Introduction

Economic globalization is a natural development trend of the labor division and cooperation around the globe, with the support of modern science and technology. This trend is irreversible and it involves any nation, covers most the facets of the socio-economic life, promote competition, strengthen cooperation while increasing the interdependence between economies. This double-side nature of international economic integration depends on the condition and level of economic development in each nation. International economic integration set an urgent need for reforming the whole banking system, from the State Bank of Vietnam (SBV) to credit institutions in such a way to enhance the capacity for managing monetary system, ensuring security for the financial system, and improving the competitiveness of the commercial banks.

Becoming an official member of WTO (tentatively by 2005) is the target for Vietnam to fully integrate to the global economic and financial system. Within the scope of this paper, I would like to emphasize a number of reforms in the banking sector of Vietnam that would partly show the readiness for international integration and WTO accession of Vietnam's banking system.

Part I. A number of achievements in banking reform in Vietnam toward market and international financial integration

After the implementation of the *doi moi* policy initiated by the Vietnam's Communist Party in 1986, the economy has gradually moved to market mechanism with socialist orientation, and integration to the world economy. Those reforms were of strategic importance in the past, and promoted the formulation and development of new economic relations as well as new infrastructure. As a result, the banking system was gradually improved and became more effective intermediation of financial resources. The direct outcome and impact of this process is a deep monetization of economic resources and relations. This also means that economic reform is closely linked to financial liberalization in a mutually supporting effect, thus bring more potential and development opportunities for the banking system.

1. Substantial change in the institutional settings

The enactment of the two Ordinances (in May 1990): Ordinance on State Bank and Ordinance on Banks, Credit Cooperatives, and Financial Companies, have resulted in the formulation of the two-tier banking system. Under this system, the commercial banks exercise the monetary transactions
and provide banking services, the State Bank of Vietnam exercise the state regulatory function of a central bank. So far, the legal framework in banking is basically completed with the enactment of the Law on State Bank and Law on Credit Institutions in December 1997. The previous measures and the current laws on banking not only recognize and protect business operation by the state-owned commercial banks (SOCBs), but also encourage the development of non-state banks, foreign credit institutions in Vietnam, on the basis of equal treatment between different credit institutions, regardless of ownership, to create a sound competitive environment, transparency, and publicity in banking operation. While in 1991 the banking system in Vietnam consisted of only 4 SOCBs and 1 joint venture bank, by 2002 there are 5 SOCBs, one policy bank, 36 joint stock commercial banks (JSCBs), 26 branches of foreign banks, 5 joint venture banks, and the presence of 41 representative offices of foreign credit institutions, financial companies, financial leasing companies, and about 900 people's credit funds.

2. Reform in operation and governance

- **Monetary policy**: Instead of being dependent on the fiscal policy as it was the case before 1990, the monetary policy has become a typical macroeconomic instrument with an overall objective of controlling inflation and promoting economic growth. Currently, the making and influencing monetary policy by the State Bank are based on market principle; market factors are respected and taken as basis for the State Bank to make decision on adjustment to achieve macroeconomic objectives. The process of reforming the monetary was done step by step, under control and linked to the reform of monetary policy instruments and reform in the institutional structure. Since 2000 such indirect monetary policy instruments as open market operations, rediscounting, SWAP arrangement for foreign exchange have been replacing direct monetary control and administrative measures.

- **Interest rate and exchange rate**: Basically these rates have been liberalized. The State Bank only influences the interest rate and exchange rate through the money market and monetary policy instruments. Therefore, interest rates and exchange rates currently reflect more closely the value of Vietnam dong, and follow the development of the international and domestic money market. Interest rates were gradually liberalized in sequencing and with caution. First of all, the real positive interest rate principle was introduced since 1992. Deposit interest rates were liberalized in 1996, and lending interest rates were determined through negotiation since June 2002. The foreign exchange rate management was shifted from the fixed multiple exchange rate, with administrative measures, to the flexible exchange rates that are regulated on the market basis.

- **Banking supervision and inspection**: International standards on supervision and inspection such as CAMELS and BASEL were gradually institutionalized and introduced. Inspection and supervision were reformed in both content and form, with more distant supervision and banking auditing (internal and independent) to support the supervision and inspection, to detect, prevent, and timely deal with violations of laws and prudential regulations of banking.

- **Commercial Banking**: In recent years, the autonomy and accountability of the commercial banks for their business have been institutionalized and enhance in practice. The commercial banks have the right to decide on the deposit and lending interest rate, to select the method of loan security. No
institution or individual can intervene illegally into the operation of the commercial banks. Directed credit or policy-oriented lending is gradually separated from the commercial credit. The international principles and standards for commercial banking (e.g., accounting and auditing, risk management, credit analysis, investment, foreign exchange, loan classification and provisioning, etc.) have been gradually introduced to Vietnam. Banking products and services become more diverse. Some commercial banks have built their e-banking system and automatic transaction system (VCB-online, connect 24, ATM, e-account, home banking, credit card, TCB FAST ACCESS, etc.). By strongly introducing modern technology, especially IT, the banks are providing more features to their customers, including the substantial improvement in the depth and quality of the banking payment system. Such a remarkable progress of the banking payment system was further marked by the participation to the SWIFT system (in March 1995) and the introduction of the interbank electronic payment system (in May 2002) that allows to develop the wholesale and retail banking through Vietnam, and to connect to the international payment system. Currently, the payment system of Vietnam reaches the average level of the region; money transfers and payment through banks in the country now takes only a few second, instead of hours, or even days as before.

- Strengthening of the commercial banks: Due to the low starting point of Vietnam's banking system, and the severe legacy of the centrally planned economy, as well as the negative impact of the financial crisis in the region, Vietnamese commercial banks face a lot of difficulties and show weaknesses. Therefore, the restructuring (financial, organizational, and operational) of the commercial banks is an urgent need for the whole banking system, and in fact this has been started since 1998 for the JSCBs and since 2001 for the SOCBs. The core of the strengthening efforts for commercial banks is the recapitalization, including increasing the chartered capital, trying to reach the capital adequacy ratio based on the international standard (8%) and to deal outright with the non-performing loans (including efforts to stop the growing non-performing loans). The restructuring of the commercial banks so far have made some progress. Almost 5 trillion VND of chartered capital has been supplemented to the 5 SOCBs, most of the JSCBs have increased their minimum chartered capital to the level of legal capital, to reach 100 billion VND per JSCBs. Some JSCBs reach the chartered capital of 350 billion VND. So far, more than 43% of all non-performing loans of the banking system have been worked out, to bring the ratio of non-performing loans in total outstanding loans from 12.7% (on 31 December 2000) to 5% (31 December 2002).

Part II. WTO accession and further banking reform

1. Opportunities for Vietnam's banking system

- International integration open an opportunity to international cooperation in financial and monetary activities between the central banks and in managing the monetary policy between the commercial banks in their transactions, and to strengthen supervision and risk prevention. Vietnamese banks can take advantage of capital, modern technology, management experience, and to develop the comparative advantage of Vietnamese banking to catch up with the international competition and outreach foreign markets.

- International integration creates motivation for banking reform in Vietnam. As a result, Vietnamese banks can have a chance to improve the quality of their products and services, to
diversify their activities based on advance banking technology, to develop a dynamic, secure, efficient banking system that follows the international practice to support the strategy for industrialization and modernization of the country and to promote trade liberalization.

2. Challenges to Vietnamese banks

2.1. Challenges to the banks’ client

In accordance with the committed roadmap in the Commonly Effective Preferential Treatment (CEPT/AFTA), by 2003 Vietnam has to reduce import tariff to 0-5% and by 2006 to 0%. The Vietnam-US bilateral trade agreement requires to set up a policy and legal framework to improve competition, to reduce government protection. More specifically, the local content based import tariff has to be removed; surcharge on price variation for all imports have to be removed. In WTO negotiation, the Initial Offer of Vietnam has been sent to all WTO members; the reaction is to require Vietnam to further import tariff reduction, to the even lower rate compared to AFTA.

The commitments on tariff reduction and protection removal alone would increase the competitiveness of partners' goods in the Vietnamese market. In fact, those enterprises that produces goods and services under commitments (fuel, fertilizer, steel, cement, import substitutes) are important customers of Vietnamese banks and likely to be significantly affected. Once the client's performance and financial health are worsened, the Vietnamese banking system will bear the brunt, and there will be more losses, with the risk of growing non-performing loans and weakened international competitiveness. Therefore, international economic integration put the banks and the enterprises under higher risks, more challenges and vulnerability. Lessons from export rice, coffee, and se products, and more recently the dumping case for Vietnamese catfish in the United States, the high antibiotic residuals in shrimps export to the European Union, and the antidumping case for Vietnamese footwear in Canada, are all the first challenges, given the incomplete and inconsistent legal framework, policy, management scheme that is far from integrating to the international practice.

2.2. Direct challenges to the banks

Not only the commercial banks, but also the State Bank faces with challenges in international economic integration.

- Monetary control: International integration in banking is associated with the rising risk and sensitivity of the domestic financial market in front of the volatile world market. Although the interest rates and exchange rates have been basically liberalized, the essential infrastructure (technical infrastructure, macroeconomic environment, institutional setting, market structure, and laws) is not in place to make sure the liberalized exchange rates and interest rates are fully effective. This put the State Bank in front of great challenges. The State Bank and the commercial banks are more prone to adverse impact of external shocks (economic crisis, war, etc.), that cause turmoil beyond the control by the State Bank in terms of interest rates, exchange rates, thus increasing banking risks.
- **Growing competitive pressure in domestic market for banking:** The opening up of the financial market will pave the way for foreign banks to penetrate the domestic financial market, thus the number of more stronger competitors will increase, with more cutting edge, better technology, and business management skills compared to Vietnamese banks. And in that situation, Vietnam still does not have a Competition Law or consistent policy toward competition in banking.

- **Poor performance for Vietnamese banks:** The Vietnamese banking system is currently characterized by low competitiveness, weak financial resources, small scale, low quality and efficiency, low professional skills in management, low technology, and high risk. Currently, the 4 largest banks account for 76% of total deposits and 73.5% of total lending of the whole system; but their equity is only about US$ 800 million, with the average capital adequacy ratio of 5% (the minimum international standard is 8%). This reflects the weak capability in sustaining risks. Credit remains the key business and source of income for the banks. Products and services of the banks are poor, with low convenience. Most of the commercial banks do not have an effective and sustainable business strategy. Staff qualification of most banks is inadequate to access new technology and modern banking. The supervision and internal audit remains weak. The information system, financial reporting, accounting, including the management information system (MIS) do not achieve the international standards and practices.

- **Banking supervision and inspection:** International integration increases capital flows and thus risks for the banking system, while the management mechanism and banking supervision is incompatible to the international practices, remains ineffective in ensuring the strict adherence to the laws on banking and the systemic safety, especially in prevention and early warning of banking risks.

- The legal system and market institutions are incomplete with many gaps compared to the international requirement for banking, thus restricting competition in banking and money market development. The current Law on Credit Institutions have some provisions not compatible to GATS and the Vietnam-US BTA, especially provisions on quantitative restriction. The Law on State Bank does not adequately address the requirements of an effective central bank in the market economy with an open financial system. So far the organized money market has been in place and becomes active. However, its effectiveness and flexibility are limited due to the poor capability of the participants, the primitive financial instruments, and incomplete legal system.

One may say that the State Bank and the commercial banks in Vietnam now have huge opportunity for development. However, the challenges and weaknesses mentioned above may make Vietnamese banks to incur losses more than they can benefit from the international integration, and risk being lagged behind the world, unless appropriate and consistent internal reform is taken in liberalizing trade in services.

3. **Further banking reform toward WTO accession**

Overall, the banking reform in the past was appropriate to the Vietnamese situation. Changes in the monetary policy, especially in interest rate and exchange rate management, was effective in promoting the banking reform and the overall economy reform. The outcomes of reform as mentioned above indicated that the State Bank and the commercial banks in Vietnam are ready for integration into the international financial community. Despite the many barriers and challenges
along the road toward WTO, the Vietnamese government with under the leadership of the Party and
strong support of the international community will further reform the Vietnamese banking system in
accordance with the Vietnam's banking development strategy for 2001-2010, including the strategy
for developing the State Bank and the strategy for developing the credit institutions to effectively
implement the international commitments and successfully negotiate the WTO accession. As the
requirement for international integration is approaching, the following measures should be
accelerated:

- Completing legal framework for banking: This includes the amendment of the Law on State Bank
and Law on Credit Institutions to be in line with the socio-economic development policies, the
international practices and standard, and first of all the government's commitments for international
integration and financial market liberalization, more specifically, the commitments in the AFTA and
the Vietnam-US BTA. Efforts are needed to create a complete banking law system, with national
treatment for domestic and foreign credit institutions, transparency, to promote sound competition
between banks, and ensure the safety of the banking system.

- Appropriate phase-out of restrictions on market access and financial and banking activities by
foreign credit institutions. The opening up of the domestic market should be conducted through
gradual removal of quantitative restrictions, scope, equity of foreign partners, and total banking
transactions. Active measures should be taken to participate into the international financial market
through issuing securities abroad.

- The strategy for banking system development in Vietnam, the international integration strategy of
the banking sector should be implemented. At the same time, there should be a specific action plan
with clear roadmap for implementing the international commitments. The international integration
strategy of the banking sector should link the reform of the State Bank with the restructuring of the
commercial banks and other financial institutions, while taking into consideration the specific
condition in Vietnam and the international practice. All of these should follow the ideology of the
Party as mentioned in Resolution 97/NQ-TW of the Politburo on international economic integration
and the socio-economic development objectives, adopted by the 9th Congress of the Party.

- The reform in the State Bank operation should be appropriate to the public administration reform in
such a way to enhance the effectiveness of state regulation in the monetary and banking business,
and to meet the requirement of monetary policy reform, the reform in banking supervision,
following the BASEL core principles, to enhance the responsibility and autonomy of the State Bank
in making and exercising the monetary policy, especially in regulating the instruments of monetary
policy. Monetary policy and its instruments should be further improved, with more flexibility, given
the development in the money market and in the macroeconomy. The indirect instruments of
monetary policy (open market operations, rediscounting) should become essentials in monetary
management, instead of administrative measures that impose the non-market approach. The distant
supervision, especially risk management and financial market, auditing should be emphasized to
support the on spot supervision.

- It is necessary to fully develop and effectively operate the money market (primary and secondary),
especially the interbank market for local currency and foreign currency.
- The mechanism for interest rates and exchange rates should be further reformed, and this should be primarily done on the market principle, to manage market transactions. The foreign exchange control should be done in such a way to liberalize current transactions, with selective control on capital transactions, to make the Vietnam dong convertible.

- The commercial banks should be substantially restructured in accordance with the proposal submitted to and approved by the government, with appropriate commitments to the international financial institutions, to have larger banks that are efficient, safe, and competitive at home and abroad. Specific measures include:

  + Organization restructuring: The organizational apparatus of the commercial banks should be reformed to be client driven and to respect market principles. The policy lending directed by the government should be totally separated from the commercial activities of the commercial banks, by setting up a number of policy banks, so that the commercial banks can focus on their profit oriented function. The autonomy and accountability in business of the commercial banks should be enhanced, with minimum subsidies and protection involved in banking activities. When necessary, only selective protection is provided to the commercial banks, with conditionality and sunset clause, following the roadmap of international commitments.

  + Financial restructuring: The commercial banks should be supplied with more chartered capital (recapitalization), and their non-performing loans completely settled to improve their financial health, competitiveness, and resistance to risks. For the SOCBs, the recapitalization should ensure the capital adequacy ratio of at least 8%, and to complete the settlement of non-performing loans by 2005. For the JSCBs, recapitalization should be done through mergers and acquisitions, more equity issued. The quality and efficiency of the business should be improved, and to reduce the non-performing loans to below safety level (less than 2%). There need to be concerted efforts to combine banking reform and enterprise reform, especially the state-owned enterprise reform, with the focus on settling the debt within the banking system and the debt owed by the state-owned enterprises.

  + Restructuring in banking supervision and inspection: Each bank has to prepare and implement the new business strategy, with focus on the expansion of activities, improving the competitiveness, and technology modernization, diversification, with more features to the products and services in modern banking. Regulatory institutions and prudential regulations should be in place to follow the international standards, such as risk management, asset and liability management, capital management, internal auditing, management information system, modern credit system, and credit manual based on the international standard. The accounting system with appropriate indicators and financial statements should be developed, following the standards accepted by the BIS. There also need to be a plan for human resource development, in terms of professional skills, language, computeracy, to meet the demand of integration and international competition.