only leading to cash shortages), supports other informal statements on how the Council of Minister interfered in business which it did not understand.

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[93]Constitution (1992) article 84.

[94]*Decree law on the State Bank of Vietnam*, May 24, 1990, Section 1, Article 14:1.

[95]*Decree law on the State Bank of Vietnam*, May 24, 1990, Article 12.

[96]CIEM in Hanoi, October 22, 1991.

Several SBV officials discussed - and worried - about the lack of SBV autonomy towards the government, "This is our greatest concern", an SBV official said, and continued: "The Council of Minister interferes. When we raised the interest rates, they got angry. They act as if influenced by old habits. Perhaps their thinking has not changed fast enough."[97] Other observers also remarked that the SBV was tightly bound to the government. The problems of the interest rates are blamed on the SBV, a foreign banker noted, but the SBV cannot really do anything about it, the decisions are made in the government.[98] A Vietnamese observer commented on the money supply increase: the decisions had been made by the Council of Ministers; the SBV Governor could not really make decisions at the moment, and the observer noted that the "Vietnamese mechanism" is to submit decisions to higher levels; he claimed that this was not a feature of bureaucracy but rather of Vietnamese culture or tradition.[99]

There are also unclear decision structures within the state administration. So far reference has been made to the government, i.e. in essence what was at the time called the Council of Ministers. In more daily matters, the SBV is also closely linked to the Ministry of Finance, although there is indeed some unclarities regarding the relative power and the areas of authorities. What partly appears to be a power struggle between the SBV and the Ministry of Finance has recently manifested itself in the parallel issuance of treasury bills by the Ministry of Finance, and promisory notes by the SBV, as discussed in Chapter VI. Some of the ambiguities in authority were possibly created by the Council of Ministers. An SBV official claimed that the Council of Ministers in late 1991 had proposed that the Ministry of Finance should lend directly to the state-owned enterprises, since their lack of capital disabled them from getting credit from the banks. The Ministry claimed that these enterprises were not genuinely loss-making, but the SBV official, giving this account, said that the SBV did not agree.[100]

In any case, neither the Ministry of Finance nor the SBV have traditionally been powerful units in Vietnam; the emphasis on the real side of the economy assigned a secondary role to financial flows, and thus also to the administration in charge of these flows, while Ministries of Light Industry and agencies such as the State Planning Commission were the important ones. And evidently, the roles and authorities among different ministries are not yet well established or clarified. An SBV official explained that the Ministry of Finance was less important than the Ministry of Agriculture and the Ministry of Commerce. She continued that people at the Ministry of Agriculture pressured both the SBV and the Council of Minister to expand credit in the agricultural

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[97]SBV in Hanoi, October 15, 1991.

[98]Standard Chartered Bank in Ho Chi Minh City, December 12, 1991.

[99]Department of Banking at the NEU, Hanoi, November 7, 1991.

[100]SBV in Hanoi, October 22, 1991.

sector, because of "urgent needs". The SBV official was annoyed with the lacking respect of the Ministry of Agriculture for the autonomy of the SBV (and the commercial banks, one may assume) and its right to make independent credit decisions.[101] These pressures from various ministries to advance credit was reported to appear also at local levels. The SBV in Danang explained how it met with officials of the local people's committee to exchange information. The local government then suggested which enterprises should be given credit, and this was a main problem to the SBV.[102]

The government authorities also attempted to influence the commercial banks. The sample is too small to establish the extent of government interference in commercial banking, but as reported in Chapter V, four banks found it worth mentioning. I do not know whether the local government in Danang was unusually patronizing, or whether the atmosphere there was, rather, unusually open, but in any case the BIDV banker in Danang, like the SBV official, stressed problems with the local government: "We have the right to refuse lending. But once when we did refuse to advance three loans (out of 26) and thus disagreed with the local People's Committee, they threatened us and used their power". What was, then, the power of the local People's Committee? "They criticize us in the meeting, and make us lose our faces in front of the enterprises", the banker explained.[103] In Ho Chi Minh City, the People's Committee has in many ways been instrumental in the progress of *doi moi*. Accordingly, none of the bankers there complained about government interference. A banker claimed that the government was only helpful in supporting their activities.[104] And in Hanoi, the BIDV banker said he did not experience any interference from the government, nor from the head office; they cannot interfere since "we are separated from them" - he claimed.[105]

3.3 Paternalism

This section has highlighted one of two major themes in this study as a whole: the difficulties in decentralizing a former centrally planned system. Strong linkages between the different agents in the financial system remain, despite the intention to create a structure characterized by independent, separate units. There is a prevailing tendency of paternalism, specifically with respect to the state bank complex. The socialist ideology stipulates the basic objectives for the society: it claims that the society

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[101]SBV in Hanoi, October 15, 1991.

[102]SBV in Danang, December 2, 1991.

[103]BIDV in Danang, December 2, 1991.

[104]ABV in Ho Chi Minh City, December 9, 1991.

[105]BIDV in Hanoi, January 3, 1992.

should meet all of the citizens' needs. This is achieved through centralized ownership and central control, which gives rise to paternalism. Like the good father who supports his family, foresees any dangers, and takes the adequate measures to protect his kin, the central power takes care of and protects the citizens.

Paternalism in the Vietnamese banking system has two distinct features: firstly, the strong organizational linkages, the control and influence pursued from the government and the SBV over the commercial banks; secondly, the paternalistic attitude towards the economy as a whole, which affects the way the bank authorities and the commercial banks view their role in the economy, regardless whether the latter push the former in this respect or not.

Paternalism and public ownership

Although I argue that there is a strong element of central control in the banking system, the discussion in this section has suggested that there are ambiguities in the pattern, specifically *within* the state-owned commercial banks, and *within* the SBV. The bank and the SBV branches at times experience and desire a considerable level of independence *vis-à-vis* their head offices, while the new banking structure requires an increased centralization of each commercial bank. Too much autonomy on the part of the branches is an obstacle to efficient coordination of banking activities; centralisation of this kind is not paternalism. Another counter-image is that there are strong linkages between the government, the SBV, and the state-owned commercial banks, but the share-holding banks, the foreign banks, and not to mention the informal and semi-informal financial intermediaries, are much more beyond control from the state authorities.

Despite these reservations, the dominating agents, the state-owned commercial banks, in the early 1990s, are generally intimately related to their authorities. In other words, the decentralization of the state-owned commercial banks is yet incomplete. Why is this the case, given the intentions with reform? One answer is that their public ownership inhibits any true independence for the commercial banks. The state, represented by the government and the ministries, has an interest to control its property. Chapter III discussed some of the disincentives created by public ownership. The individual has little motive to properly ascertain the profitability of the asset, and there are difficulties in incurring adequate investments.

Although the quality of management may be poor, the public owners have a responsibility to do so. Moreover, the "owners", i.e. the government officials and the ministries, may have vested interests in maintaining close control. As indicated elsewhere in this chapter, new organizations and new banking methods disrupt the prevailing power structures. This may threaten some agents' possibilities to influence

and benefit from the system. The driving forces behind corruption obviously motivate agents to preserve the present situation. They would for example, insist on discretion in decision making and general infererence in matters which ideally (in the ideal commercial banking system) would not be their business. This reason for resisting reform is accompanied by another motive, which is ideological: a strive to maintain the old system based on a conviction that a socialist system, after all, is better for the country and the people. These two motives may in practice be very difficult to separate, not least because power tends to corrupt. In spite of the idealistic intention (based on the idea that the old linkages and control mechanisms are necessary for the stability and affluence of society), it leads to a power structure from which individuals benefit (from which one is reluctant to part).

In all circumstances, Vietnamese economic reforms, arguably, have come about by sheer necessity, and have not been motivated nor accompanied by political upheaval. Indeed, observers claimed informally in 1991 that there was a worry about the events in Eastern Europe where the political power also was afflicted, and that this made the Vietnamese leadership more hesitant to pursue economic reforms. In Vietnam the basic political structure has not changed. The basic ideology remains, at least in official statements. This makes it difficult to interpret the fundamental intention with reforms. The political process behind the economic reforms is a slowly moving animal. The bottom line is that the power structures and the close linkages between the authorities and the banks remain.

Paternalism and unclear rules

The above sketches a situation where the agents - in the banks and in the ministries - are aware of the ideal structure for a commercial banking system, but resist it for ideological reasons (i.e. commercial banking is not really what they want) or for corrupt reasons (i.e. proper commercial banking means lost power and incomes). But the second feature of paternalism in the Vietnamese banking system, although also ideological, is a reflection of the difficulties in understanding the ideal structure of commercial banking. The argument follows the discussion in section one of this chapter, where the difficulties in understanding the market economy and the implication of that for coordination was emphasized. As the ABV banker in Haiphong put it: "The financial mechanism is not united; every region understands problems of the financial mechanism differently".[106]

Throughout these chapters we have come across statements and behavior which reflects the legacy of the socialist system. This legacy is characterized by a protective

[106]ABV in Haiphong, November 12, 1991.

attitude from the bankers and from the bank officials towards the economic agents in the country. They see it as possible and desirable to have an overview of virtually all activities in the economy; an overview which enables the banks and the authorities to off-set imbalances in society. We have seen this type of paternalism in the attitude to savings: the banks should provide a savings facility for the poor, as a kind of insurance, and the interest rates must therefore be quite high (regardless of market conditions). Other aspects of interest rates also reflect this attitude. The stiff interest rate structure fulfills social and industrial policy considerations rather than bank profitiability motives. And apparently the government has had a lot of say in these questions. A Vietnamese observer explained in 1991 that there had been a strong resistance in the government against increasing the interest rates on credit, since that would mean that the state-owned enterprises would be ruined.[107]

As discussed in Chapter VI, the state-owned enterprises not only received subsidized credit, but also additional credit although their business was unprofitable. The fear was that they would otherwise have to close down, thus causing unemployment. So "we have to go slowly or they will collapse", an ICBV banker said.[108] Farmers is another concern for the state-owned commercial banks and the authorities. Most bankers expressed worry about poor farmers who might not be able to repay loans if interest rates were too high. Again there seems to have been strong pressure from the government in this context. Bankers who did not support farmers received criticism, reported an SBV official.[109] This need to off-set imbalances can also be observed in the relationship between the North and the South. "The ABV in the South is profitable", an SBV official said, "but it makes losses in the North. The South could support the North, but they would not do that", he complained.[110]

The present situation sends contradictive signals to the banks. On the one hand banks should be commercial, make profits, act independently and with a self-interest. On the other hand, the bankers, as well as the political bureaucracy, are still thinking in terms of central planning and control. The transition to a market economy is viewed as necessary and welcomed, but there is a remaining "subsidy thinking".[111] An SBV official explained that "social thinking is very heavy in Vietnam", referring to social considerations with respect to interest rates.[112] Foreign bankers also confirmed the difficulties in commercial banking. The Vietnamese bankers had problems with the

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[107]SPC in Hanoi, September 26, 1991.

[108]Head-office of ICBV, January 6, 1992.

[109]SBV in Hanoi, September 28, 1991.

[110]SBV in Hanoi, January 2, 1992.

[111]See also Nguyen Duc Thao & Pham Dinh Thuong (1994), pp. 27-28.

[112]SBV in Hanoi, September 28, 1991.

basic banking philosophy: to whom should one lend, what is the role of the banks?[113]

There is not a uniform misconception throughout the banking system, however. Different individuals interpret the situation differently. There is variation between different banks, and also between regions. In the South, where the market system was abandoned only after reunification in 1976, the understanding of the rules of the market seems greater. Yet, there seems to be a general problem in the South just as in the North, since the banks have their feet in two different camps. As a legacy of the monobank system, banks are part of the centralized state bureaucracy. Bankers perceive themselves as *protectors* of weak groups in society, and thereby protectors of the established structure. In the new era, bankers are supposed to act as a kind of *entrepreneurs*, who presumably do not bother about weak groups, but rather participate in a process which continuously changes the economic structure of society (ideally improving conditions also for weak groups in the long run). The central and the commercial banks thus have unclear ideas about what is expected from them, and are uncertain about what a "commercial banking system" actually implies. They are therefore uncertain about the proper decisions to make, and to what degree decision making may be delegated. The double role played by the banks creates contradictions and uncertainty, which slows down coordination and organizational change.

The situation also relate to motivation problems. People in decision making positions will strive to maintain power and influence in the system, since it is not clear how they would benefit from fundamentally changing their behavior by delegating decisions and losing control. And their behavior will in turn make the new role of the banks more unclear to others. Again, this hampers organizational change, thus stigmatizing the transformation process.

3.4 Concluding Remarks

The problem of incomplete decentralization is a formal problem; the bank authorities retain an explicit right to intervene in central and commercial banking. It is also an informal constraint; ideology and tradition influence the varioius agents' relationships. The central bank, burdened by heavy bureaucracy and lack of competence, has close ties to the state-owned commercial banks. Meanwhile, the rest of the financial system is under less supervision and control than what is customary in other countries. The central bank is itself not autonomous. The government intereferes in monetary policies and other aspects of central *and* commercial banking.

[113]BNP in Ho Chi Minh City, December 11, 1991.

The incomplete decentralization is problematic because it motivates intervention from the part of the authorities, and thus fosters less of responsibility and commercial banking behavior from the part of the banks. It also motivates resource waste by opening up for various influence activities. But the degree to which incomplete decentralization hurts depends on the kind of interference the authorities engage in, and the banks are lobbying for. If the authorities act in order to promote more and better commercial banking, the costs of interference could potentially be compensated for by increased financial efficiency. The other central element in play in this period, the difficulties in establishing clear rules for the smooth operation of the banking system, means however that the kind of interference occurring in Vietnam is indeed costly.

Due to the socialist legacy, the role of the banks in the market economy is not fully clear to the bank authorities. There is a remaining attitude of paternalism, where the banking system is seen as an instrument to off-set imbalances in the society. Thus there is a contradiction between the new role for the banks as entrepreneurs and their old function as protectors of the weak sectors of society.

4. Summary

Banking reform includes reorganization of the overstaffed and bureaucratic state-owned commercial banks. Improvements are made, but cumbersome decision structures persist. To a degree the new bank organizations implies further centralization of decisions within the banks, which is not always appreciated by the formerly more autonomous branches.

Transition to commercial banking is foremost a retraining project. Retraining of the bank staff is underway. The hierarchic traditions might affect whom are to be offered the training, however. The most able might be excluded. The possibility to practice the new skills acquired may be obstructed by the lingering old banking methods.

For efficient banking (and bankers) to develop, retraining must be accompanied by adequate work incentives. Bank wages remain extremely low, while the promotion opportunities may be limited for the young and ambitious. The bank staff may have little choice but to put their energy into more rewarding side activities, and those who can may leave the state banks for better paid jobs in the emerging private sector.

As important as introducing new skills of commcercial banking and relevant work incentives is the bankers' ability to put their new role into its context. The Vietnamese market economy is yet in its infancy and this makes it difficult to properly understand the potential role of banks as financial intermediaries. The current situation creates opaque rules as to what banks should and should not do.

The legal framework for banking is in a process of transformation. The new constitution is a fundamental document which establishes the continuation of the market reforms, although with a socialist orientation. Also regulations more directly relating to banking contain ambiguities and contradictions.

Banks are required to take collateral from borrowers in the private sector. The regulation for establishing collateral contracts as well as laws on property rights are, however, unclear. Moreover are there general problems of enforcing the rules. A bankruptcy law has been introduced only recently.

The unclarities created by the lack of a coherent legal structure and the difficulties of enforcement create room for lawlessness, corruption, and discretion. Wide-spread corruption is reported to be heavy a burden on Vietnam. It is possible to distinguish, however, between the rule breaching which serves to alter inadequate legislation, and the rule breaching which truly serves to further corrupt the system.

The state-owned commercial banks maintain close links with the central bank, which in turn is closely related to the various government bodies. Similar to the organizational problems in the commercial banks, the SBV is troubled by obscure decision structures and lack of competence. The SBV is, however, undergoing change, and is gradually improving its monetary policy and bank supervision skills.

Both the SBV and the commercial banks report on government interference. The prevailing tendency of paternalism relates to the incomplete decentralization and the unclear rules in the period of transition. For ideological reasons, the state banks remain contr
olled by the government. Preserving the control is furthermore in the interest of individuals who may benefit from the present power structure. In addition, the view that the state (and thus also the state banks) should continue to be the protectors of society by off-setting imbalances remains. The autonomous and atomistic role of commercial banks as enterprenurs promoting economic activities is not given sufficient room to develop.

CHAPTER VIII

CONCLUSIONS

The picture on the cover of this study illustrates one of the dilemmas of Vietnamese bank reform. Ho Chi Minh, the father of the nation, sits on the roof of the State Bank in Hanoi. In the building underneath, the transformation of the old monobank is in full flow. Behind the trees, in the busy streets, the market is expanding every day. But the legacy of the socialist system endures. The position of the patriarch, on top of it all, symbolizes the lingering paternalism.

This study has explored the difficulties of transition in Vietnam, and emphasized the lengthy process of institutional change. Old structures and old competence are to be transformed into new structures and new skills. Rules are to be changed, agents are to learn and adapt. Despite the reorganization of the state banks, the poor operation of the financial market remains a major cause for the prevailing capital shortages. The emerging entrepreneurship relies on self-finance and informal financial sources. The Vietnamese save in gold or foreign exchange, and rely on cash transactions.

This final chapter summarizes some of the findings of the Vietnamese bank transition, by explicitly utilizing the concepts of coordination and motivation costs. It then picks up points made in Chapters II and III, and discusses how these relate to the two main themes explored in the study. The chapter ends with a few speculative remarks regarding the future of the Vietnamese financial system.

1. Coordination and Motivation in the Vietnamese State Banks

What are the costs of coordination (i.e. of acquiring, processing and exchanging information) and of motivation (i.e. of specification, observation, verification, and enforcement) in the Vietnamese banking system in the period of transition?

This study has in various ways highlighted the problem of information. The task itself has been hampered by the inaccessibility of adequate information about the banking system, and the difficulty of finding reliable measures of banking activities. In the absence of consistent statistics and performance indicators it is an intricate task to ascertain the nature and the magnitude of the banking problem. This reflects an important coordination problem for the Vietnamese banks and the economy in general. The high costs of acquiring information complicate the coordination of economic exchange.

Due to the deficient accounting systems, along with the almost complete absence of auditing, it is hard for the banks to evaluate their potential clients. The clients, likewise, have difficulties in judging the capacity of the different banks. The banking authorities do not fully know what and how the banks are doing. This measurement problem has its roots in the old socialist system, where prices and profits played a subordinate role. Moreover, the tradition of secrecy and the benefits accruing to those who hold on to exclusive information further obstruct the access to information. The legacy of the old system influences the processing of information, i.e. the interpretation of a given situation. Establishing the profitability of an enterprise, or the quality of the asset portfolios of the banks, is one thing. But what does the outcome of such an analysis mean for a Vietnamese banker, with his head in the old system? If an enterprise is less profitable than expected, does this mean that it should be shut down, or is it a sign that the management needs to be under less pressure while given additional state bank credit? Sometimes, it appears, the latter interpretation governs credit decisions.

Another example is that the interviewed bankers rarely talked about the financial resources of the Vietnamese population, currently saved as gold, dollars or circulated informally. The bankers did not seem to regard these resources as a potential for growing deposit volumes. Obviously, the banks had little motive to mobilize these resources because of the flawed interest rate structure. However, the bankers also frequently referred to the poverty of the Vietnamese people and the banks' explicit focus on the enterprise sector. They did not seem to interpret the existence of considerable informal saving and an active informal financial sector as a sign that there were resources in the economy, which could be theirs if they played their roles as financial intermediaries.

There is a lot of scope for ambiguity. For example, what is at stake if a banker grants additional credit to an enterprise in difficulties? The bank may assume that the enterprise needs resources to be able to identify a new line of production, and thus become profitable. In the view of the banker, the ongoing market reforms may justify this unique softness of the budget constraint. The enterprise, on the other hand, may interpret the additional credit as a sign that the pattern of bailing out enterprises in times of trouble will continue. Thus a misunderstanding of each other demonstrates a failure of information exchange between bank and the enterprise regarding the objectives and conditions for the agreement.

These coordination problems reduce the efficiency of the banking system, diminishing, as a result, the coordinating role of the banking system in the economy. An inadequate payment system, for example, slows down the interaction between different economic agents. The limited financial intermediation through the banks also means that savers and borrowers have difficulties in matching their respective interests. The regulated interest rates deprive the economy of an instrument to signal demand and supply of financial resources.

It will be more difficult to reach an agreement when there is a lack of unanimoty on the features of the new situation (i.e. to exchange information). Problems of coordination are almost always interrelated with those of motivation. The high coordination costs means that banks are not sufficiently motivated to accept deposits, owing to their neglect of the savings potential. Similarly they are reluctant to advance credit since they do not have sufficient information about their potential clients.

The banks are regulated by banking laws and by decrees and orders from the bank authorities. The specification of some of these rules provides flawed incentives to the agents. The regulation of interest rates is particularly important. Its perverse structure constitutes an obvious disincentive to commercial banking. Banks are not motivated to mobilize savings from the population; state bank borrowing is a cheaper source of resources to the banks, while enterprises have little incentives to deposit money in the banks. Lending rates are, moreover, either too low (for the loans to the state enterprises) or too high (for private clients). Hence the former are too low to cover the cost of funds, while the latter motivates excessive risk taking. As a result the banks are unwilling to advance loans.

The new economic system implies new roles for the state (the bank authorities) and for the banks. If there is some ambiguity regarding the implications of these new roles, however, the implicit contracts between the different agents may be misspecified. We have seen it in relation to the expectations of banks regarding state protection. Banks believe that their contract with the state is such that the state will come to rescue if the banks make losses (presumably some state enterprises have a similar idea about their relationship with the banks). We have also seen how the government assumes that

it is within its mandate to intervene in central banking matters, for example in monetary forecasts, thus reducing the autonomy of the central bank. Hence, the assumptions contained in the tacit agreements between banks, bank clients and bank authorities, lead the agents to act contrary to the intentions of reform.

The agents have good reasons to hold on to these misspecified, implicit agreements. The benefits of maintaining power and control are probably the strongest forces behind the whole chain of interference from the government to the SBV to the commercial banks and to the enterprise sector. Another specification problem is that of the incentives provided by the current banking regulation. The fragmentary and ambiguous legislation gives room to differing interpretations of the rules. The implicit contracting which has filled the gap may contradict the overall objective of creating viable commercial banking.

Information problems are behind much of the banks' lack of motivation to advance credit. The true characteristics of potential projects (from the perspective of the banks) as well as the true quality of the banks (from the perspective of the clients) are difficult to assess. Adverse selection may occur. High interest rates attract only high risk projects. There might also be problems of moral hazard. Borrowers may take on too much risk in order to be able to pay the high interest rates. When the banks cannot fully monitor their clients, they might be tempted to deviate from the original agreement.

When a lot of information is private, the agents have more freedom to choose the image which best serves their interests. Some enterprises, as well as banks, may benefit from emphasizing their weakness (that they have a lot of overdue debt and unprofitable clients etc) in order to receive additional credit, state support or foreign aid. Others may have motives to exaggerate their strength, in order to maintain a powerful and trusted position in the market. Moreover, the implication of a certain type of behavior is negotiable. Under current conditions, should not loss-makers be given a break in order to get on their feet and reorganize? Some of the bankers explicitly referred to the future potential of their clients, when explaining why they continued to receive credit. The absence of standardized accounting systems and external auditing makes verification of the performance of the agents ambiguous and complicates the negotiations.

The deficiencies in the legal and judicial system mean that external enforcement mechanisms in many instances are absent, and this may lead to time-inconsistent behavior. When outstanding loans accumulate, how can the bank enforce repayments? The best option for the bank may be to wait a while. Bank profitability falls, but that is the problem of the banking authorities. Public ownership makes enforcement of prudent enterprise management expensive (in the short run). Similarly, the bank authorities may have reason to soften their demands on the banks. In addition, bank clients may also have problems in enforcing appropriate treatment on the part of the

banks. If the bank refuses to pay out money on time to a depositor, or if the cashier demands an extra fee for the service, what can a saver do but wait or pay? The system as a whole will be penalized, but not the individual banker, when confidence in the banking system is in decline.

External enforcement may be replaced by control within the banks. The potential profitability of banking is central to efficient self-enforcement. Inadequate interest rates, the arrears, and high bank taxation can hardly be conducive to profit-generated banking. The incentives for self-regulation are thus scanty at the moment. The survival of the state-owned banks is more dependent on the good-will of the bank authorities than on prudent commercial banking. In a longer perspective, commercial banking may become more competitive. But at that point, the bureaucratic state-owned commercial banks may not be the most competitive on the market.

2. Incomplete Decentralization and Unclear Rules

The fundamental question underlying this study has been why transition takes time. The possibility to generalize from the case at hand depends on the degree to which the Vietnamese transition resembles that of other transforming countries.

The State Bank in Vietnam, prior to reform, was an integral part of the command system. The orthodox socialist system was characterized by central planning and central authority. Transition in Vietnam means the abandonment of central planning, but not necessarily central authority. As pointed out in the study, the state sector was less dominant in Vietnam than in other currently transforming countries. However it still played a central role in the formal sector of the economy. Similarly, the central authority was not quite as strong in Vietnam as in some other socialist countries. Some changes in the system were initiated spontaneously and from below, prior to more comprehensive reforms. Probably, with a stronger central authority, less fence-breaking would have been possible. At the same time, these gradual changes in the economy, from above and from below, have supported the idea that it is inherent problems in the command system that lead to its revision. In that respect, Vietnam resembles other transforming countries. Transition came about when the centrally planned system had met its match.

In most transition countries, the reform of the financial system lags behind and constitutes a bottleneck in the market orientation. This is true also for Vietnam, where the state banks dominate the banking sector. In this respect, Vietnam today seems to have chosen, or settled for, a market socialist solution: a combination of market coordination and public ownership. As argued in Chapter III, this solution does not, however, appear very stable. Indeed, many of the banking problems observed in this study seem to be a product of the instability of the situation. In turn this has given rise

to the inability of the financial intermediaries to provide adequate financial services to assist in market development.

Market socialism is characterized by incomplete decentralization in two different ways. Firstly, there is the *de facto* public ownership, that gives the authorities a free hand to intervene. The banks therefore have reason to try to influence and negotiate with the authorities in order to receive special treatment (like additional provisions of state bank credit, or the possibility to reallocate reserve funds to other types of accounts). Secondly, the prevailing socialist orientation implies a tendency to preserve an old view of the role of banking and old patterns of behavior. The bankers - and the authorities - are still governed by ideas of the balancing and all-supportive role of the state sector. The state and its banks should off-set inequalities, and see to the protection of all those activities which are believed necessary to society. In this sense, there is a kind of mental incompleteness in relation to decentralization. Even if a number of bank decisions were truly separated from the authorities, the bankers would remain attached to the notion of being part of an overall strategy for development, rather than being atomistic units with an interest only in their individual line of business.

This difficulty of grasping a new role for banking is closely related to the problem of the opaque rules prevailing in the transition period. The poorly developed legal framework and the ambiguities inherent in the formal regulation mean that the formal rules by themselves are sometimes unclear and may therefore obstruct efficient banking. Moreover, there are discrepancies between formal and informal constraints. Here reference can be made to the cultural lag discussed in the last section of Chapter III. The formal intention of the banking reform, expressed in the new laws and the official rhetoric, is to create a commercial banking system, channelling financial resources based on profit criteria. Informally, the behavior of the banking staff, and the banking authorities, lag behind. The banks continue to focus on the state sector, and allow other considerations than the enterprises' repayment capacity to influence credit decisions. The banks do not see deposit mobilization, nor the provision of an efficient payment system, as their main task. It was not the role of the socialist bank and it is in this tradition they continue to work.

Accordingly, the perception of the banks' tasks, and consequently their actions, may work against the intentions of the banking reform. If the banks believe that it is sound policy to keep writing off state enterprise debt, this works against the intention of making the banks profitable and aware of the repayment capacity of their clients. Another consideration is that the agents may have different interpretations of a given situation. The reform process throws the banks and their employees into a completely new situation, without any blueprints or well established norms. The understanding of what should and what should not be done may differ, and coordination suffers. An example could be how payments between two regional banks should or should not be

cleared through the SBV. The banks may have one idea of how this payment is smoothly organized, the SBV another. Another example is when different SBV officials argue about the kind of statistics that they need to acquire in order to assess the performance of the banking system.

Of course this is a learning problem. As time goes by, when the banking staff has received more training, and when the formal rules are better specified and operationalized, the banks will gradually adapt their understanding to that of a commercial bank's role. The agents' learning is, however, affected by the observations they make. The possibilities of enforcing the desired behavior central here. Lessons are drawn from observing the kinds of actions that are and are not allowed. Hence, the shortage of appropriate enforcement mechanisms affects the growth of the legal system and accordingly the development of banking. When the formal rules cannot be enforced, the agents have no observations of permissible and non-permissible behavior on which to draw conclusions . Without a uniform interpretation of what the different agents should and should not do, it is not clear what behavior will be punished. This may restult in passivity. If you do not know whether you should go back or forward, it is better that you stay where you are. Hence the transition moves on slowly.

The Vietnamese case shows that so long as decentralization is incomplete and the rules are unclear, the transition will take time. The tensions between contradictory formal rules, between informal and formal rules, and thus the slow process of assimilating new ideas of banking behavior provides an example of incremental institutional change. The desired market behavior will not come about instantaneously, despite comprehensive reform measures.

The magnitude of the transition problem depends, however, on the point of departure for the organization or country in question. Institutional change is path dependent. A recurrent observation in this study has been the legacy of the socialist system. This legacy is the source of the incomplete decentralization and unclear rules. Hence it is crucial for the further development of the banks. All the transition countries embody the legacy of the command system. Generalization from the Vietnamese case is thus feasible - to a certain extent. The emphasis in this study has been on system-specific features of Vietnamese reform. Of course, other factors are also important. The specific characteristics of Vietnam: a developing country in the South-East Asian corner of the world, with a relatively homogenous population, and a culture characterized by cooperation and obedience, are also, indeed, elements to consider. In a future evaluation of the relative success of Vietnam compared to other transforming countries, these country-specific features should be considered. The present study has only provided one piece to the puzzle of economic transition.

3. The Future of Vietnamese Finance

In market economies, the financial system plays a key role. Special attention is therefore paid to the stability and prudency of banking. There is, moreover, a distinct separation of roles in the market economy: the state conducts industrial and social policies, the central bank assures monetary stability, and the commercial banking system undertakes the task of financial intermediation. In the transforming economies, the legacy of the monobank, with its intimate relation to the state, results in a role confusion. The market reforms means that indirect policy instruments replace central planning and command. As long as the state, the central bank, and the commercial banks are not sufficiently separated, there is a temptation for the state to use the banks to pursue policies which may impede the possibilities for the state-owned commercial banks to become truly commercial. Interest rates are administered and repressed to stimulate investments, while credit allocation is determined by direct orders.

Repression and control of the financial system is not, however, a phenomenon unique to former socialist countries. As seen in Chapter II, many other Asian countries, for example, have experienced tight control of their financial systems. By various measures, more liberalized conditions for these banking systems have been introduced. In most of these countries financial intermediation today works farily well. The question is to what extent the short-comings of Vietnamese finance resemble the problems that these other countries have had, and whether Vietnam would experience a similar, positive development if the repression was overcome? To arrive at an answer to these questions, one would need to perform a study similar to the present one, although this time of the transition from repressed to liberalized financial conditions in market economies. However, the repressed banking systems in, for example, Indonesia or Korea, operated in economies where the market mechanism already governed most of economic exchange. The findings from this study shows that the tradition of the centrally planned system has a heavy impact on the agents' possibilities to act and interact. I therefore argue that there is a fundamental difference in bank transition from socialism to capitalism and transition from one type of regime to another within the framework of market exchange.

The focus in this study has been the state-owned commercial banks, which are undergoing constant change. Transition is a lengthy process. Some steps have led to a worsening of certain practices, some of the problems encountered remain today, but many of them are by now history. It is my general impression that, overall, things are gradually improving - even in the state banks. The picture of Ho Chi Minh on the State Bank roof was there in the fall of 1991. Perhaps symbolizing a vanishing paternalism, a year later it had been removed. Nevertheless, the importance of the state-owned commercial banks in a future Vietnam is an open question. Other financial agents

continuously enter and expand. Less burdened by old traditions, the new share-holding banks, along with the foreign bank branches, might very well become the leading financial intermediaries, as and if the country continues to develop in economic terms.

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