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Conditionalities of development

EXECUTIVE SUMMARY

1. Political stability, prudential deregulation and economic transformation: a framework for a market economy

Economic transformation hinges on two crucial inputs: political stability and prudential deregulation. If one of them is missing, growth and development will not ensue and development aid will be wasted.

1.1. The politics of economic transformation
Vietnam, one of the poorest countries in Asia, has politically opened up and economically embarked on a course of transition from central planning to a market system. Cut off from Western aid, it was forced to relie on domestic strength rather than foreign assistance.

1.2. Conditionalities of development
In the political sphere Vietnam offers political stability, observes human and civil rights and has created a situation of equal opportunity at the start of the transition. Economically it has adhered to a policy of gradual privatization, prudential deregulation and reform towards macroeconomic stability - with remarkable initial success.

2. Economic transformation

The experience of Vietnam during the period 1981-92 proves beyond doubt that the policy framework is the most important determinant of change and development and that policies do have an immediate impact on growth and income.

2.1. Agriculture: from penury to food abundance
Reforms directed at the privatization of land use started in agriculture as the dominant sector of the economy. Private land use rights led to drastic increases in agricultural production and made Vietnam first self-sufficient in rice production and then the third-largest rice exporter of the world. The issuance of land certificates, an important prerequisite in rural credit and essential for property transfers, is in process. Distorting agricultural price interventions are being adjusted. The agricul*tural tax, despite shortcomings, is being used as a policy in*strument for the intensification of land use and technological innovation. One of the unresolved problems in agriculture is how to adapt agricultural exension and technology transfer services to the differentiated needs of millions or private households.

2.2. State enterprises: the hens which eat the golden eggs

The most critical, because unreformed, factor in Vietnam's transformation are state enterprises: a permanent threat to the banking system, the budget and macroeconomic stability. Spoon-fed by the Government with subsidies, they suffer from overinvestment, technological backwardness, overemployment, lack of financial discipline and lack of markets. Not more than a third are profitable. A comprehensive restructuring program would require a thorough technical and financial analysis of the sector at international accounting standards, legal authority to restructure and the introduction of commercial accountability where privatization cannot immediately be achieved. There is much to be learned from the experience of *Treuhand* in eastern Germany.

3. Monetary reform: adjusting the policy framework

Monetary reform, from unrestrained budgetary expenses to a balance in the growth of money supply and GDP, is at the heart of Vietnam's economic transformation.

3.1. The pre-reform period: a financial system beyond control

A state monopoly over finance, a pervasive subsidy system, negative real interest rates and an inverted interest rate structure with deposit rates above lending rates interacted to produce excessive money supply, financial disintermediation and hyperinflation.

3.2. Incipient reforms: a half-hearted start

Initial reforms in 1987-88 directed at trade and monetary liberalization were only partially successful. They brought down state controls, stemmed inflation and increased exports but failed to achieve stability.

3.3. The reforms of 1989: towards a comprehensive approach

It was only in 1989 that the Government raised interest rates to positive levels, devaluated the currency to its market value, curtailed money and credit expansion and reduced the overall fiscal deficit. The immediate impact was dramatic, with a substantial flow of assets into the banking system and a drop of the inflation rate to around zero. This was paralleled by further trade liberalization and privatization measures throughout the economy, resulting in the growth of output and exports. Yet the high level of monetary restrictions was not maintained, and inflation re-emerged.

3.4. The reforms of 1990: institutional differentiation

The fundamental weaknesses of the financial infrastructure were remedied in 1990 by separating central and commercial banking, differentiating institutions, diversifying ownership, allowing for foreign participation, granting more bank autonomy and increasing competition. This initiated institutional growth and financial innovations, including some of a fraudulent nature.

3.5. The reforms of 1991: strengthening bank supervision

The state responded by granting the central bank supervision responsibility over the banking system.

3.6. Fiscal reforms: the state tightens the belt

When price reforms in 1988 nearly wiped out enterprise transfers to the budget, state finances virtually collapsed. Fiscal reforms in 1989 emphasized tax equality among the state and nonstate sectors and greater revenue mobilization. This was accompanied by expendure reforms, eliminating budgetary subsidies. Guided by principles of equity and efficiency, tax reforms will remain an ongoing concern.

3.7. Trade and exchange reforms: opening up to the outside world Through currency devaluation and trade liberalization, Vietnam has ended it policy of separation and dissociation and paved the way for broadened external relations, which was immediately reflected in growing exports and imports.

3.8. Assessment: enlightened reforms

The first four years of comprehensive reforms in Vietnam have demonstrated that policies have significant effects and economic transformation progresses. They are *bolder and more enlightened than in other socialist economies in transition,* says one of the foremost reform and adjustment arbiters.

4. The financial infrastructure: from state finance to commercial banking

Through its reform policy the state has recently laid the foundation for the expansion and differentiation of the banking system. It is now up to the state to lay the foundation for its viability by reforming the state enterprise sector.

4.1. From colonial origins to socialist monobanking

Under the Socialist Government the former colonial banking system was consolidated into a mono-tier structure, with the role of the state banks conf med to executing government decisions over resource allocation. Instead of gaining in efficiency, banks became lethargic and ceased to function as intermediaries. Their performance deteriorated drastically.

4.2. The banking reforms: differentiation of infrastructure

The banking reforms of 1988 and 1990 laid the infrastructural foundations for financial intermediation. Central and commercial banking functions were separated, and a legal framework was provided for private, mixed and public financial institutions as well as foreign banks and joint ventures. ABV, the Agricultural Bank of Vietnam, and ICBV, the Industrial and Commercial Bank of Vietnam, both government-owned, are by far the largest commercial banks. While the vast network of credit cooperatives has collapsed under the new market pressures, shareholding banks are slowly emerging as the most promising type of financial institution.

4.3. Commercial banking issues

Open or unresolved issues include the lack of proper financial statements, poor portfolio quality and capital adequacy as a result of nonperforming state enterprise assets, cheap money supply by the central bank which discourage savings mobilization, social banking practices, lack of operational guidelines, lack of management autonomy, lack of effective middle management, the absence of an efficient accounting and auditing system, the absence of a management information

system, the conversion of branches into profit centers or shareholding banks, the lack of performance-related incentives, accountability of management and
- perhaps the biggest task - human resource development.

4.4. Informal financial markets: the forgotten part of the financial infrastructure
Informal financial institutions are ubiquitous in Vietnam, among them rotating savings and credit associations *(ho, hui)* and money lenders. The bulk of small and microenterprise funding is locally nobilized and allocated by nonformal intermediaries. Yet little systematic information is available about the functioning of the existing institutions.

4.5. Linking banks and self-help groups
Linkages between banks and self-help groups (SHG) are spreading in APRACA member countries. In Vietnam weaknesses of the rural banking infrastructure have prevented such bold innovations. Yet a small project exists under the Farmers Association which centers on SHG upgrading and linkage banking through VBA and SHGs as credit guarantee groups which indicates that the approach deserves further attention.

5. Issues in financial system development

Financial system development requires an interrelated set of measures: on the levels of the policy framework, the financial infrastructure, institutional autonomy and viability, and innovative strategies and products. Not all goals are equally compatible, and there is no cookbook recipe. For an optimal course, it takes prudence and judgement - and perhaps well-coordinated technical assistance of the highest caliber.

5.1. Interrelated reforms: vicious circle or spiraling effect?
Macroeconomic and financial sector reforms are interrelated, but their objectives may be contradictory. In the case of state enterprise reforms, massive budgetary allocations are required which are incompatible with fiscal restraint.

5.2. Too much money... and how to curb it
Excessive money supply has been a crucial issue in Vietnam undermining macroeconomic stability. After the spectacular success of a tight money policy in 1989, the central bank succumbed to Government pressures and released the monetary brakes. This allowed state enterprises and the budget continued access to credit but drove up the inflation rate. There is only one cure:
prudent budgetary restraint combined with vigorous domestic resource mobilization, withdrawing both public and private demand to balance money supply and GDP.

5.3. The banking crisis: the making of distressed banks
The newly created commercial banks inherited their portfolio from the central bank. It is largely comprised of bans to state enterprises most of which are in jeopardy. In the absence of adequate audits, the extent of the problem is unknown. But it is likely that the banks were in distress since their inception. Banks must rigidly adhere to commercial banking principles, in order not to further aggravate the problem, and to rapid real growth of its private sector business, in order to outgrow their portfolio problem.

5.4. Banks must lend: up to their insolvency

Yet the transition to private sector business, which is still small in Vietnam, will take time - and technical assistance. Meanwhile banks continue to lend, perhaps up to their insolvency.

5.5. Borrow to lend! - a solution to the banking crisis?

Lack of funds is decried by the banks as one of their major problems. Savings mobilization from private households may be the solution, because banks will be more prudent in lending their own funds and those conduited on behalf of the Government.

5.6. Domestic savings exist! But can they be mobilized?

Savings in gold, US$ and rice are widespread in Vietnam, even on the village level. They have been the main source of private self-financing by the savers themselves. Banks have started to tap these savings but will require product innovations, infrastructural expansion and staff motivated by incentives.

5.7. Interest rates: a lever of domestic resource mobilization and financial reform

Depending on whether returns on savings were positive or negative in real terms and whether lending rates were above or below deposit rates, interest rates functioned as instruments of financial system development or repression. Accordingly, they either created incentives for domestic resource mobilization or for uncontrolled deficit spending. Vietnam has definitely moved in the direction of positive real returns and corrected the inverted interest rate structure. But continued consistency in the application of commercial rather than social criteria of interest rate determination will be required to create confidence in the banking system.

5.8. Banks need freedom - they also need to be watched

Banks need more autonomy: the central bank in monetary affairs, commercial banks in customer selection and interest rate determination. Banks have grown faster than the regulatory environment. Tighter bank supervision requires a functioning auditing system within banks and supervisory services by adequately trained staff of the central bank.

5.9. Deposit insurance: no protection is the best protection

In the absence of sound banking institutions and a stable environment, the introduction of formal deposit insurance would be premature. It would create moral hazard and do more harm than good. So far the Government of Vietnam has demonstrated its political will to remedy emergency cases.

5.10. Banks: the hens which lay the golden eggs

There are profit and turnover taxes imposed on the banking system, which are unequally applied to different institutions and thereby distort the market. The turnover tax, in addition, discourages financial intermediation and should be abolished. This would benefit the economy and ultimately also the Government.

6. VBA: restructuring a government-owned agricultural bank

There have been promising initial steps by VBA from subsidized public sector lending to financial services for private rural households, comprising savings mobilization and credit delivery. For a full adjustment to market-oriented banking, VBA requires commercial autonomy and an innovative push backed by a comprehensive package of technical assistance.

6.1. Monetary and financial policy and its impact on agriculture and rural development

In the emerging market economy banks are to play a new role as financial intermediaries, yet they are weighted down by the legacy of preferential lending to priority sectors - at a huge loss. In a small segment of its business, VBA has shown that it can mobilize savings and lend to large numbers of rural households, including the poor - at a profit. The Government now has to decide: between social or commercial banking, credit for a few or financial services for all.

6.2. Adjustments in VBA towards a market-oriented agricultural and rural banking system

For VBA to become an effective financial intermediary, adjustments are necessary on three levels. On the *policy level,* the Government has to dean up VBA's balance sheet and accord VBA autonomy in customer selection and interest rate determination. On the *institutional level,* both retail and wholesale banking through intermediaries may be required. This may also include the conversion of branches into shareholding banks. On the *product level,* VBA needs innovative savings schemes to create its own resource base.

6.3. Vietnam Bank for Agriculture: Its transition towards market-oriented rural banking

VBA, mandated by the Government to provide adequate financial services to the rural economy, bears the full brunt of the transition to a market economy. While it lost the nonperforming assets, inherited from the State Bank, of some 38,000 collectivities, it has yet to build up a delivery system and adequate savings and credit products for some ten million private households. With policy assistance and budgetary support from the Government, VBA has successfully taken its first steps on the road to the market economy. But massive technical assistance will be required if Vietnam is to go all the way in the shortest time possible.

7. Rural finance and agricultural banking: a planning framework for technical assistance

Rural finance and agricultural banking are largely in the hands of VBA. To fully utilize its potential as a financial intermediary, VBA, jointly with APRACA, organized a policy dialog workshop and worked out a planning framework for VBA and donors.

7.1. Policymakers, VBA and APRACA: a policy dialog workshop

In May 1992, policymakers, VBA executives and APRACA representatives met at a a joint workshop in Hanoi on *The Transition towards a Market-oriented Rural Banking System.* The workshop resulted in a a planning framework for VBA which may at the same time provide a framework for technical assistance.

7.2. The core problem of VBA

Participants agreed that VBA's core problem consists in its lack of autonomy as a commercial bank concerning its capital base, interest rate determination and customer selection.

7.3. Objectives and results to be attained: a planning framework

It is the objective of VBA
to become a viable commercial bank serving all segments of the rural population and relying eventually on its own resources and profitability.

To achieve this objective, results or outputs will have to be attained, (1) on the policy level: Strengthen the capital base of VBA, Separate government-directed credit programs, Hake VBA an autonomous bank; (2) on the institutional level of restructuring the organization of VBA: Strengthen the management capacity of VBA, Set up a staff training system, Restructure the bank's organization, Establish innovative banking units, Study intermediaries for wholesale banking, Apply adequate risk management and diversify Operations addressing all sectors of the rural economy; (3) on the financial product level: Introduce new savings and credit products as well as combinations thereof; Introduce effective strategies for savings mobilization.

7.4. The reorientation of VBA and the need for assistance

The Government has demonstrated its commitment to commercial banking by authorizing VBA to engage in savings and credit services to all sectors of the rural economy, to write off inherited nonperforming assets and, most recently, to determine interest rates within much broader limits. As VBA lacks the planning and executive capacity for a comprehensive reform and restructuring program, it requests (1) assistance from APRACA member countries to learn from their experience and (2) technical assistance from donor countries.

7.5. Proposals for technical assistance

VBA and APRACA consultants agreed on the following fields:

(1) Team of policy advisers on different institutional levels for financial system development with coordinated advisory services

(2) Consultancy team to VBA on the restructuring of its organization and products

(3) Feasibility study on the demand for financial services among all segements of the rural population

(4) Feasibility study for a bank partnership project with VBA, centering around bank strategies and product innovations

(5) Continuing the policy dialog

(6) Exposure programs in APRACA member countries

(7) Training program for planning moderators

(8) Publication program

7.6. Making use of APRACA's intermediary services

APRACA assists its members through a service package reaching from information exchange to structured training programs and from advisory services to financial technology dissemination.

8. Financial repression, deregulation and rural finance: lessons from abroad

Indonesia is one of the APRACA member countries which went first through the experience of financial repression, then of prudential deregulation and finally of strengthening control and super-vision of the banking system. Some of that experience may contain important lessons for other Southeast Asian countries.

8.1. Central planning and financial repression: the dilemma of planning and development

Development has failed on most Third World countries because governments virtually monopolized not only the functions of policymaking and public administration but also of banking and entrepreneurship. This generated a weak formal sector, thriving on privilege and protection, paralleld by an immense informal sector, officially ignored and practically harrassed. Planning by central authorities became a substitute for development, while the economy and the financial system remained repressed. Development only ensues when government, public administration and private sector each play their proper role. prudential planning will only succeed with the market, not against the market.

8.2. Prudential deregulation, re-regulation and financial system development: the case of Indonesia

prudential deregulation in Indonesia proceeded in several steps:

(1) Interest rate autonomy conf erred upon private banks; (2) deregulation of the policy framework; (3) deregulation of the institutional framework; (4) tight-money policy and withdrawal of subsidies; (5) strengthening of bank supervision; (6) deregulation of bank ownership. The impact on domestic resource mobilization, financial growth, economic development and poverty alleviation was most remarkable.

8.3. Deregulating rural finance: the example of BRI

BRI is a prime example of the self-restructuring of a government-owned agricultural bank in a deregulated financial environment.