

# TRANSACTION COSTS AND TRANSITION: THE CASE OF THE VIETNAMESE BANKING SECTOR

Lisa Román

Stockholm School of Economics

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## 1. Introduction

Vietnam is one of many countries presently undergoing fundamental institutional change: The market mechanism replaces central planning. Among countries experiencing economic reform, Vietnam is comparatively successful. Many inherent characteristics contribute to this; it is a relatively homogenous society, and the country is rich in terms of human and natural resources. The prospects for productive investments are substantial, but lack of capital is an important obstacle in the growth process. The intermediating function of the financial system appears to be a bottle neck in this context. Despite recent reorganization, the formal financial sector still has a long way to go until it functions as an active intermediary of investment capital, contributing to economic growth.

This paper discusses the state of the Vietnamese financial system in the early 1990s, how well it succeeds as intermediary of capital, and why the banks have problems in performing their new role as commercial banks. Primarily, the purpose is to shed light on the development in the Vietnamese banks themselves, and thus to better understand general problems in the economy at this stage of the reform process. In a larger perspective the ambition is to contribute to the debate on transition from central planning to market systems. A reoccurring theme in the presently booming literature on transition processes in former socialist countries is the need to establish basic monetary arrangements for the market economy, including a functioning commercial bank system. The literature provides insightful discussions on desired ingredients in financial reform, and also reports on the short-comings of the financial systems in the nascent market economies, not yet living up to the expectations.<sup>1</sup> There is, however, little systematic analysis of the reasons why the necessary institutional framework does not evolve and transform as rapidly and accurately as desired. This paper contributes to such analysis by exposing some of the underlying mechanisms behind slow institutional change in the Vietnamese financial sector.<sup>2</sup>

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1. See, for example, Blanchard et al (1991), Calvo & Frenkel (1991), Gomulka (1992), McKinnon (1992), Nuti (1992), Stiglitz (1992), and Sachs & Lipton (1993). For country reports on banking developments in Eastern Europe, see Prindl (1992) and Gowland (1992).

2. See Neuber (1993) for a principle discussion on the institutional inertia in the transition process. Johnson, Kroll & Horton (1993) do approach the new commercial banks appearing in Ukraine since 1988 focusing on how they respond to transaction costs.

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The approach in this paper is to study how the financial system in the process of transformation induces and responds to transaction costs. Before proceeding into the presentation of the Vietnamese economic and financial reforms, a few words on the basic idea behind the transaction cost perspective. The perspective assumes that economic interaction takes place in an institutional setting, constrained by transaction costs. In response to these costs, new institutions emerge, more or less efficient.<sup>3</sup> The transaction costs may be sorted into two broad categories: Those of coordination and those of motivation. Coordination costs have to do with information: Acquiring, processing, and exchanging information in order to coordinate different activities. Motivation costs concern agents' incentives. If contracts between agents - explicit or implicit agreements - are ambiguous or misspecified, or if the possibilities to enforce contracts are limited, this will affect the agents' behavior, and possibly give them incentive to act contrary to the original intention of the agreement.<sup>4</sup>

The rest of the paper is structured as follows. Section 2 discusses some methodological problems involved in studying economic events in Vietnam. Section 3 briefly presents *doi moi*, the Vietnamese economic reform process, and the general economic situation in Vietnam. Section 4 gives the main content of the reorganization of the financial system and an overview of the present financial structure. Section 5 I analyses whether and to what extent financial intermediation is a bottle-neck for economic development in Vietnam. Section 6 I discusses the problems appearing in the transition process, with a focus on their effect on various transaction costs. Section 7 concludes the discussion.

## 2. Methodological remarks

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 difficulties in Vietnam is that the reform process is ongoing and has yet

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3. The idea of institutions as a response to transaction costs was originally put forth by Coase (1973). Williamson (1975, 1985) advanced the theory. North (1990) uses the transaction cost paradigm for his theory for institutions and institutional change. To Coase and Williamson firms and other organizations are relatively efficient responses to the prevailing transactions costs, while North, among other, says that the institutions emerging are not necessarily efficient or socially productive.

4. Milgrom & Roberts (1992) make the distinction between coordination and motivation costs in their text-book on economic organization and management.

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received little documentation. In addition, the dubious quality and the limited availability of statistical data is a well known phenomenon in many centrally planned economies, and Vietnam is no exception.<sup>5</sup> Moreover, as a legacy of the communist system, Vietnam has a tradition of particular secrecy in the financial sector. I base my arguments on secondary material such as books, articles, and official documents, statistical data for banking operations and the economy in general, as well as on a large number of interviews.

Statistical numbers should be viewed as fairly rough estimates and measures; they are more like indicators of possible trends and magnitudes, rather than exact numbers nor definite truths. As of lately, quite a few statistical publications have appeared in Vietnam, the quality of which is yet difficult to assess. Comparing this data with equally uncertain figures reported in official publications, data obtained through interviews with Vietnamese officials, and information in various newspapers and journals, it seems fair to say that a lot of effort is made but that the quality still leaves much to be desired.<sup>6</sup>

The interviews are of two types. One complements and partly substitutes the lack of written information on the situation in Vietnam. Discussions with Vietnamese economists, politicians, and people in the public administration, as well as with foreign observers, belong to this category. The second type are fairly standardized interviews with bankers (mostly managing directors or deputy directors) in the financial system. The questions asked concerned their banks' main activities, the main problems experienced, and how they viewed their role in the financial system. I interviewed officials at head and provincial offices of the central bank and of the various commercial banks (mainly the so called state-owned commercial banks) in four urban areas: two in the North (Hanoi and Haiphong), one in central Vietnam (Danang) and one in the South (Ho Chi Minh City). I also talked to foreign bank representatives in Hanoi and Ho Chi Minh City.

Given the rapid changes taking place in Vietnam, the presentation, although referring to the situation as recently as in 1991 and 1992, may be best regarded as an historic account of a particular period in the Vietnamese transition process. The situation is changing. For each obstacle overcome, the transformation process is taken yet another step further.

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5. Discussed, for example, by Nove (1986) and de Vylder & Fforde (1988).

6. Examples are *Economy and finance of Vietnam 1986-1990* (1991); *Economy & Trade of Vietnam 1986-1991*, (1992); Tran Hoan Kim, (1992); Tran Hoang Kim and Le Thu, (1992).

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### 3. Vietnamese reform

The reform of the Vietnamese economy, like in many other centrally planned economies, started with the objective to improve the prevailing system. But reform within and of the system have proved to be two inseparable phenomena.<sup>7</sup> Restructuring the state-sector, granting enterprises larger autonomy to increase efficiency, erodes the tax base and impoverishes the state, requiring further reform. Fundamental transformation of the system is automatically set in motion.

The reform process dates back to the late 1970s. Since the mid 1980s economic reforms in order to strengthen the market mechanism have been actively promoted by the Vietnamese government; the process has been labelled *doi moi* (renovation).<sup>8</sup> The reforms include comprehensive price liberalization, decollectivization of rice production and encouragement of household farming, and increased autonomy of state owned enterprises (while eliminating their direct subsidies). In addition, the private sector has received official recognition. The foreign exchange rate has been liberalized, i.e. adjusted to the parallel market level, while restrictions on foreign trade have been significantly reduced, and foreign investments encouraged. Moreover, there have at least been periods of positive real interest rates coupled with general limits to overall credit expansion. Fundamental reform of the financial sector is also part of the reform package.

The achievements of reform are so far encouraging: GDP is increasing, the inflation rate is moderate, exports are expanding, and investments prospects are substantial. Altogether, this has altered the early 1980s' gloomy picture of an economy suffering from severe food shortages. Most urban areas are today flooded with consumer goods, and food markets are prospering; the country is opening up towards others, and foreign investors are turning to Vietnam to explore natural resources and make use of a cheap but well-educated labor force.

But the transformation process, although largely impressive and prospering, also highlights the poverty of the state. As protected state employments gradually disappear, while

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7. Pointed out by McKinnon (1990).

8. The literature on *doi moi* is rapidly growing; see, for example, de Vylder & Florde (1988), Vo Nhan Tri (1990), Forbes et. al. (1991) Ljunggren (1993), and Than & Tan (1993).

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income opportunities in the agricultural and the private partly informal sector increase, so do income differentials and social problems. Of importance are the obvious differences in economic development and general standard of living between North and South Vietnam. While the political power remains in the North, the economic power rests in the South. An indication is that national income per capita in South Vietnam may be around an annual USD 300, as compared to the overall GDP per capita of perhaps USD 180.<sup>9</sup>

A basic problem in the reform process is a severe lack of capital for productive investments, constraining both enterprise and state investments. Infrastructural development is lagging behind. The fiscal situation of the Vietnamese government is poor, and external lending from the convertible area has not been available due to the US government's objection to international organizations' lending to Vietnam since 1980, a ban which was dropped only recently.<sup>10</sup>

Increasing income differentials and the socio-economic problems resulting from the poor state finances, should be valued against the longer term prospects of successfully reforming the economy. Expanding income opportunities seem to have created new dynamic in the society. And while the tightening of the state budget implies a reduction in social expenditures, this is a prerequisite for successful stabilization of the economy which probably facilitates the reform process.

Vietnam's transition to a market economy seems irreversible, although the accompanying political transformation is a process with ambiguous turns. The poverty of the state and the increasing social problems is a headache for the Communist Party, striving to keep both the people's confidence and the power. The official version is that the market mechanism will be used in the construction of a special kind of Vietnamese socialism.<sup>11</sup> On the other hand, there is in the debate a more and more open discussion about crucial points such

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9. Hoang Ngoc Nguyen (1992), p 36; GDP according to World Bank estimates. Note that the GDP is an estimate subject to a large number of approximations; moreover, in purchasing power parity terms, the GDP is probably significantly higher throughout the country.

10. In early July, 1993; see *Far Eastern Economic Review*, 15 July 1993. Vietnam was for long dependent on Soviet aid, primarily in the form of subsidized imports. This aid had by 1991 ceased completely due to the break down of the Soviet Union. The effects on the Vietnamese economy seemed, however, less dramatic than expected.

11. See, for example, *Far Eastern Economic Review*, February 4, 1993.



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as the question of private ownership. There are even people who openly address the delicate subject of the future political system, and the prospects for democracy.<sup>12</sup>

#### 4. Financial system reform and the present structure

With this background, we turn to the reform in the financial sector. In principle, financial reform encompasses state financial aspects (such as tax reform and financial autonomy of enterprises) and a new approach to monetary policy (concerning interest rates, exchange rate policies and price stabilization), as well as the creation of an efficient banking system. Here focus is on the reorganization of the banks partly involving monetary policy aspects, while I leave state finance issues aside.

Apart from a few experiments in commercial banking around 1987, the banking system remained in its old costume until 1988, but has since gone through several phases of reorganization. The government in 1990 passed a new banking law which specified the banking structure: the former monobank (the State Bank) was to be replaced by a two-tier system, consisting of the State Bank of Vietnam (SBV; the central bank), and commercial banks.<sup>13</sup> Although the law sees the central bank as a distinct body, SBV in the early 1990s is organizationally still quite closely linked both to the government and to the so called state-owned commercial banks. These include two former departments of the monobank (the Agricultural Bank (ABV) and the Industrial and Commercial Bank (ICBV)), and two specialized banks from the monobank era (the Bank for Foreign Trade (BFTV) and the Bank for Investment and Development (BIDV)). The banking law also makes a distinction between banks, credit cooperatives, and finance companies, but does not state any difference in treatment between these types of organizations. This equality in the law has yet to be matched by reality.

In effect, the formal financial system is dominated by the four state-owned commercial banks. These operate in fairly separate segments of the economy. For example, the ABV is still largely an agricultural bank. Most of the former State Bank district branches in the rural provinces were taken over by the ABV, making it the largest employer of the four. The

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12. Discussions with Vietnamese scholars and officials in Hanoi in November 1992; See Luu Bich Ho & Le Anh Son (1992) and Vo Dai (1992) on ownership, and *NIAS Newsletter*, April 1993 on democracy.

13. *S.R.V. Banking Decree Laws* (1991).

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BFTV handles foreign trade transactions, and is also managing the foreign currency reserve of the country (which indicates the close links between the SBV and these state-owned commercial banks).

Most of the credit from these banks goes to state-owned enterprises. Dominating receivers of credit are the trade and the industry sectors. Private enterprises receive less than ten percent of the credit.<sup>14</sup> Household savings amount to about 65 per cent of total deposits.<sup>15</sup> Although real deposit interest rates have been positive for most of the time since 1989, keeping savings accounts with the banks is often connected to practical difficulties. Cash shortages often prevail, and many banks charge extra fees for removal of funds, making bank deposits an unpopular saving form.<sup>16</sup>

Complementing the state owned commercial banks are some twenty five joint-stock banks (or share-holding banks), their principal owners often, being state-owned enterprises and individuals in joint-ventures with enterprises. International banking has entered the market in the form of joint-ventures between two of the state-owned banks and a Malaysian and an Indonesian bank respectively; there are also foreign banks, at least ten of which have been permitted to open branch offices since 1992. Apart from commercial banks, few other financial institutions and financial instruments exist. There are a number of very small credit cooperatives, and a couple of so called finance companies, which provide investment capital for a limited number of enterprises; there are also a few new insurance companies. Government bonds are sold, but in very limited quantities. Establishing a stock exchange is a highly desired goal, but lack of functioning property rights and commercial legislation, makes this a subject for the future.

There is possibly a lot of potential for the share-holding banks. Most of them do not carry the burden of old debts and old organizational structures. Apart from two or three share-holding banks exclusively dealing with foreign trade transactions (with head-offices in Ho Chi Minh City), these banks are quite small and have yet had little incentive to expand activities under the given interest rate structure and the other problems in the financial

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14. According to SBV figures.

15. Estimate based on information from the SBV and the individual banks.

16. These illegal fees are reported by many Vietnamese in interviews and conversations. See also *Far Eastern Economic Review*, 1 July 1993.

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environment (which I will return to). The foreign banks primarily deal with foreign enterprises and trade transactions.

A particular feature for Vietnam is the large number of gold-shops included in the financial system and under the control of the SBV. Gold has always been an important wealth keeper in the Vietnamese society. *Doi moi* brought growing wealth to segments of the population, and along with the escalating inflation rate the gold market boomed. Apart from the already existing public gold-shops, the government in 1989 decided to recognize the private gold market by legalizing gold trade and issuing licenses to private shops. This gold trade, and the foreign exchange market in streets and shops in the urban centers, are part of a kind of semi-formal finance, recognized by the authorities but not fully under their control.

In addition there is in Vietnam, like in many other developing countries, a significant informal financial sector. It chiefly consists of two types of financial activities. First, there are loans given for various investments and consumption purposes by professional money-lenders, friends or relatives. The interest rates charged depends on the relationship between the lender and the borrower (the closer you are, the less you pay), and the riskiness of the investment. Second, and important, there is the traditional saving club, the *hui*, which is a variation of the rotating savings and credit association existing in most developing countries.<sup>17</sup>

Getting any good quantitative measure of the size of the informal financial sector is even more difficult than for the formal system. My evidence is thus largely anecdotal, and mainly concerns activities in the urban areas.<sup>18</sup> Informal lending is primarily provided for construction work and trade purposes. When loans are given by relatives and friends it is often a kind of investment funding, where the "interest rate" depends on profits generated by the project. Money-lenders provide short-term loans at comparatively high interest rates. It seems like most any Vietnamese, in the North and in the South, is familiar with the tradition of *huys* and can describe how these saving schemes develop intricate methods to adapt to the inflation economy. This ancient form of saving and lending is prospering in Vietnamese business circles.<sup>19</sup>

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17. See Floro & Yotopoulos (1991) and Adams & Fitchett (1992) on informal finance.

18. Information obtained from interviews in Hanoi, Danang, and Ho Chi Minh City, in the autumn of 1991.

19. See also *Far Eastern Economic Review*, March 4, 1993.



## 5. The financial intermediation problem

How well does the so far described financial system fulfill its role? The formal financial system is in many respects in an embryonic state with respect both to central and commercial banking. For example, most of the conventional policy instruments available to a central bank are not applicable in the Vietnamese case (such as required reserve ratios, open market operations, and discount rates). However, the SBV does affect monetary and financial conditions mainly through centralized interest rate levels, and control of the money supply.

The state-owned commercial banks are in many respects a legacy of the planning system. Despite reform, the banks still suffer from the stiff and inaccurate interest rate structure. Not only have lending interest rates been lower than the inflation rate (making the real interest rate negative), lending rates have also been lower than deposit rates, which has made banking a fairly unprofitable business. An ingredient in the reform program is the increased independence of enterprises. To an extent this has implied a hardening of the credit constraints by limiting access to credit and increases in interest rates.<sup>20</sup> However, many unprofitable enterprises do still, for various reasons, receive continuous support by additional, subsidized credit through the banking system. Not only is this credit unprofitable to the banks due to the interest rate structure, it is often not repayed at all. There is a large share of defaulting loans in the banks portfolios.<sup>21</sup>

How severe is the financial intermediation problem? We may approach an answer, by first studying the investment and saving potential in the society in relation to the size of the formal financial system. Second, we can look at the degree of financial depth to get an estimate of the importance of financial institutions for the economic activities in the country.

20. See McCarthy (1993), p 100 ff for a discussion on consequences for the industrial sector of the *doi moi* measures.

21. Assessing the magnitude of bad debt in the financial system is difficult. According to SBV, some 15 per cent of outstanding loans to state-owned enterprises were either lost or under renegotiation in September, 1991. Of the relatively small share of total credit to the cooperative and private sector (some 4.5 per cent of total outstanding credit in September 1991), the proportion of arrears is even higher (some 35 per cent). However, arrears out of outstanding debt is not the same as the total amount of the banks' poorly performing assets, which most likely constitute a significant proportion of the state owned commercial banks' assets. Banks continue their operations, and do not seem too worried about this problem, despite that the quality of their portfolios might technically speaking make them insolvent. They await governmental decisions on how to clean up enterprise debt and thus the banks' balance sheets. Any detailed information on this is, however, difficult to obtain.

Briefly, investment opportunities are abundant, but lack of capital is a problem in Vietnam. Shortage of capital exists for the state's infrastructural investments, in the state industry, as well as in the private sector. Capital accumulation is low. The national saving rate is below ten percent of GDP in 1990 and 1991 (compared to some 30 percent for the rest of South East Asia), while public saving is negative.<sup>22</sup> Foreign capital is in high demand. The Vietnamese government has anxiously awaited the opening up of international organizations' lending for public investments. Vietnam welcomes foreign investors, and foreign investors are eager to enter the Vietnamese market. More than 600 projects were licensed by April 1993,<sup>23</sup> but most of these projects are far from actual implementation. The lions share of state investments goes to the industrial and agricultural sector. Only some twelve per cent are spent on transport and trade, indicating a fairly low share of infrastructural investments. Total state investments as a share of GDP amounted to close to six per cent in 1989 and 1990.<sup>24</sup>

But official statistics do not capture the whole picture. There is a growing private sector, which is not yet fully included in official figures. Gross fixed investments in small-scale industry and the private sector is growing.<sup>25</sup> In a survey of small-scale private enterprises, lack of capital was reported one of the major obstacles in growth by around 55 percent of urban and 65 per cent of rural enterprises respectively, of which the majority considered it to be the main obstacle.<sup>26</sup> Quantitative measures are scarce, but there is apparently an unsatisfied need for capital. There are also most probably substantial financial resources in the population, which are not yet intermediated through the banks. Household savings amount to only some 65 per cent of deposits in the formal banking system. People instead save in gold, foreign exchange and rice. Apart from passive inflation hoarding, some of this saving is obviously also intermediated through the informal financial sector.<sup>27</sup>

Table 1 presents credit and deposit volumes in the state-owned and other banks in 1989 to 1992.<sup>28</sup> The state-owned commercial banks provided some 95 percent of total formal

22. Kimura (1993), pp 65-66.

23. *Far Eastern Economic Review*, 27 May 1993.

24. Tran Hoang Kim (1992), tables 61 and 64. GDP according to World Bank estimates.

25. Truong & Gates (1992), p 29.

26. Ronnäs (1992), pp 153 and 110.

27. Note, however, that the banks did manage to absorb part of this saving as a response to the increase in interest rates in 1989; Dollar (1993), p 214.

28. The data in the table uses various sources, and should, as any financial data for Vietnam, be used rather as

credit, while they received some 91 percent of deposits in 1991. In addition, the shareholding banks' ("others") nominal deposit volumes between 1989 and 1990, and total deposits declined in real terms (given an inflation rate of some 60 percent in 1990). This is probably a result of the positive real interest rates introduced in the 1989 reform program, which brought a large inflow of deposits into the banks but also resulted in a credit crash: The high interest rates stimulated the foundation of a large number of smaller credit cooperatives, most of which, however, collapsed in 1990 as a consequence of some of these cooperatives' truly fraudulent activities. This credit crisis caused significant losses

Table 1

TOTAL CREDIT AND DEPOSIT VOLUMES IN THE BANKING SYSTEM AS OF THE END OF THE YEAR (1991, SEPTEMBER); bn VND

	1989	1990	1991
<u>Credit</u>			
ABV <sup>a</sup>	1,271	1,516	2,772
ICBV <sup>a</sup>	1,126	1,759	2,684
BFTV	1,247	1,481	1,856
BIDV <sup>b</sup>	474	730	1,094
Others	<sup>c</sup> 400	n.a.	<sup>d</sup> 360
Total	4,518	5,486	8,766
<u>Deposits</u>			
ABV	807	1,136	<sup>e</sup> 1,526
ICBV	1,185	1,893	<sup>e</sup> 2,653
BFTV	281	455	516
BIDV	<sup>c</sup> 148	126	145
Others	<sup>c</sup> 700	345	<sup>d</sup> 415
Total	3,402	3,610	5,255

<sup>a</sup> interview, <sup>b</sup> information material from the BIDV, <sup>c</sup> IBRD (1991), <sup>d</sup> very approximately, <sup>e</sup> as of September 1991.

Source: SBV and the individual banks if not otherwise indicated.

indicators of relative magnitudes and trends, than treated as exact numbers. The figures for "others" (i. e. mainly joint-stock banks and cooperative banks) is even more uncertain than those for the state-owned commercial banks. In the Table I have included figures of total deposits and credit according to SBV data, as well as credit according to a statistical publication and a World Bank report. The differences in the figures from these sources give an indication of the problems in assessing the events in the Vietnamese economy by studying statistical numbers.

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to depositors, while it severely hurt the public's confidence in banks.<sup>29</sup> Some of the decline in the deposit volume is, however, a result of decreasing real interest rates.

Another way to measure the degree of financial intermediation is to look at financial depth. An increase in the stock of financial assets implies a deepening of the financial system. In principle, financial depth means that more financial saving is put into productive use as the banks have more resources to advance as credit.<sup>30</sup> Vietnam is a financially shallow economy. Table 2 shows that *domestic* liquidity (M2D, or currency plus deposits in the banks) as a share of GDP, has circled around 17 to 22 per cent in years 1988 and 1993. According to these figures, M2D as a share of GDP even diminished in 1991 and 1992 compared to the previous years. Total liquidity (M2) as a share of GDP mean while increased significantly from 1988 (around 19 percent) to 1989 (30.5 percent), and has since then been somewhere right below 30 percent. The slight increase in financial deepening compared to the 1988 situation is thus largely due to an increase in foreign exchange deposits, which reflects that the confidence and usefulness of the domestic currency have not augmented.

Vietnam is thus a cash economy. Cash in circulation to M2D is between 44 and 69 percent for the period studied. Moreover, the increase in the proportion of cash in circulation in 1990, 1991 and 1992 indicates that the financial system is not improving as reallocator of financial resources or as a means of payments. Cash is rather becoming more attractive than deposits in the banks. Demand deposits even nominally decreased between 1989 and 1990 (in response to real interest rates again going down after the positive interest rate intermezzo in 1989).<sup>31</sup>

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29. See Nguyen Xuan Oanh (1991), p. 8.

30. See the discussion in *The World Development Report 1989*, pp 26-32.

31. As always, these percentages should be treated with care, and only taken as indicators of magnitudes.



Table 2

MONEY SUPPLY 1988-1993, December; bn VND;

	1988	1989	1990	1991	1992	1993
- currency outside banks (cash in circulation)	1,024	2,352	3,735	6,419	10,579	14,218
- demand deposits	1,303	1,615	1,578	2,707	4,232	4,870
- time deposits		1,357	2,365	2,821	4,119	5,794
Dong liquidity (M2)	2,327	5,325	7,677	11,945	18,931	24,883
- foreign currency deposits	242	2,096	3,680	8,354	8,213	7,406
Total liquidity (M2)	2,569	7,420	11,357	20,301	27,144	32,288
As % of GDP						
Currency	7.7	9.7	9.8	9.2	10.4	11.4
Demand deposits	9.8	12.2	10.3	7.9	4.2	3.9
Currency and demand deposits (M1)		16.3	13.9	13.0	14.5	15.3
Time and foreign currency deposits		14.2	15.8	16.0	12.1	10.6
Foreign currency deposits	1.8	8.6	9.6	11.9	8.0	5.9
Dong liquidity (M2D)	17.5	21.9	20.1	17.1	18.6	19.9
Total liquidity (M2)	19.4	30.5	29.8	29.0	26.6	25.8
Currency as % of						
- Dong liquidity (M2D)	44.0	44.0	49.0	54.0	69.0	57.0
- Total liquidity (M2)	40.0	32.0	33.0	32.0	39.0	44.0
GDP, bn VND	13,266	24,308	38,166	69,959	101,870	125,000

Source: 1988-1991: SBV; 1992: IBRD (1993), p 242; GDP figures: Haughton (1994), table 1.

The M2D/GDP ratio of around 18 percent for Vietnam may be compared to the situation in other developing countries. Average M2/GDP ratios for three groups of developing countries - high-growing, medium-growing and (s)low-growing economies - were around 43, 31, and 23 per cent respectively for the years 1965-87, according to a World Bank study.<sup>32</sup> In Vietnam, economic growth approach the high growth level, while the financial depth is even less than in the slow growing countries. financial intermediation is significantly less advanced than in most other developing countries.

Cash transactions dominate, the financial system is not very deep. However, an important share of financial transactions going through the banking system does not necessarily

32. A sample of eighty developing countries, presented by the *World Development Report 1989*, p 27.

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imply financial efficiency. If the banking system is fundamentally inefficient in reallocating resources, i. e. not able to provide credit for productive investments - either not advancing any credit at all or putting them into loss-making activities - the best thing to do is not to use these inefficient banks, but instead depend on cash transactions and informal finance. The Vietnamese case may very well be of this kind. Nevertheless, the informal sector is less able to supply long-term credit and the absence of financial depth is an indicator of a problem. If the financial system was deeper and more efficient, more capital *could* be provided to productive investments. The deposit volume would be much larger if the banks could mobilize savings more efficiently, and these funds could be used as credit for investments if banks were willing and able to act as commercial intermediaries.

## 6. Transactions costs in the transition process

Why are there problems of financial intermediation in Vietnam? An obvious answer is that the banking system has not yet had enough time to change, and that nothing more than a rudimentary state of commercial banking may be expected at this date. This paper does not aim to criticize an imperfect system per se; the central purpose is to understand the transition of a system and localize key obstacles in the process.

We will look a bit closer at problems facing the Vietnamese banks, with a focus on the state-owned commercial banks. The analytical approach is to consider how coordination and motivation are affected by the current situation in the banks. Of the problems here discussed, most of them concerns both coordination and motivation costs. High coordination costs, for example, are rooted in various information imperfections, imperfections which also give rise to motivation problems.

### 6.1. The role of the central bank

The central bank in the market economy ideally conducts monetary policy and supervises the commercial bank. Through monetary policy a central bank attempts to affect monetary and financial conditions in order to achieve price stability and growth conditions. The supervising function is a prerequisite for stability in the system. In order to maintain this role, the central bank needs *power*. Power requires relative independence both in relation to the government and to the commercial banks. For example, a conservative central bank manager may hold back a government more inclined to expand state expenditures,

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ultimately threatening price stability.

In the Vietnamese case, the central bank is closely linked both to the government and to the state-owned banks. The monobank tradition implied a symbiotic relationship between the State Bank and the government, a tradition which does not vanish over night; especially not since the banking legislation partly maintains the close bondage. The law states that the governor of the state bank shall be a member of the Council of Ministers, the highest executive body of the Vietnamese government (until replaced by a Cabinet in 1992, and a newly created Council for Monetary Policy and Banking taking care of financial issues).<sup>33</sup> The contacts with the Council of Ministers is also stressed by the role of a "supervisor of the government", who has no vote in meetings with the Board of the Bank, but may express his (or her) view, and should report to the Council of Ministers if the Board has views differing from the supervisor.<sup>34</sup>

In addition, the separation of commercial banking and the central bank is a process in several steps. Most bankers in the state-owned commercial banks are clear on their relative independence towards the SBV. They sometimes complain, however, that the SBV interfere in their activities, and that they receive contradicting orders from the SBV and the governmental agencies (at local and central level).<sup>35</sup> Some SBV officials, in turn, claim that the government puts pressure on them to interfere with commercial banking, for example obliging a bank to provide credit to a specific sector or enterprise, which these SBV officials find is beyond the tasks of the central bank.<sup>36</sup> In short, there seems to be a number of unclear power relations in the banking system which contribute to high coordination costs.

## 6.2. The payments system

An important role for a banking system is to provide a payment mechanism. Not only is the banking system the source of cash used in financial transactions, but check accounts and

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33. Decree law no 37, section 1, article 14:1.

34. Decree law no 37, chapter 2, article 12. Indeed the problem is of importance in practice. Officials at the SBV have indicated the problems of interference from the Council of Minister on issues within SBV authority, in interviews in 1991 and 1992.

35. Interviews with bankers in the state-owned commercial banks, autumn 1991.

36. Interviews with SBV officials.

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clearing systems between banks facilitate various transfers of payments, thus reducing transaction costs and increasing efficiency. Central for maintaining an efficient payment system is that banks are credible borrowers of people's savings. This credibility depends on banks' ability to provide rapid, accurate and reliable payment services.

Vietnam is a cash economy. Large financial transactions are made in cash. Payments through banks are extremely slow, sometimes requiring weeks for transfers between different banks, but also between different offices within the same bank.<sup>37</sup> In addition extra fees are often charged for this slow service, and banks are thus relatively unattractive for business transactions.

The short-comings in the payments system is due less to lack of computers (even if such would help), than to a poorly developed accounting system and an impractical structure for transfers between banks.<sup>38</sup> Transfers thus require tedious bureaucratic procedures. Other obstacles is a severe cash shortage (which prevailed up until 1992), which discourages or inhibits banks to provide the banking services expected. Not only does this result in cash transfers, but this cash never even enter into the banks in between payments, since it is difficult for clients to withdraw the money when needed. In addition, low wages and poor control mechanisms allow for corruption which also discourages client from using banks for payments services. Evidently, the slow transfer system complicates coordination both within the banking system and in the economy as a whole, and it reduces people's motivation to use the banks for their financial transactions.

### 6.3. Management and banking skills

Reform of the banking system is a gigantic training project, where the employees are to learn new tasks of commercial banking (new accounting procedures, new criteria for credit advancements, new service skills).<sup>39</sup> The bankers I have spoken to have been surprisingly well oriented in matters such as project appraisals and credit worthiness (although with large variations). Applying new banking skills is, however, difficult when accurate accounting and auditing systems do not exist. The huge risks involved in banking make bankers

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37. The majority of the bankers mentioned this problem of the payments system as a major problem for their bank.

38. Examples of the time-consuming procedures were explained by several bankers. Many bankers mentioned the great need for computers to facilitate banking operations.

39. Bankers claim lack of banking skills to be one major obstacle in the banks ability to adapt to the new situation.



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cautious. Credit to private enterprises is provided only against 100 percent collateral, according to most bankers. Apparently, the banks regard state-enterprises as safer loan-takers: Banks expect the government to somehow bail out or at least not punish the banks for losses incurred by credit to state-owned enterprises. Among the fairly small share of credit given to the private sector (as discussed above), a large proportion of the loans are not repayed.<sup>40</sup>

"True" commercial banking skills (such as project evaluation techniques and appropriate client services) is in the Vietnamese case complemented by a large number of unorthodox banking methods. As in any country, banking has to do with confidence, contacts, and long-term relationships. In Vietnam, these features of the banks' relations to their clients sometimes borders to corruption.

It takes time to implement new banking methods and to establish bank credibility among the population (i.e. a general confidence that banks will treat credit applications objectively, or that savers will be able to withdraw their deposits without delays and penalizing fees). Meanwhile, coordination costs are substantial for financial transactions since individuals and businesses are restricted to informal financial or cash transactions, or are forced to refrain from the economic activity altogether.

#### 6.4. Understanding the market economy

Some of the above mentioned problems touches upon the perceived role of the banking system in the transforming economy. A mutual understanding of different agents' tasks and responsibilities reduce coordination costs in any institutional setting. How do the banks perceive their role in the emerging market system in Vietnam?

A problem for Vietnamese bankers is that they are supposed to behave as commercial bankers while living in a commercially sterile environment. There is a shortage of relevant information: financial statements and auditing systems, as well as "business news" in mass media. Nevertheless, bankers seem, by and large, to have learnt the lesson and to understand the new expectations for the banks in the market system. Most bankers in my

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40. A banker in Ho Chi Minh City explained that his bank prepared the opening of a real estate department in order to sell buildings acquired as collateral and now belonging to the bank.

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interviews would give a statement about their role in the economy claiming that they were now a commercial bank, operating under the new market mechanism. The old role was to be part of the subsidy system, the new role to provide credit independently, and to compete with other banks, primarily by providing better services.<sup>41</sup>

However, many interviewees reveal a number of peculiarities when elaborating on the new role and the problems encountered. An example: "The decision making process has to be further centralized", one banker at the head office of a bank said, motivating it by the fact that the head office had the new know-how. Such increased centralization is not typical of commercial banking in market economies, where bank branches succeed by making relatively independent decisions based on their knowledge of local conditions. In this case, the problem has to do with how to value relevant know-how. Right now it is knowing what a commercial bank is, how to evaluate risk, how to make financial judgements, and understanding new accounting systems which are the important new knowledge. This knowledge is first extended to the head offices of the banks. But eventually, when the bank as a whole gains experience in these tasks, increased branch independence is necessary for efficient banking.<sup>42</sup>

The banker's statement might only refer to the present period of transition, where the head offices indeed must take the lead and the responsibility of the new activities of the bank. The statement might, however, also be an example of a protective attitude often encountered in the interviews, where the bank managers see it as possible and desirable to have an overview of virtually all the economic and banking activities in the country. At the core of this problem are contradictory signals sent from the leadership level (both the leadership of the country and of the banks), and a legacy of the old central planning system. On the one hand banks should be commercial, make profits, act independently and with a self-interest. On the other hand, the cadre of the banks, as well as the political bureaucracy, are still thinking in terms of off-setting imbalances in the economy. The transition to a market economy is viewed as necessary and welcomed, but there is a remaining "subsidy thinking" originating in the socialist system. Most bankers express concern about poor farmers who might not be able to repay loans if interest rates are too

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41. Some bankers, however, claimed that competition was not a problem.

42. Note that the issue concerns direct influence over such decisions which naturally belong to the local bank's mandate. Strategic, principal decisions, in a large organization, are of course made centrally also in a commercial bank.

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high. Loss-making enterprises is another head-ache which bankers worry about. If loss-makers would not receive additional credit they should have to close down, thus causing unemployment. Therefore, banks have to continue to provide cheap credit to poor farmers, and help the state owned enterprises to survive, reason these bankers.

There are other motives why banks are tied up against the state owned enterprises. There are personal realtionship, corruption, and also a kind of 'debt trap' ("If we keep supporting them there is at least a chance we will eventually get our money back"). But bankers surprisingly often refer to explanations of the kind that "we, *after all*, have to support these enterprises *at least for a while*". Not for any other reason than that it would be too bad if the enterprises went bankrupt, it appears.

Bankers' interpretations vary 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 is greater. For example, a banker in a Southern state-owned commercial bank firmly claimed that "we have to make profits". Nevertheless, 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. In the same time as banks become commercial, they maintain, in a socialist spirit, an old role of society's protectors, supporting the weak. This double role makes it difficult for bankers to determine which are the appropriate decisions to make. This is a coordination problem which increases bureaucracy and slows down decision making, thus stigmatizing the transformation process.

Problems of coordination affect motivation and vice versa. Uncertainty about whom to turn to for a specific decision, is a coordination problem with incentive effects. Should you ask for permission or should you make the decision yourself? The safest bet might be to do nothing, at least for the time being. The uncertain decision structure provides little incentive for independent action.

#### 6.5. The interest rate structure

The interest rate structure is a legacy of the central planning system, and rather an inflexible instrument. Not being able to set interest rates in relation to market conditions, means that the banks, for one thing, have little incentive to expand their activities, and in addition that they prefer cheap loans from the State Bank rather than absorbing resources from the population.

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The view on the interest rate policy is gradually changing, however. There are still limited possibilities for banks to determine their own interest rates,<sup>43</sup> but two important changes have occurred. First, there is a general recognition of the benefits of applying "the system of positive interest rates"<sup>44</sup>, i.e. a positive spread between lending and deposit rates, and positive real interest rates. Second, the SBV and the ministerial level have (in 1992) agreed that interest rates in principle should not be related to the borrowing organization's ownership structure (with a few exceptions.)<sup>45</sup> However, a clear distinction between interest rates paid for deposits from the population and from the enterprises remains. The former interest rates are substantially higher than the latter, and there is thus little incentive for banks to devote resources on mobilizing the people's individual savings.

#### 6.6. Lack of legislation

When bankruptcy laws and other commercial laws are missing, enforcement costs are high. This is one of the most fundamental and severe problems in the transition process in Vietnam today. A basic dilemma is the absence of a bankruptcy law. Unprofitable enterprises may be closed down, and the employees laid off, but there are no procedures to settle financial transactions and creditors are left in the air. Banks have also limited possibilities to enforce repayment from enterprises still operating, or from individuals if the loan-takers refuse to repay. In addition, lack of procedures for legal agreements make contracts unspecified and ambiguous, and adds to the enforcement problems.

Hence, banks largely conserve the old industrial structure when supporting loss-making state companies by providing additional credit. This bailing-out strategy is understandable in the short run: it prevents companies and industries from shutting down business, which would be costly both in terms of unemployment and supply of products. In the long run, however, the support of unprofitable companies is destructive as it provides no incentive for firms to exit (through the absence of the bankruptcy alternative) at the same time as new companies are prevented from entering the market (through the lack of sufficient credit). Enforcement costs are high also on the deposit side. Depositors may be denied

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43. Interest rates are determined by the SBV, decided by the Council of Ministers, and distributed as decrees over the country.

44. As the interpreter in one interview translated a statement from a banker.

45. According to SBV official in December 1992.



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to withdraw their deposits until the bank has managed to get hold of cash from other sources. No legal procedure or political system can give voice to the interest of depositors in this situation. Deposits remain low and the banks have little money to advance. In a situation with high enforcement costs, personal relationships become important, and corruption flourishes.

### 6.7. Competition

The intention of financial reform is to develop a commercial banking system, which implies a competitive banking system. Competition is a fundamental driving force in the market economy, motivating agents to improve and expand. Competition between the state-owned commercial banks and between these and other banks, is in principle permitted and encouraged by the Vietnamese banking legislation. However, the new state-owned commercial banks are former State Bank departments, dealing with different sectors of the economy. Local and sectorial monopolies exist.

Another aspect of competition is the degree to which the formal financial system faces competition from the informal financial system. Experiences in many developing countries show that informal financial institutions both supplement and complement the formal institutions. 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. But *huiss* and private money lenders, as long as they are better informed about clients and projects, are rather functioning as complementing institutions in the spectra of financial intermediaries in Vietnam.

### 7. Concluding remarks

Vietnam is a growing economy, with a dominating but impoverished state sector. Economic reform has been a process rather than a clear-cut program. Reform has brought the emergence of a commercial banking system, however still in an embryonic state. Despite the reorganization of the state-bank system, the poor functioning of the financial market is a major cause to the prevailing lack of investment capital in the Vietnamese economy. The emerging entrepreneurship relies on self-finance and informal financial sources. The individual Vietnamese saves in gold or foreign exchange, and rely on cash transactions.

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The formal banking system is, however, undergoing rapid change, albeit a number of obstacles face the banks in this process. Lack of legal institutions and banking skills limit the banks' possibilities to act in the new economic environment. Banks do not manage to mobilize adequate savings, nor to advance credit for efficient use. They contribute to softening budget constraints for state enterprises by continuing to provide subsidized credits.

Some of these problems are caused by the transaction costs occurring in the transition period. Important in this context are the increased coordination costs related to the difficulties in understanding the new economic structure. In order to be able to operate in a given institutional setting, you have to have a fundamental view of your role in the system. If your view is different from others', and if you have difficulties in actually understanding what you are supposed to do, this will create problems.

The Vietnamese banks have, in a sense, a double role to play in the society. 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 thus they also protect the all economic 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 top leaders of 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 decisions making may be delegated. The double role played by the banks creates contradictions and uncertainty, and this coordination problem slows down organizational change.

The unclear decision structures, resulting from the uncertainty about the new role of the banks, 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.

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When banks do not provide banking services as expected, but maintain bureaucratic and discriminating procedures, there is no way to establish a general confidence for the banks. Hence, the banking system is not able to act as a reallocator of financial resources, and establish the efficient financial system which the development process would benefit from.

However, the short-comings in the formal financial system might be less an obstacle to economic growth in Vietnam than in other reforming countries. The structure of the Vietnamese economy is predominantly rural. The expanding private sector consists of small-scale enterprises, which to the extent they are externally financed rely on the informal financial sector. It might be that this sector expands along with private enterprises, thus marginalizing the inefficient state-owned banks. One should not underestimate the Vietnamese ability to establish a functioning financial system at surprisingly high speed. The giant state-owned commercial system dealt with in this paper might not, however, play a central role in this process. A purely speculative final remark is that the new shareholding banks along with the foreign bank branches will become the important financial intermediators of investment capital, necessary for the further growth of the Vietnamese economy.

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**Abstract**

*The former centrally planned economy of Vietnam is undergoing transition into a market economy. The reform of the banking sector is a key feature in the process. This paper discusses the structure of the Vietnamese financial system in the early 1990s, and its so far limited role as financial intermediary. The paper points to a number of interrelated coordination and motivation costs, which slows down the transformation of the banks. In order to understand why transition takes time, it is important to clarify the obstacles behind institutional change. Focus is on the unclear role of the central bank, the poor payment system, the lack of proper banking skills, the agents' vague understanding of the market economy, the deficient interest rate structure, the lack of legislative framework, and the inadequate competition between different financial institutions. However, in Vietnam the important financial agents for the future might be the recently entered foreign banks and perhaps an increasingly formalized informal financial sector, rather than the state-owned commercial banks.*