FOR A HEALTHIER FINANCIAL SECTOR

by Dr. LÊ KHOA

Making the financial sector healthier is an urgent matter that has become a focus of attention of the Government since the Liberation Day. In his first press conference, Nguyễn Tấn Dũng, Deputy Prime Minister and Governor of the State Bank of Vietnam said he would try his best to overcome existing shortcomings of the banking system with a view to making it healthier and more helpful to the economy. He also thought that all companies had to be more active in order to beef up the financial sector and the banking reform had to aim at promoting production.

To achieve these targets, in our opinion, it's necessary to identify achievements and shortcomings of the financial sector, and then, understand why it's difficult to reform the financial sector and how to carry out this reform.

I.IN THE FIRST YEARS AFTER UNIFICATION

The subsidized economy kept on existing for years after the Liberation Day. It's aid and loans from the former Soviet Union that allowed the Government subsidize all industries. The exchange rate then was VNĐ18 to the ruble. This exchange rate wasn't realistic and failed to serve as a means of assessing the value. As a result, there were two markets, and two prices, in the economy: the official (or organized) and the black ones. In the official market, all selling and buying prices were set by the State. Not only state-run companies, but also farmers had to sell their goods at the set prices. And this market allowed the government to pay low wages to civil servants and workers. In the black market, prices affected by the supply and demand relationship were much higher than those in the official market.

In these years, goods tended to run from the official market to the black one. The government had gone against all economic laws when trying to prevent this flow. There were many imbalances: trade gap was very big, consumption exceeded production, there were shortages of food; fuel and raw materials, production lines were several decades older than their counterparts in neighboring countries. These imbalances led to high inflation rates and replacement of bank-notes. When the domestic currency was devalued, the exchange rate stayed unchanged. The Governor of the State Bank had no right to issue more notes when necessary without permission from the Government, and the banking system was always strapped for cash.

In the 1980s, the Soviet Union increased its aid and loans to Vietnam to one billion rubles a year in order to make up for economic imbalances. At the same time, the exchange rate to the dollar was made more flexible and this helped to increase trade between Vietnam and the dollar area.

In the late 1980s, Vietnam started its economic reform by removing subsidization schemes and government monopolies and developing a mixed economy. The bank note resumed its role as a medium of exchange. Farmers were allowed to sell their products on the free market, so they tried their best to increase food output, and as a result, Vietnam became the world's third biggest rice exporter. Major investments in oil, rubber, cement and hydropower industries and abundant supply of rice helped to reduce the trade gap. By 1990, most economic imbalances were removed.

However, the financial sector hasn't been healthy. The "price-wage-money" reform that raised wages paid to civil-servants and officials by 10 times (while the budget income couldn't afford such a raise) led to hyperinflation (300% in 1986 and 500% in 1987) which, in its turn, made the raise in wages meaningless. The banking authorities, instead of getting to the bottom of the inflation, decided to raise interest rate (to 12-14% a month) with a view to reducing bank circulation. This aim was achieved but at the expense of high interest rates suffered by those who borrowed from banks. In the years 1988-90, many companies went bankrupt because they couldn't pay interest to banks.

From 1990 on, the interest rate was brought down but up to 1998, it still stayed high (1.2% a month) in comparison with what charged by foreign banking systems. Because of a large proportion of loan capital

to working capital, most local companies had to make big interest payments to banks. This was one of reasons why local companies could make only meager profits and many of them suffered losses.

II. FROM 1990 TO 1995

As was stated above, the Soviet Union, in the 1980s, provided Vietnam with some one billion rubles worth of aid and loans every year, thereby helping Vietnam reduce the trade gap and realize major investment projects. In the early 1990s, the Soviet Union crumbled and Vietnam couldn't keep on realizing certain investment projects and developing the bilateral trade with the Soviet Union as planned. Thus, the collapse of the Soviet Union caused great damage to many developing economies, including Vietnam. The Government had to adjust its financial and monetary policies in order to deal with new difficulties.

In this period, foreign relations played an important in the economic development. One of great achievements obtained through financial and monetary policies was a remarkable increase in foreign investment in Vietnam: up to 1998, some US$11 billion were put in Vietnam and helped the economy gain a growth rate of 9.5% in 1995. However, there were many shortcomings in these policies.

The financial and monetary policies affect all economic sectors, therefore, to find out shortcomings of the banking system or the Ministry of Finance isn't enough to make the financial sector healthier, so we have to study all economic sectors before new financial and monetary policies can be made.

1. Foreign sector

Although a call for saving and protection for local industries was made everywhere, Vietnam kept on importing a lot of manufactured goods that could be made locally (such as fertilizer, diesel engines, powdered milk, paper, iron and cement) along with many non-essential goods such as cars and motorbikes. It's acceptable that in the market economy, everybody tries to make as big profit as possible, but the market economy must be regulated by macroeconomic policies. In the years 1995-96 for example, Vietnam imported four million tonnes of fertilizer while an amount of some three million tonnes was enough and Vietnam could produce part of these fertilizers. Import of too many consumer goods means wasting foreign exchange and causing damage to local industries, and as a result, many companies suffered losses and failed to repay debts to banks or pay taxes to the Government. In our opinion, the banking system was in no way to blame but those who were responsible for this failure were authorities allowing import of such goods and failing to prevent smuggling. Bad management of the foreign sector led to increases in foreign debt (from some US$3 billion in 1990 to 12 billion in 1998). Many banks have had to find ways to deal with L/Cs issued to companies that were on the brink of ruin.

However, the economy also benefitted from investment made by the foreign sector. In the last three years, total foreign investment (not including the ODA source) reached US$2.4 billion on average and it was considered as the biggest source of investment of the economy. But the other side of the coin was that the market share controlled by foreign-invested companies was increasing and caused both economists and local companies' directors to worry.

2. Corporate sector

Local companies have a common characteristic: their loan capital is disproportionately large. Most of them have spent more money on bank interest than on wages for laborers because the interest rate in Vietnam is rather high. Even banking authorities considered this situation as unreasonable.

The second common characteristic is that most local companies could make no profit: their production lines are some generations old, their management lack experience and managerial skills, and they have no ability to compete against imported goods and foreign-invested companies.

This situation has produced bad effects on the public finance: if companies suffer losses, banks have no chance to retrieve loans and the Ministry of Finance receives no tax payment. To make the financial sector healthier, there must be macroeconomic policies to help companies gain big sales and profits. This way of thinking isn't common under the socialist regime because high profit is considered as high exploitation of labor. In fact, the socialist economy, like the capitalist one, requires big sales and high profit. The problem is how to use the profit gained. It can be used for making new investment, tax and interest payments, giving bonus and incentives to workers or sharing out among shareholders. In short, poor sales and profits always produce bad effects on the banking system and national budget income, so policies to increase companies' sales and profit will certainly help to make the financial sector healthier.

As for companies, poor sales and profits prevent them from modernizing their production lines and other facilities. This remark can be proved by the fact that retained profit from companies represented only 3-7% of the gross investment in the last three years.

One of reasons for low gross investment in Vietnam is the lack of policies to develop heavy industries by providing them with orders placed by the Government and state-run companies. That is why many constructors of investment projects had to depend on imported equipment and machines. This situation has limited domestic investment and increased import value with the result that foreign debt accumulated and growth rate slowed down.

3.Government sector

The Government has tried its best to increase its investment. In the years 1995-1997, the government investment represented 17.5-20% of the gross investment. However, the national budget income is limited because of a poorly performed public sector, so the Government had to borrow from bankers who are reluctant to supply loans to investment projects for fear of a higher inflation rate. Many economists advised increasing the budget deficit in order to finance investment projects and stimulate the banking operations but this opinion didn't raise much interest.

4.Household sector

In this sector, there are many trends that aren't favorable for the financial sector: preferring imported goods to local ones, buying gold and hard currencies instead of depositing money with banks, using gold or the dollar for making major transactions, and so on. In recent years, however, certain changes could be seen: private persons started to deposit money with banks in spite of low interest rates or buy bonds and shares. Generally, private investment represented 24-30% of the gross investment in recent years but this source of finance didn't produce good effects on production because private persons tended to invest in real estate.

In short, reasons for an unhealthy financial sector come from all of above-mentioned sectors, and of course, there are also problems with the banking sector.

Table 1: Structure of Gross Investment (US$ million)

	1991	1992	1993	1994	1995	1996	1997	Total
From Government	243.3	634.7	1,315.0	929.0	1,201.3	1,509.8	1,402.9	7,236.0
From Companies' retained profit	163.8	60.5	63.9	87.1	173.4	281.7	617.3	1,447.7
From shareholders	26.0	42.8	77.6	104.5	115.6	130.0	144.3	640.8
From banks	134.6	68.0	269.4	429.7	436.8	606.8	793.6	2,738.9
From private persons	811.1	1,158.6	1,474.8	1,904.5	1,978.6	1,928.8	1,940.0	11,196.4
Total domestic investment	1,378.9	1,964.6	3,200.8	3,454.8	3,905.8	4,457.2	4,898.0	23,260.1
From ODA			159.8	505.2	340.5	317.9	400.8	1,724.2
From foreign investors	243.3	554.1	1,205.4	1,846.4	2,177.7	2,448.9	2,717.6	11,193.4
Total foreign investment	243.3	554.1	1,365.2	2,351.6	2,518.2	2,766.8	3,118.4	12,917.6
Grand total	1,622.2	2,518.8	4,566.0	5,806.4	6,424.0	7,224.0	8,016.4	36,177.8

Source: based on data and proportions worked out by Đào Ngọc Lân in "*Về nguồn vốn và sử dụng nguồn vốn đầu tư để tăng trưởng*", *Kinh Tế và Dự Báo* (Economy & Forecasts Magazine), March 1997.

5.Banking sector

The banking system has made good progress in recent years: developing the system outside subsidization schemes, solving the shortage of cash by gaining the right to issue bank notes, attracting both local and foreign investment. However, there are also shortcomings in the banking system.

+ Lack of a monetary policy to develop the heavy industry needed for the industrialization and modernization: Before 1996, banking authorities aimed at mobilizing dead money, controlling inflation rate and maintaining the value of the domestic currency. Solutions they chose were based on the quantity theory of money: if the money supply doesn't increase, or increases slightly, and the amount of goods and services supplied increases, the general price level will not rise. To achieve these targets, the banking system allowed import of consumer goods and appreciation in value of the domestic currency. This policy caused foreign debt to increase, put local companies at a disadvantage before foreign competition and failed to concentrate bank loans on development investment projects. And as a result, bank credit represented only 7-8% of the gross investment in the years 1995-96 although the banking system controlled the money supply and had the right to issue notes.

+ A lot of bank loans were used for importing goods that could be made locally or investing in real estate. Certain banks, especially commercial banks, have paid too much attention to assets mortgaged to them instead of examining purpose of borrowers. Therefore, in HCMC and other cities, bank loans were spent on luxury goods and gambling, or used to relend at higher rates of interest. More dangerously, many borrowers had no intention to repay debts to bank, and some of them have got away with it because banking authorities had no measure to control and punish venal lending officials. As a result, bank loans weren't employed effectively and sometimes they became losses to banks.

+ Lending rate was higher than average profit rate gained by companies: To avoid insolvency, many companies have borrowed new loans to pay mature debts, and after a while, compound interest forced them to go bankrupt or appear in court. Until then bank officials discovered that borrowers had borrowed from many banks or mortgaged false title deeds and they had been assisted by venal lending officials.

III. HOW TO MAKE THE FINANCIAL SECTOR HEALTHIER?

As we know, the financial sector has close relations with other sectors, therefore we need a macroeconomic policy that embraces all sectors. with a view to preventing other sectors from causing bad effects on the financial sector, or in other words, dealing with problems arising from other sectors.

At present, a Deputy Prime Minister concurrently the governor of the Vietnam State Bank has enough ability to adopt a special policy not only to reform the banking system, but also help with reforming other sectors. Let's study what should be included in such a special policy.

In 1997, many measures were taken to reduce the trade gap, supervise lending officials, control inflation rate and at the same time, supply loans needed for government investment and make the exchange rate more flexible. The Ministry of Trade controlled import more strictly and the Customs General Department tried its best to prevent smuggling. These measures helped to make a US$2 -billion decrease in the trade gap and raise the banks' contribution to the gross investment from US$606 to 793 million. These are encouraging signs, but the financial sector needs an overall policy including consistent and well-coordinated measures to play well its role in accelerating the economic development. The following are our suggestions:

1.Foreign sector

In foreign trade, foreign exchange must be only used for importing goods needed for local production, especially raw materials and modern machines and equipment.

Foreign investment must be oriented towards fields and industries beyond reach of local companies. Special encouragement will be given to investment in export processing zones.

2.Corporate sector

Many measures can be taken to increase companies' sales and profits, such as offering debt relief to a certain extent to companies with good track record, lowering the lending rate, limiting import of goods that could be made locally, and so on. Particularly, the Government must help to develop the heavy industry and give orders for its products. At present, engineering industry in HCMC and other big cities can make many machines. If the Government give orders and invest in new engineering factories, there will be a new economic boom.

3.Government sector

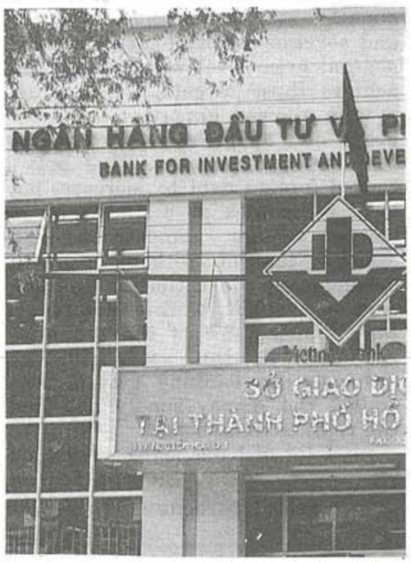
The government had better reduce the amount of civil servants and cadres whose salaries come from the national budget, concentrate more money of development programs and increase the money supply in order to finance investment projects.

4.Household sector

There must be measures to encourage the public to consume locally-made goods instead of imported ones, put their savings in banks; bonds or shares, and use the VN đồng as the legal tender as required by law.

5.Banking sector

The problem is at what scale



these measures are applied. Like J.M. Keynes when he helped the American Government carry out the New Deal after the Great Depression, we want to suggest increasing investment from the central bank, because the bank investment in 1997 was US$793.6 million, representing only 9.9% of the gross investment. In our opinion, following Keynes, we could increase the bank investment by two or three times because the central bank controls the money supply and sources of foreign exchange. With loans supplied by the central bank, the Government can give orders to the local heavy industry. The exchange rate can also be adjusted with a view to promoting export and enhancing the international competitiveness.

The problem is how to change from the policy to increase the trade to fight against inflation to the policy to allow inflation in order to increase the gross investment. In fact, when factories financed by inflation come into operation, the supply of goods will increase and cause the price level to fall. The process of increasing the money supply to finance investment projects can include many stages: making feasibility study, evaluating the project and its management, making plan to provide the project with loans, protecting products made by the project from foreign competition after it is finished, etc. To concentrate money on production projects, banks must report the volume and purpose of loans supplied to the credit risk center run by the central bank. The central bank had better use open credit or solf loans to encourage certain customers such as investors and exporters, allow other banks to borrow from or re-mortgage assets held by them to the central bank for loans at discount rate, or allow banks to use part of required reserves. The lending rate must be lowered because it is rather high in comparison with rates offered in foreign countries. Interest rates can't be considered as a means of attracting dead money held by the public. The central bank must make small savers understand that they can put their money on bonds and shares, instead of depositing it with banks, if they want to earn big interest. Of course, this matter will be easier when the stock exchange is established in Vietnam.

IV.CONCLUSION

As the Governor of the Vietnam State Bank said, a lot of things should be done to make the financial sector healthier. In our opinion, the most important task is to work out a right monetary policy to serve the industrialization and modernization. However, we are so flooded with financial information that everybody can make some statements about monetary policy. Experience shows that badly-prepared policies (such as reforming price-wage-money systems, using high interest rate to fight against inflation, or adopting a fixed exchange rate system, etc.) could cause huge damage.

By tradition, the Government and the Party always trust scientists, we hope that Vietnamese scientists will make the best use of their economic knowledge to serve the industrialization and modernization. There are a lot of development theories, but only the theory about how to employ grey matter really matters■