MAINTAINING SOCIALLY-INCLUSIVE ECONOMIC GROWTH BY ENABLING OPPORTUNITY
ACHIEVING SUSTAINABLE DEVELOPMENT IN VIETNAM

Master of Arts in Law and Diplomacy Thesis

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DEDICATIONS

I would like to dedicate this paper to the children of the 15 May School for showing me the transformative value of access to entrepreneurial opportunity. And to my parents for all of their support and patience over the years, without them, none of this would have been possible.

CONTENTS

ABSTRACT

Throughout its development, Vietnam has proceeded with caution in its experimentation with market mechanisms and global integration, employing substantial measures to reduce poverty through socially-inclusive economic growth. The past decade in Vietnam can be characterized by robust economic development and absolute poverty decline premised upon extensive legal and economic reform, increased foreign investment, industry-wide deregulation and privatization, and the awakening of a long-suppressed entrepreneurial spirit.

This paper presents industry and competitive analyses of Vietnam's telecommunications and banking sectors and explores the effect of a gap in access to these services on continued entrepreneurial opportunity and socially-inclusive economic development. The main argument against the importance of the provision of access to telecommunications and financial services to impoverished communities is the traditional belief that these products are of marginal value to populations struggling to cope with physical and economic security. I argue to the contrary, that convenient and affordable access to these services can generate entrepreneurial opportunity and income enough to mitigate many of the physical and fiscal challenges that afflict the poor.

I propose that the effective provision of universal access to these services requires comprehensive privatization, increased competition, cross-sector convergence, and the hybridization of the lower cost structure and network effects of mobile telephony with the high sunk cost infrastructure inherent in traditional banking and information exchange networks. The achievement of these targets can allow for a more affordable and accessible service that will reach a larger, more cost sensitive user base. The significant reduction in the cost of use, coupled with a marked enhancement of the value-offer, will result in the broad delivery of connectivity, financial services and information exchange. This in turn, will bolster entrepreneurial upstarts of all sizes, create employment, link and strengthen the private sector, and generate socially-inclusive economic growth in Vietnam.

INTRODUCTION

Over the past decade, the Government of Vietnam has initiated legal and economic reforms that have unleashed a long-suppressed entrepreneurial spirit and stimulated economic growth. Only two decades prior, Vietnam was a war-ravaged country facing famine and a failing command economy. Today, the country is continuing its extensive transformation from an inward-looking planned system to one that is international and market-oriented. Throughout its development, the Vietnamese government has proceeded with caution in its experimentation with market mechanisms and global integration, employing substantial measures to reduce poverty through socially-inclusive economic growth. Initially, Vietnam relied heavily on foreign direct investment (FDI) and domestic consumption as its primary engines of growth, which required large inflows of capital and outflow of exports. Though these flows are steady and somewhat stable at present, their exposure to risk and volatility intensifies as the nation rushes to join, participate and compete in the global economy. In staking much of its future on the constancy of foreign remittance flows, export demand, and foreign investment, the Vietnamese government has had to expedite its market liberalization and mass privatization schemes without first sufficiently reinforcing its nascent private sector. To maintain its impressive economic growth, Vietnam must reduce its dependency on potentially stochastic foreign capital flows and markets by continuing to support the expansion of entrepreneurial activity that generates socially-inclusive economic growth.

This paper presents industry and competitive analyses of Vietnam's telecommunications and banking sectors and explores the effect of a gap in access to these services on the generation of income-generating opportunity and socially-inclusive economic development. Chapter 1 outlines Vietnam's economic history leading to market liberalization and privatization. Chapters 2 and 3 provide synopses of Vietnam's telecommunications and banking sectors, analyzing the competitive landscape, and framing the gap in access to these services for the poor. Chapter 4 provides policy recommendations for both sectors and addresses the potential impact cross-sector convergence and hybridization of these traditionally difficult to merge industries can have on sustainable development. The paper concludes with arguments for the effective provision of universal access to services that can create or sustain income-generating opportunities and socially-inclusive economic growth.

1. INSTITUTIONAL ANALYSIS

1.1. Macroeconomic Overview

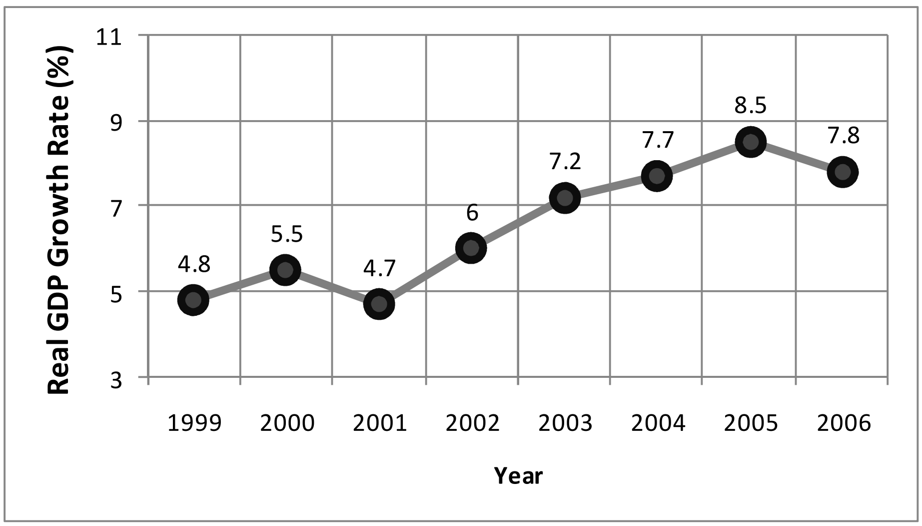
Vietnam embarked on its transition to an industrialized economy after becoming disillusioned with the widespread poverty and hunger that accompanied strict state control. The government launched its "renovation" process (*Doi Moi*) in 1986, amidst a collapsing Soviet Union, its main market and vital source of foreign assistance, as it prepared to face its own domestic fiscal crisis. The Vietnamese government opened its economy to foreign trade and investment, choosing not to adopt Russia's "Big Bang" strategy but instead implementing the nationalist East Asian "developmental state" model of privatization (Hoff & Stiglitz 2004/Packard 2005).[1] This gradualist approach, described by the late Chinese leader Deng Xiaoping as a process of "crossing the river by feeling the stones under the feet," provided authorities with time to develop supporting institutions for businesses, households and individuals to learn and adapt to new economic rules, and for the new rules to be modified based on actual experience (Packard 2005). Using this approach, the Vietnamese government controlled the pace of reform, intervened when they saw fit, and retained ownership over the country's development strategy, a plan which emphasized a commitment to growth, poverty reduction and social equity (IMF 2006). In avoiding a rushed mass privatization of its state-owned enterprises and hasty exposure of its competitively inexperienced, inefficient and under-capitalized domestic firms and farms to intense and often insurmountable competition, Vietnam avoided the economic collapse that many other transition economies experienced in the early 1990s.

Vietnam's cautiously managed market liberalization approach allowed the country to generate impressive but constrained economic growth. To serve its social objectives, the government channeled state-owned enterprise (SOE)-generated revenues to subsidize investments in infrastructure, education and health, resulting in socially-inclusive economic growth that strengthened the national stock of physical and human capital and provided firm ground on which to build a private sector. These efforts have led to Vietnam's impressive average GDP growth rate of seven percent over each of the past seven years and reduction in

[1] The "developmental state" model promotes sustained economic development through steady high rates of economic growth and structural change in the productive system, utilizing its administrative and political resources to the task of economic development.

poverty incidence, which stood at over 70 percent in 1990, down to around 18 percent in 2006 (IMF 2006). Vietnam's major drivers of growth have been the FDI inflows and foreign aid that has poured into the country due to reduced trade barriers and progressive global integration. Vietnam's deteriorating control over foreign investment and capital mobility restrictions increases the importance of a strong private sector core to fuel domestic private consumption and generate sustainable economic growth.

FIGURE 1. VIETNAM: REAL GDP GROWTH RATE (%) 1999-2006.



Source: CIA World Factbook

The Vietnamese government took a bold deregulatory and market liberalizing step in 2000 by passing its first pro-market legislation, the Enterprise Law[2]. The Enterprise Law dramatically increased the number of newly registered local enterprises. As of 2006, aggregated figures of registered businesses numbered well over 150,000 and amounted to over US$19 billion in committed capital (World Bank 2006). In its efforts to further improve the nation's business environment and prepare its economy for accession to the World Trade Organization (WTO), the Vietnamese government passed the Unified Enterprise Law and Common Investment Law in late 2005.[3] Since initiating reform, Vietnam has increasingly recognized the essential role that the private sector plays in economic development, and has accordingly set out

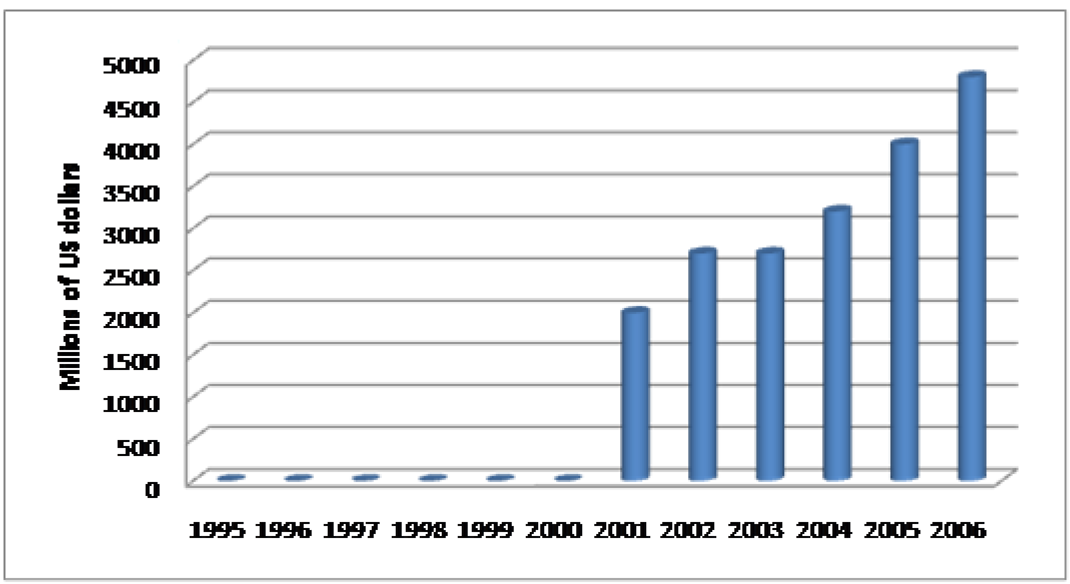
[2] The Enterprise Law of 2000 simplified and made accessible formal avenues for enterprise registration, which reduced licensing-based informal business practices while stimulating the creation of successful and profitable SMEs.

[3] The 2006 Unified Enterprise Law purports to treat all enterprises as equal, regardless of whether their ownership is domestic or foreign and only recognizes four types of businesses: limited liability companies, joint-stock firms, partnerships and private enterprises. The 2006 Common Investment Law seeks to create universal regulations for foreign and domestic investors.

to facilitate increased private sector investment and market institution development to promote competition and employment creation.

Despite restricting capital inflows and outflows, Vietnam enjoys a robust influx of capital. The present structure of positive capital inflows reflects the central bank's filtering of volatile short-term capital flows through the banning of short-term loans, the holding of medium- and long-term loans in short volume and the encouragement of long-term inflows such and FDI and private transfers.[4] A main source of capital inflows is FDI, and in 2005, FDI commitments reached an eight year high of US$5.72 billion (Nguyen et al 2006).[5] In recognizing the vital role that FDI plays in its economic development, Vietnam has made great efforts to become competitive in attracting FDI through amendments to its legal frameworks such as the Unified Enterprise Law and the Common Investment Law[6]. These improvements set free Vietnam's entrepreneurs, stimulating private sector development and providing essential fodder for its economic growth engine. Additionally, remittances from overseas Vietnamese constitute

FIGURE 2. FORMAL INWARD REMITTANCE FLOWS INTO VIETNAM (1995-2006).



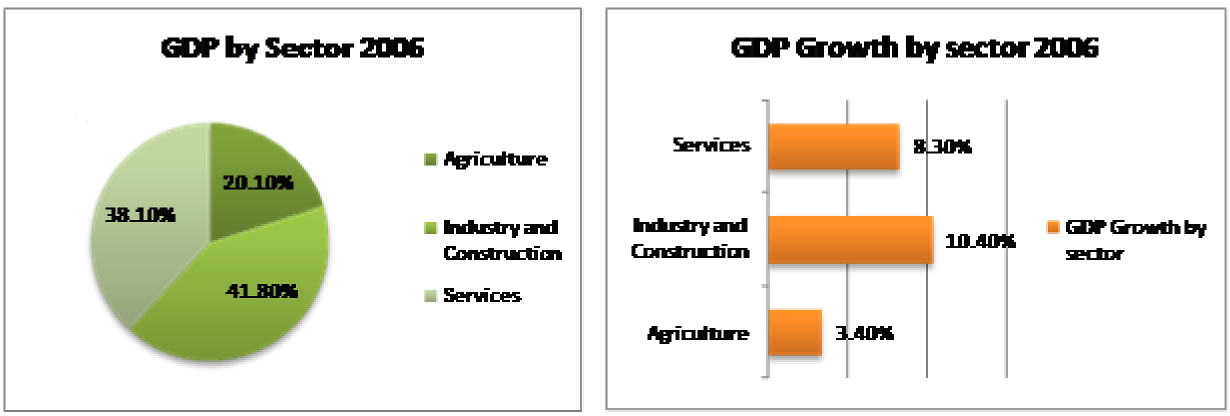
Notes: No data is available for years prior to 2001. *Source*: Remittances data, Development Prospects Group, World Bank, 2007.

[4] The majority of which are in the form of loans from international financial institutions such as the IMF, World Bank and ADB.
[5] Over 6,000 foreign-invested projects are presently in operation, constituting nearly US$52 billion in FDI inflow pledges, with actual disbursements totaling nearly US$28 billion.
[6] See Appendix for more detailed synopsis

another important segment of the capital inflow. Registered and informal remittances[7] have risen consistently since the late 1990s and today are estimated to total US$8-12 billion annually (USAID/DFID 2006).

Over the past decade, several key structural changes have taken place in Vietnam's economy, resulting in a substantial shift in the country's economic structure. Agricultural output has contracted, while the share of industry and services has experienced a marked increase.[8] These changes have been the product of market-oriented reform, gradual reductions in barriers to

FIGURE 3. VIETNAM'S GDP AND GDP GROWTH BY SECTOR (2006 EST.).



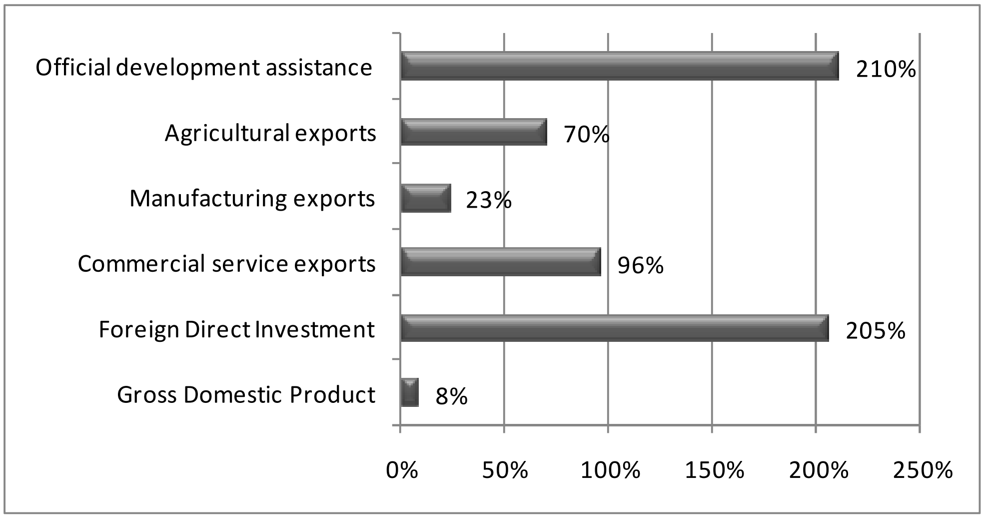
Source: U.S. Department of Commerce.

competition and private sector development. In addition, Vietnam has achieved sufficient ratios of investment and resource mobilization in terms of GDP, which signals that the challenges ahead exist in increasing efficiency in resource allocation, improving capital productivity and strengthening domestic infrastructure for businesses to effectively utilize capital (Camen 2005).

The domestic private sector has generated much higher output and employment per unit of investment than either the state sector or foreign investment, despite persistent channeling of capital financing to less efficient state-owned entities. The private sector investment-to-GDP ratio is projected to reach 40 percent over the 2006–2010 period, roughly US$140 billion, and the state share of this total investment is expected to decline from 51.1 percent (2001– 2005) to 44.6 percent. Over the same periods, the private sector share is expected to increase from 49 percent to 55.4 percent, with an increase in the share of domestic private investment from

[7] Money transferred through channels other than banks.
[8] Comprising a growing share of the economy with industry (rising by an estimated 9.3%) and services (7.7%).

FIGURE 4. REMITTANCE INFLOWS AS A SHARE OF SELECTED FINANCIAL FLOWS AND GDP



Sources: Migration and Remittances Factbook, Development Prospects Group, World Bank, 2007; Global Development Finance, World Bank, 2007, International Monetary Fund, Balance of Payments Statistics, 2007; International Trade Statistics, World Trade Organization, 2006. Data for 2005, except for GDP (2006) and Agricultural exports (2004).

29.8 percent to 34.4 percent, further indications that the private sector will be vital to the Vietnamese economy's future growth (ADB 2006). To date, progress in state-owned enterprise (SOE) and state-owned commercial bank (SOCB) privatization has proceeded slowly due to the legacy of strict state control and inefficiencies inherited from the centrally-planned system.

As benefits of market liberalization became apparent, Vietnam responded by intensifying its reforms and international integration. In addressing the growing importance of its private sector and attempting to meet the subsequent challenges of a more liberalized environment, Vietnam adopted a bolder approach to SOE and SOCB reform. As a result, the number of SOEs steadily fell from over 12,000 in 1990, 5,600 in 2001, to an expected 1,500 at the end of 2007.[9] In Vietnam, the divestiture of SOEs mainly transpired through equitization, whereby the SOE, after a sale of shares, is converted to a joint-stock company[10] that operates under the Enterprise Law, rather than under the SOE Law. Other forms of SOE transformation utilized by Vietnam have included mergers, conversions to limited liability companies and outright liquidation (ADB 2006). To date, the equitization focus has been on smaller SOEs, however, the list of sectors with 100 percent retained state ownership has recently been substantially shortened (Packard 2005). Since 2004, the average size of transformed SOEs has been increasing, prompting the

[9] US Department of State. Vietnam 2006 Investment Climate Statement. Accessed on May 9th, 2007. http://www.state.gov/e/eeb/ifd/2006/63598.htm
[10] Jointly owned by the State and other share-owning entities.

government to create the State Capital Investment Corporation (SCIC) to promote and manage the government's stake in equitized SOEs. Although progress in privatizing larger SOEs, both general corporations and state-owned banks, has been slow, it is important not to discount its contribution to and consequence on economic growth.

1.2. Trade Liberalization and Global Integration

Vietnam's national decentralization efforts, in addition to its gradual integration into the world economy through bilateral, regional and multilateral trade agreements, have triggered an accelerated pace of reform. The nation's accession to the WTO in November of 2006 has had significant implications on the Vietnamese economy in lowering the country's trade barriers on goods, introducing competition for services and modernizing an array of laws and regulations. Moreover, WTO membership has directly exposed the Vietnamese economy to a highly competitive and globally integrated market that will require an efficient banking sector to encourage investment in domestic industries and markets. Accordingly, the government's strategy should be to develop a sound investment environment conducive to both financial and private sector growth. To achieve such goals, the government will need to focus on developing an effective banking sector that can protect the interests of all investors, operate competitively domestically and within the world's financial markets, retain sufficient domestic resiliency to manage macroeconomic shocks, facilitate business through modern infrastructure and regulation, and integrate those currently operating in the informal sector.

Vietnam took significant steps toward integrating itself into the global economy and as development strategies produced positive results, the government responded with deeper economic reform. One of the first moves involved normalizing trade relations with the U.S. in 1993. Since then, Vietnam joined ASEAN in 1995, became a member of APEC in 1998, and signed the Vietnam–US Bilateral Trade Agreement (VN-US BTA) in 2000. In 2006, Vietnam fulfilled its ASEAN Free Trade Agreement (AFTA) obligations and early in 2007 it was granted accession to the WTO. In entering into free trade agreements and acquiring obligations to reduce control over its markets and barriers to trade, the Vietnamese government may have unwittingly accepted a pace of integration that outpaces its capacity to manage change.

1.3. Historical Antecedents to Privatization

Vietnam's legal and regulatory reform has stimulated robust expansion in domestic demand, rapid growth in private investment and strong export performance, which in turn, has produced a marked increase in the productivity of the Vietnamese private sector. Parallel to these reforms, Vietnam has gradually privatized many of its small and weak non-financial state-owned firms and has taken measures to extend this privatization scheme to its remaining SOEs including the state-owned banks that are financing the nation's economic development. Today, private enterprise plays a significant role in the economy, generating over 40 percent of Vietnam's GDP and employing 30 percent of its workforce (ADB 2006). The growth of most private enterprises, and in particular that of small and medium enterprises (SMEs),[11] however, continues to be constrained by limited access to financing, difficulties in assessing collateral value and private credit risk, and the lack of reliable and affordable telecommunications and information access. National reform initiatives and impending international obligations have intensified competitive pressures levied on Vietnam's private sector, potentially jeopardizing its ability to continue to generate high economic growth. The continued success of Vietnam's private sector and the nation's economic development in general, will depend upon the allocative efficiency and expansion of its banking sector and reach and reliability of its pro-market infrastructure.

1.4. Poverty and Socially-Inclusive Economic Growth

In exchange for increased foreign interest and investment, greater flow of human and financial capital and improved technology and innovation, Vietnam's government has made concessions to relinquish control over its economy and markets. As a result, the nation's cautiously managed liberalization scheme that has allowed it to maintain socially-inclusive economic growth, may be compromised. Vietnam has made significant progress in reducing poverty and improving other quality of life indicators. Poverty incidence in Vietnam went from over 70 percent in 1990 to around 18 percent in 2006, attestable mainly to the country's explosive economic growth and implementation of social programs. Despite the substantial

[11] In Vietnam, SMEs are defined as enterprises with a monthly revenue of VND 6-40 million (US$377-2,516) and employing fewer than 10 employees.

magnitude of these gains, freedom from poverty remains fragile, since many of those considered "near poor" subsist only slightly above the poverty line and are thus vulnerable to country, community and individual economic shocks. Despite considerable progress in reducing poverty in the last decade, there are still about 4.6 million households (slightly more than 24% of the population) living in poverty (World Bank and DFC 2007). Access to utility infrastructure services, such as clean water and electricity, has markedly improved throughout the country and even the poorest communities are seeing improvement, albeit languid. Vietnam has achieved universal primary education but the general population and especially marginalized communities are still limited in access to post-primary education, which has had a proven impact on poverty reduction in other developing countries.[12] Key health indicators such as infant and toddler mortality rates, child malnutrition rates, and maternal mortality rates have vastly improved since 1990, but health improvements for the rural poor are occurring slower than for higher income groups.[13]

2. OVERVIEW OF VIETNAM'S TELECOMMUNICATIONS SECTOR

2.1. Introduction

Vietnam's telecommunications sector is expanding rapidly, primarily due to mobile and fixed-line growth, and its future development is upbeat. The optimism is so great that the Vietnamese government has recently declared the telecommunications sector as vital to the nation's present and future economy (MPT 2007).[14] Over the past three years, Vietnam has sustained an average annual growth rate of about 42 percent in total teledensity.[15] Mobile usage has grown at an average of 53 percent each year for the past four years, and predictions of Vietnam reaching a total teledensity greater than 50 percent by 2010 are widespread. This target is ambitious considering that the 2005 figure for total teledensity was about 20 percent.[16] The market segments that will be most important to, or affected by, universal service initiatives and international free trade obligations are the fixed-line local and long distance and mobile sectors due to their cost of use and ease of accessibility. The internet's late adoption and initially

[12] Asia Development Bank (Balisacan et. al. 2003)
[13] *Ibid.*
[14] Stated at the Ministry of Posts and Telematics Forum for Vietnam's WTO readiness.
[15] This figure is higher than China and is one of the highest in the world.
[16] World Bank – Toulmin et. al. 2006.

languid development resulted from the Vietnamese government's initial propensity for control over information. The sector, however, has since grown exponentially in terms of internet users.

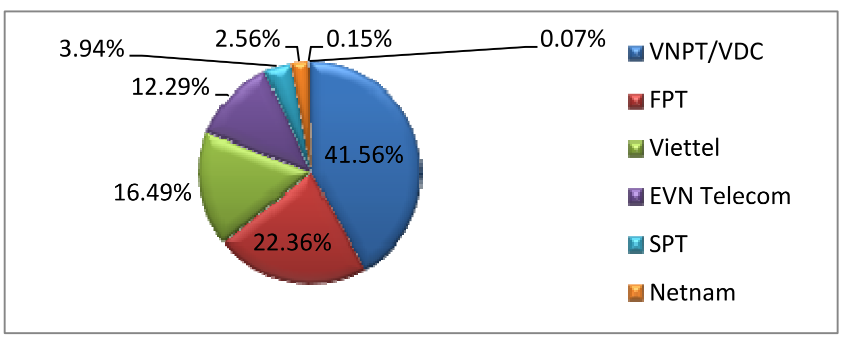
TABLE 1. INTERNET USAGE AND POPULATION STATISTICS

YEAR	USERS	POPULATION	% POPULATION	USAGE SOURCE
2000	200,000	78,964,700	0.3%	ITU
2005	10,711,000	83,944,402	12.8%	VNNIC
2007	16,737,129	85,031,436	19.7%	VNNIC – JULY/07
2007	17,546,488	85,031,436	20.6%	VNNIC – SEPT/07

Sources: ITU, VNNIC

As of September 2006, the number of Internet subscribers in Vietnam stood at 3.86 million, inclusive of the 375,000 broadband subscribers; with an estimated 14 million people or 16.85 percent of the population using the Internet regularly; this figure is expected to reach 35 percent by 2010.[17] Broadband demand has increased significantly and has vastly surpassed local Internet capacity. However, Internet distribution is not uniform with 72.76 percent of Internet subscribers residing in the two largest cities, Hanoi and Ho Chi Minh City. Seven other cities and provinces including Hai Phong, Thua Thien-Hue, Quang Nam, Da Nang, Khanh Hoa, and Binh Duong account for 10.48 percent, and the remaining 55 provinces account only for 16.76 percent.[18]

FIGURE 6. MARKET SHARE OF INTERNET SERVICE PROVIDERS OPERATING AS OF SEPTEMBER 2006.



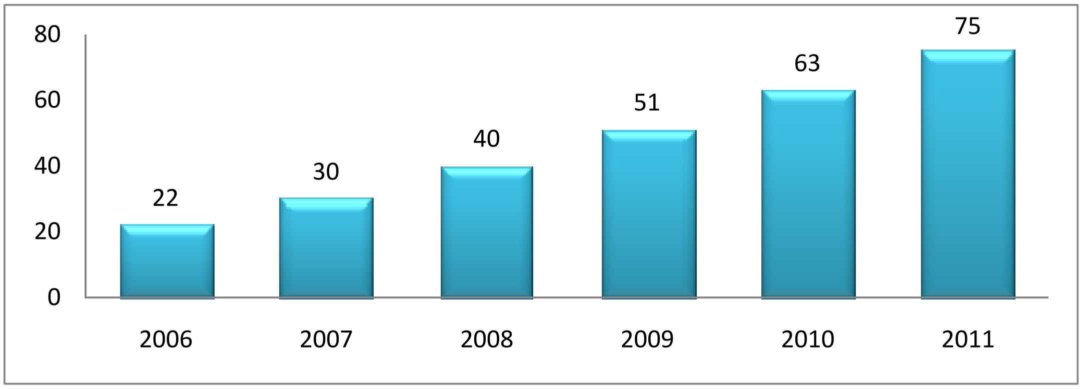
Source: U.S. Commercial Service

Given, that personal computer ownership in Vietnam is 22 per 1,000 population,[19] the digital divide obstacles to hardware access, high usage costs and the relative deficiency of culture and

[17] U.S. Commercial Service. Telecommunication Equipment and Services – Vietnam. http://www.buyusa.gov/asianow/vtelecom.html
[18] Ibid.
[19] Economist Intelligence Unit

language specific content are significant. Broadband investment is starting to ramp up, with several billion dollars earmarked for broadband backbone construction. From a technological

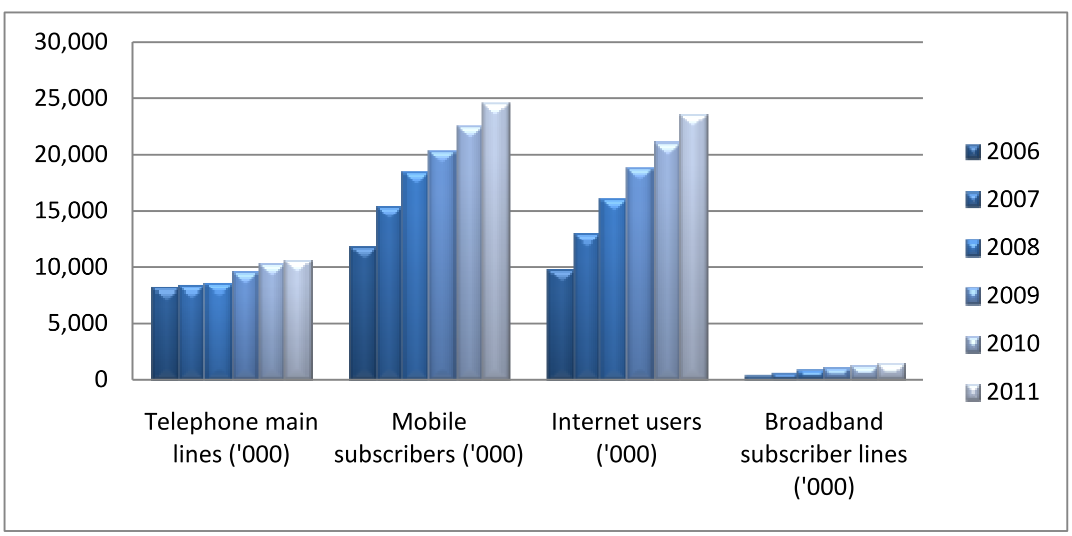
FIGURE 5. PERSONAL COMPUTERS (STOCK PER 1,000 POPULATION 2006-2011)



Source: Economist Intelligence Unit

standpoint, universal services do not have to be the most advanced ones, but instead, the scope should demonstrate a basic level of services that responds to regional uniqueness (Xia and Lu 2005). This raises questions regarding Vietnam's investments in next generation technologies that will only be accessible and productive to a small portion of the population. That said, it is with little doubt that all three telecom sectors will be essential to Vietnam's continued economic growth and development.

FIGURE 7. VIETNAM: TELECOMS FORECAST (2006-2011)



Source: Economist Intelligence Unit

Vietnam currently has one of the three fastest growing telecom markets in Asia, with total industry revenues of $1.88 billion in 2005 and forecasts of $5 billion by 2010.[20] In pairing the rates of growth with the fact that the Vietnamese market is still one of the smallest in Asia, the industry offers great opportunity for financial investment and economic development. The Vietnamese government is at a crossroads in determining whether that expansion will be skewed toward profit- or welfare-maximization. The government proclaims to have both policy agendas as targets for development, however, it appears that Vietnam has lost significant control over the pace of the former without having first sufficiently insulating the later.

Vietnam's regulatory overhaul has resulted in its discontinuation of the Postal, Telephone and Telegraph (PTT) model for an increasingly open-market approach. These nascent markets are enabling entrepreneurial opportunity and encouraging technological innovation. Technology, in turn is influencing regulation through the increase of license allowances and the reduction of asymmetric protections for the incumbent operator, creating a virtuous loop for the growth and development of Vietnam's telecom sector. Policy and regulatory effects may lead to the convergence of joint-venture firms and rapid diffusion of Information and Communication Technology (ICT) into the private sector as the industry liberalizes. Further steps to encourage competition will require fair interconnection fees, competitive pricing, openness to new technology, sound licensing practices and the implementation of policies that encourage market growth, such as the freedom to choose the technologies and market segments within which to compete. As a result, markets will become pro-consumer and pro-competitive as telecommunications sheds its utility status and is instead viewed more in a trade and investment context. Improved technology will result in better and higher quality products and services, lower costs and more service options as barriers to entry are reduced and firm-specific first-mover advantages are explored. Ultimately, the incentive to invest will spark innovation, reduce monopoly power and promote competition.

The aforesaid bodes well for telecommunications and business development, however, questions loom regarding its effect on the future of socially-inclusive growth. Will reform mean that the Vietnamese government will lose control of the telecom sector? How will the reform affect the incumbent and state's revenues? How can the government and incumbent make up for these lost revenues and will universal access goals survive? Moreover, will domestic companies

[20] World Bank – Toulmin et. al. 2006.

be able to survive competition from international carriers? The following analysis will help frame the answers to these questions and appraise the course of privatization and deregulation.

2.2. Institutional Analysis and the Telecommunications Sector

Vietnam's telecommunications sector, like many others around the world, began with an organization around the PTT model, where the monopoly government-owned PTT was responsible for all aspects of postal service and telecom. The Department General of Posts and Telecommunications (DGPT), a unit of the government, was the sole public telecommunications provider in Vietnam until 1993, when it was split into two organizations. The DGPT covered strategic, regulatory and development aspects of telecom while the newly created Vietnam Post and Telecommunications (VNPT) arm assumed operations of the national telecom network as a state-run monopoly. Around the same time the country developed its first national IT policy, which envisaged the gradual transition from a command- to market-based economy. This policy was a precursor to entry into several international free trade agreements that included many concessions central to Vietnam's telecom sector liberalization. Further national initiatives followed to modernize the network infrastructure, supplement liberalization trends and permit market entrants to challenge VNPT's monopoly.

Since initiating its *Doi Moi* reform policy, Vietnam has gradually allowed competition to seep into the telecom market segments, thereby weakening the monopoly grip of the state-owned incumbent, VNPT. Vietnam's telecom liberalization policy is based on multi-economic ownership sector participation, composed of a commercially-oriented state-owned incumbent operator and a gradually increasing competitive fringe of entrants. The Vietnamese government's shift in national initiatives resulted in private sector development and international integration, which served to increase the amount of domestic and foreign competition in the telecom industry. Waning monopoly power forced the Vietnamese government to partition post from telecom, separate policy and regulation creation from operations (though still state-controlled), authorize the introduction of internet service and substantially reduce prices for local, long-distance and international telephony in preparation for increased competition.

Despite Vietnam's impressive progress in areas such as teledensity expansion, price reduction and tolerance for competition, the sector is still lagging behind other countries in the region in many aspects. Interestingly, while the introduction of mobile and broadband technologies have arrested growth in fixed-line telephony in other countries in the region, in Vietnam, the government is still eager to invest in and propagate its fixed-line infrastructure. It will be interesting to discern whether this is a strategy premised upon Vietnam's vision of telecom being an enabler of development or if it is simply a ploy to preserve revenues via interconnection pricing fees. Another noticeable feature of Vietnam's telecom sector is that it does not have an independent regulatory body and has slight discourse in creating one. The DGPT has since become the Ministry of Post and Telematics (MPT), further distinct from VNPT, but still state-run. Internationally, an independent regulator is the accepted norm, with more than 100 countries subscribing to this model. An independent regulatory body is vital for Vietnam's telecommunications sector's future, in terms of its capacity to prepare the industry for increased competition, adopt advanced technology, and deal with convergence issues and stakeholder diversity.

The sweeping legal and regulatory reform that has unleashed an entrepreneurial spirit previously subdued by fears of government expropriation and bureaucracy, has rebuilt in some cases and created in others, bustling urban centers that offer employment opportunities that are attracting rural poor and further reducing rural poverty. Private enterprises, whose activities were negligible in 1993,[21] now account for over half of investment capital usage per annum. Many of these private firms are export-oriented which requires a well functioning ICT infrastructure and an array of sophisticated value-added services, such as broadband and VoIP. Decision makers recognize that these new private enterprises need to use telecommunications effectively to be efficient, and that even more growth and employment can be created by increasing the ICT adoption rate among these small and medium enterprises (SMEs). In this sense, upgrading these firms in the area of ICT is another way for telecommunications growth to aid in poverty reduction.[22] An additional opportunity for generating poverty-reducing growth involves utilizing telecommunications technology as an enabler of development. More affordable and easily accessible telecommunications services for the poor stands to increase productivity in entrepreneurship capacities, foster faster and improved access to health, technical and educational information and elicit earlier disaster warnings and response.

Despite increased domestic and international competition and other measures to reduce monopoly control, state-owned firms have done reasonably well in recent years, with three-

[21] Entrepreneurial boom resulting from the introduction of the Enterprise Law (1999) and Investment Law (2000)
[22] A long recognized aspect of socially-inclusive telecommunications development in the World Bank's poverty reduction strategy for Vietnam.

quarters of them returning a profit (Dapice 2005).[23] Regionally, the economic growth rate has been second only to China, but with a better showing of socially-inclusive economic growth. With great optimism, the country is now aiming for middle-income country status by 2010.[24] However, progress is notably lagging in priority areas such private competition and participation in all telecom segments, interconnection management, progressive pricing regulations, modern and transparent regulatory institutions and processes, and in rural telecommunications infrastructure development and capacity. Significant progress in these areas will require further rural market expansion, incorporating the demands of stakeholders, and drafting a new, modern telecommunications law to attract further investment, protect consumers and incentivize industry to provide service access to the rural poor.

2.3. Telecom Sector Competitive Analysis

At present there are six telecommunications infrastructure operators in Vietnam, two regional with geographical restrictions on their operations and another with the capacity to provide maritime communication services. Nearly all Vietnamese telecommunication companies are state-owned with little private investment or cross-ownership among carriers. Vietnam's telecommunications sector is dominated by Vietnam Post and Telecom (VNPT), the state-run monopolist incumbent that is estimated to account for 94 percent of fixed-line market share and 72 percent of cell phone market share.[25] National initiatives to liberalize the industry and increasing international obligations have produced a competitive fringe of entrants under the watch of the Ministry of Post and Telematics (MPT).[26] Vietnam's telecom sector is transitioning to a partially-privatized model in anticipation of increased competition resulting from the reduction of entrance barriers and the influx of greater foreign investment, participation and ownership.

In addition to its considerable market share, VNPT is active and dominant in a variety of business lines and market segments. It is a conglomeration of SOEs, joint-stock, joint-venture and other company units that offers a full range of telecom services. This organizational structure includes numerous subsidiary member units, including the national television network

[23] Rates of return on equity of 7-8 percent per year.
[24] USAID & VNCI 2005.
[25] U.S. Commercial Service. Telecommunication Equipment and Services – Vietnam. http://www.buyusa.gov/asianow/vtelecom.html
[26] The regulator that is now separate from the operator, but still presently state-controlled.

company, a data network company, the international communications company (BCC[27] with Telstra), 61 provincial and city operating companies (with several BCCs including Telstra, France Telecom, and NTT) and several paging and payphone companies. Additionally, VNPT owns the two dominant cellular companies: Mobifone (BCC arrangement with Comvick) and Vinaphone (holding contracts with Nokia), which together comprise VNPT's Vietnam Mobile Telecom Services division and 65 percent of the total mobile market.[28]

Although VNPT appears to be an untouchable telecommunications juggernaut, competitors are increasingly being granted access to all market segments. This list includes Viettel, an SOE owned and operated by the Ministry of Defense, EVN Telecom, a firm owned by the state-owned electricity company, Vishipel, a 100 percent owned subsidiary of Vietnam Maritime Corporation that provides marine communications services, Hanoi Telecom, and Saigon Post and Telecommunications (SPT), VNPT's closest competitor with 2.6 percent of the total market.[29] Although all of these players of note are state-owned, they have served their purpose in forcing VNPT to innovate and modernize its network as well as provide improved service at lower prices. In fact, as a result of increased competition, falling equipment costs, and changes in government policy, VNPT has dropped prices for international calling and the cost of leased lines by about 70 percent over the past two years, resulting in prices that are seven to nine percent below regional averages.[30]

VNPT is in the planning stages of modernizing, corporatizing and equitizing its structure, and to date, has privatized or spun off 26 of its 41 units.[31] In addition to increasing its exposure to competition, VNPT has also installed of 1.148 million new fixed lines in 2004, an estimated 1.3 million additional fixed lines in 2005, and approximately 1.75 million more in 2006, effectively bringing the total of fixed-line penetration near 10 percent.[32] Additionally, mobile subscriber bases are up over 100 percent for three consecutive years. Furthermore, the Vietnamese government has shown that it is sincere in taking steps to open and truly privatize its telecom markets, as evidenced by its plans to equitize the two mobile phone carriers, Mobifone and Vinaphone. Encouraging still, was the government's denial of a request from broadcaster

[27] Business Cooperation Contract (BCC). BCCs are cost and revenue sharing agreements under which the foreign partner generally provides the needed equipment and training for local operators.
[28] Business Monitor International Inc. Vietnam Telecommunications Report Q4 2006.
[29] Ibid.
[30] according to MPT and one independent analysis
[31] Business Monitor International Inc. Vietnam Telecommunications Report Q4 2006.
[32] It is worth note that these figures were in line with expectations and that the lines were installed with international standards.

Vietnam Television to enter the lucrative mobile market, a firm reaffirmation that mobile licenses were no longer to be issued and that potentially derisive and inefficient entry was to be deterred.[33]

Vietnam's mobile market is currently served by five cell phone network operators, with one new entrant to launch service before the end of 2008. The market is dominated by three carriers: Vinaphone (subsidiary of VNPT), Mobifone (subsidiary of VNPT), and Viettel Mobile (owned by the Ministry of Defense), with approximately four, 4.7, and 2.5 million subscribers respectively. S-Fone (an SPT venture with a Korean consortium) holds only 4.24 percent of the mobile market. EVN Telecom recently launched CDMA service this year, and its market share is accordingly modest at only several hundred thousand subscribers. Hanoi Telecom will be the first to apply 3G technologies in Vietnam, through a project between Hanoi Telecom and Hutchison Telecommunications.[34]

In general, Vietnam operates a well-run and reliable telecom network that provides relatively fast connections, but often slow transmission speeds. Although new services are available, most firms continue to focus their telecom use on traditional telephony and internet services, suggesting that important platforms for innovation are yet to be exploited. Most business concerns focus on the relatively high prices of Vietnam's telecom services. This infers that price reductions have the potential of increasing demand for services (USAID 2004).[35] Although the internet got off to a late start in Vietnam, in November 1997, mainly due to concerns over information censorship, it has since grown very rapidly in the urban centers. There were an estimated 7.5 million users in 2004 and 14.6 million for 2007. These figures, however, are still moderately low considering the regional penetration rate of 17.3 percent and high concentration of users in urban areas. Voice over Internet Protocol (VoIP) is now available on a limited basis in parts of Vietnam by dialing an additional number. In other countries the cheap price of VoIP has helped to lower telephony prices substantially, and this effect is also anticipated in Vietnam.

Although Vietnam's gains in network expansion, introduction of competition and reduction in prices have been impressive, the country still has much room for improvement.

[33] ICCE 2006. As noted at this Conference on Communications and Electronics October 9-10, 2006
[34] Ibid.
[35] Based on a telecom survey conducted by USAID, the service quality assessment from firms came back satisfactory for connection times and the overall assessment of transmission speed for various services was "normal to slow." Internet was perceived to be slow. The general assessment of the level of technology was that it was relatively new and up to date although not state of the art. The preliminary assessment of the quality of telecom services was essentially positive.

Despite legal and institutional reforms accounting for much of the gains to date, by global standards Vietnam's telecom sector appears restrictive and only semi-transparent. True competition remains light across most telecommunications segments and mostly involves other state-owned players engaging in cross-ownership with other state-owned operators. The fact remains that VNPT still commands nearly 85 percent market share across the entire telecommunications industry, equating to the virtual non-existence of true private enterprise activity in the telecom marketplace.

In gradually relinquishing its monopoly control, VNPT has started to lose revenues that it was directing toward socially-inclusive telecommunications infrastructure expansion, a success of which was the provision of connectivity access points to over 90 percent of the country's rural communes.[36] With VNPT's task of modernizing the current urban center infrastructure just recently completed, only now can the state-owned monopolist shift its focus to extending telecom infrastructure and service to the rural poor. The main challenge for Vietnam's universal service initiative is timing, since many of the country's international obligation deadlines are expiring and compliance will usher in increased foreign competition. This is potentially problematic since the influx of profit-maximizing and operationally more efficient firms will likely claim market share and revenues without having equal concern for socially-inclusive economic growth or universal access initiatives. These joint-venture participants and fully foreign firms will initially target revenue capture from across the industry, pursuing the most lucrative services and densely populated urban centers. Domestic and foreign competitors alike will cannibalize much of the urban market expansion in mobile and internet, which are significant revenue generating business segments that have allowed VNPT to cross-subsidize its rural network expansion.

2.4. International Integration and Teledensity Expansion

Global integration results in the lowering of barriers to entry, which in turn increases levels of technological adoption and penetration. The result is falling electronic component costs, the implementation of next generation networks and disruptive technologies, and well as the introduction of competitive markets. In addition, deeper market liberalization raises FDI ceilings, which is crucial to attracting future major investments for telecommunications

[36] At least one fixed-line phone connection within an hour's walk to the rural commune's center. World Bank – (Toulmin et. al. 2006)

infrastructure development. To be competitive in FDI flows, Vietnam must continue its reforms and deregulation to support a level of disclosure and transparency that fosters a positive investment environment. Foreign firms bring with them both technology and experience with the potential for spillover, but with the catch of concurrently introducing potentially insurmountable competition that might be derisive to the domestic market development. Furthermore, there are potential tradeoffs in terms of social welfare losses that can be linked to rent-seeking behaviors and obligations to adhere to trade concessions.

Vietnam's telecom sector liberalization and openness to foreign competition are the commitments made under the Vietnam-US Bilateral Trade Agreement of 2000 (VN-US BTA). In accordance with these commitments, Vietnam must allow US companies to set up joint-ventures with Vietnamese partners that are authorized to provide telecom services. US firms maintain the right to establish joint-ventures, composing up to 50 percent of the capital equity structure, and to participate in value added services, such as e-mail, voicemail and electronic interchange from December 2003 and in internet services beginning December 2004. US companies are also permitted to set up joint-ventures with a maximum equity share of 49 percent in wireless and data services, from December 2005, and this invitation to enter will be extended to basic voice telephone services, including fixed-line local, long distance and international telephony in December 2007.[37] In addition, just prior to Vietnam's accession to the WTO, the Ministry of Post & Telematics issued a decree outlining the legal framework for foreign investment and privatization.

The Doha round of WTO negotiations produced a Basic Telecommunications Agreement that seeks to strengthen and expand the rules for telecom market access, which is slated to be included as a standard commitment within the WTO framework. Moreover, pressure on the Vietnamese government to further liberalize is mounting as its maturing obligations are quickening the pace at which it must comply. Despite moving at a faster pace than comfortable and allowing greater equity investment in its telecom business segments, a comparison of Vietnam with other Asian countries in terms of limits on foreign ownership shows that Vietnam is lagging behind more progressive regional telecom investment environments.[38] This essentially equates to Vietnam having to change even faster than it is at present to be regionally competitive in attracting FDI. With all of these changes on the horizon, it appears likely that the dominance

[37] World Bank – (Toulmin et. al. 2006)
[38] International Development Association 2007.

of VNPT will drastically decline in the coming years and that non-state-owned entities will soon enter and contend for market share. The stalled negotiations of the Doha Round will unlikely give Vietnam's telecommunications industry a reprieve. Instead, the WTO will most likely adopt the VN-US BTA's settlement as the minimum standard for telecommunications obligations. Per most-favored nation treatment, the VN-US BTA's requirements will apply across the entire telecom sector and will be applicable to all member nations. One important aspect to note is that the VN-US BTA allows for direct investment, which implies increased opportunities for foreign investment, ownership and control in and of domestic firms. These requirements seek to ensure competitive telecom markets for new entrants, with additional commitments on regulatory disciplines covering, competition safeguards, interconnection guarantees and transparent licensing processes. In respect to these provisions and concessions, Vietnam's government stands to lose a significant portion of the revenue previously earmarked for socially-inclusive economic growth objectives. It will be interesting to observe whether the gradual increase in competition that was helpful in propagating the network will arrest and reverse or bolster and develop these gains as competition creeps into the market.

The increased importance of the telecommunications sector to the future of Vietnam is apparent and it appears that international obligations will significantly bolster access to foreign capital, business credibility, innovation and technology and information and resources. In exchange, Vietnam has potentially placed in profit's way, the future of its universal service objectives and socially-oriented economic development. Foreign firms will enter with virtually unlimited access to capital in comparison to its local counterparts. Their profits will likely be repatriated in part or whole, thereby reducing retained earnings rolling over to domestic investment. Foreign firms will compete not just for market share, but also for human resources, forcing local firms to compete also on wages and benefits. This bodes well for those employed in these industries, but may potentially undercut opportunity for countless others. In addition, the risk of foreign oligopoly and monopoly exists, which has the potential of introducing cultural imperialism and inappropriate consumption patterns. In summation, Vietnam's international integration may have come at a great cost to the nation's ability to arrive at its optimal mix of investment promotion, deregulation and retention of national control, and maintenance of socially-inclusive development.

2.5. Universal Access Initiatives

Vietnam's network expansion is one of the fastest in the world, albeit from a low starting point. The number of fixed telephone lines grew from 0.4 per 100 inhabitants in 1995 to nine per 100 in 2006.[39] Perhaps more impressive was the number of mobile subscribers, which grew from 23,500 in 1995 to 17.5 million in 2006. Teledensity is expected to pass 10 percent for fixed-lines and mobile is projected to hit 25 percent by the end of 2007.[40] Internet penetration has also grown rapidly to an estimated 14.6 million users, though mostly concentrated in urban centers. Under VNPT, the existing network has been digitized and upgraded and only now is the firm capable of pushing into the rural regions populated by 73 percent of Vietnam's 84 million inhabitants.[41] Access to telecommunications can be a powerful engine for economic growth as an enabler of income-generating opportunity and entrepreneurial development. Telecommunications can improve the lives of the poor and raise the quality of their education, increase the efficiency and transparency of government and help Vietnam become more integrated and competitive in the global economy. Although telecom services are relatively advanced in urban centers, many rural regions have little or no access to telecom services. To compound the issue, nearly a third of Vietnam's villages lie in virtually inaccessible mountainous locales. Despite these obstacles, Vietnam has nearly achieved the community penetration portion of its universal service objectives, with telephone access occurring in nearly 90 percent of its rural communes.[42] With broad household penetration as its next target and VNPT's resources and monopoly power on the decline, this subsequent level may be difficult to achieve. Many of the 54 ethnic minorities that live in rural Vietnam reside in the mountainous regions, where fixed-line infrastructure would be economically infeasible to build and too difficult and expensive to maintain. Mobile technology alleviates the physical line infrastructure and "last-mile" connection concerns, but still may be too costly to provide in comparison to demand. Satellite-based mobile would reach these populations, but would be much too expensive and thus out of reach for the masses.

[39] USAID & VNCI 2005.
[40] Business Monitor International Inc. Vietnam Telecommunications Report Q4 2006.
[41] Chowdhury et. al. 2007.
[42] ITU's Maitland Commission's definition of universal service minimum for the developing world – "within an hour's walk"

Vietnam has enjoyed success in generating exceptional economic growth rates without losing sight of poverty reduction. Most of the universal service initiatives and achievement has come under VNPT's market dominance and the Vietnamese government's careful watch over competitive entrants. In fulfilling its international obligations, Vietnam has uncharacteristically and hastily engaged in a spree of privatization, deregulation and lowering of market entry barriers. Concern exists over the capacity of VNPT's new globally integrated and market-oriented environment and its potential to arrest the promotion of universal service for the rural poor as competition heats up, sunk costs prohibit expansion and revenue streams dry up. Universal service has potential in creating a reliable emergency network that could save countless lives in during Vietnam's flood seasons. It can allow the rural poor to contact family members that have left farms for firms and schools to command higher and more stable salaries to remit home financial support. Additionally, efficiency gains exist for rural commerce in the form of increased productivity and reduced transaction costs, and the potential for information sharing to improve farming techniques, health and intermediary price-gauging can have significant multiplier effects. These benefits may fall further out of reach for low-income and poor households if development and growth are no longer paired. At this point, it is worth revisiting China's universal service dilemma, which bears similarities to Vietnam's, though obviously on a much larger scale. In China's case, market forces failed to provide universal services, resulting in the collapse of the partially completed network, and leaving policy makers to conclude that universal access provision was strictly a government responsibility (Xia and Lu 2005). From this experience it is feasible to gather that without government provision of social welfare-maximizing policies, market failure may follow the disengaged incentive of foreign and privatized firms to provide universal service.

While governments seek to maximize social welfare, usually at the expense of financial gain, private firms operate with profit-maximization or cost-minimization as their guide. As more non-state-run competitors enter Vietnam's telecom market, the incentive to expand the network to low-income and poor populations will be significantly undermined as increasing foreign participation brings less incentive to engage in nationally beneficial initiatives. Private telecom service providers are reluctant to extend services to marginalized populations because they assume that there is insufficient demand to cover the costs of provision. Moreover, rural Vietnam exhibits lower population densities than urban areas and rural residents have significantly lower incomes and presumably less demand for telecom (Hudson 2002). With these principles in mind, the poor will have to show that their aggregate demand and purchasing power is worth servicing. Access to telecommunications and financial services will be vital to creating access to income-generating opportunities, which will likely take the form of entrepreneurial activity.

As VNPT privatizes and loses market share, its ability to cross-subsidize its universal service initiatives with revenues from more profitable segments will decline, forcing it to find funding for its universal service initiatives elsewhere. At present, several NGOs offer limited financial support and the Vietnamese government has created the Vietnam Public Utility Telecommunications Service Fund in 2005, to serve as the Universal Service Obligation mechanism for the country. It will be capitalized with $31.5 million, with 40 percent contributed by the state. The balance will come from enterprises operating in the sector, with five percent from mobile, four percent from international long distance and three percent from domestic long distance revenues.[43] Moreover, regulations have been included in many of the free trade agreements to permit non-anti-competitive rent collection that will fund universal services. Although there has been significant progress in connecting almost all of the communes to fixed-line infrastructure, the fact remains that Vietnam has done too little to address its universal service concerns compared to the pace at which it has engaged in international integration. As a result, the next phase of rural network expansion may be too costly and difficult to fund, and even more difficult to incentivize private industry to provide. Vietnam's universal service fund and development aid will likely fall far short of financing the high levels of penetration and teledensity growth achieved under VNPT's monopoly, leaving the potential for low-income and poor populations to remain un- or under-served.

[43] Asia Development Bank (Balisacan et. al. 2003)

3. OVERVIEW OF VIETNAM'S BANKING SECTOR

3.1. Introduction

The financial sector in Vietnam has been changing rapidly, but the coverage of low-income and poor people has been low in priority and generally disjointed. Improved access to a range of appropriate, affordable and demand-driven financial services for these segments, however, will play a large factor in the ability of these populations to extract themselves from poverty via sustainable income generation. The evidence that access to financial services can influence positively the reduction of poverty is mostly operational, as there are few impact studies to support this conclusion from ground information. The operational evidence infers that there exists strong demand from low-income and poor populations for financial services and that they are also willing to designate a large portion of their incomes to pay for access to these services. Most of the confirmation of this operation evidence stems from the fact that across the globe, banks and other commercial sources for financial services have begun to downscale to reach these market segments. Poor populations often lack the capacity to become economically independent since they usually are excluded from resources vital to achieving these goals. Due to the lack in capacity to assess this segment's creditworthiness and risk profile, this segment is likely to encounter with what effectively amounts to a poverty penalty[44] rendered on service usage (Prahalad 2004). Moreover, these segments are likely under-educated, inexperienced in business, in poor health, saddled with large families they can barely care for, isolated in rural villages or urban slums, and often discriminated against. Low-income and poor populations are also likely to lack access to the capital necessary to drive existing or potential enterprises or acquire personal assets or collateral. As a consequence, they look to informal sector lending, financing from friends, family, neighbors or acquaintances with capital to invest, at high interest rates. This results in financial services from banks or other formal financial institutions being typically elusive to the poor.

The financial sector in Vietnam is progressively deepening in response to overall economic transformation, increased demand from the private sector for credit, and as a result of its exceptional economic performance. However, Vietnam's financial sector remains largely

[44] The poor tend to reside in high-cost ecosystems even within developing countries. The poor pay a premium for everything from rice to credit. A poverty penalty is the result of local monopolies, inadequate access, poor distribution, and strong traditional intermediaries.

undeveloped, with many local business transactions occurring outside the banking system. A partial explanation for the aforementioned problem involves the Vietnamese government's stalled commitment to the structural reform of its banking sector and toleration of chronic misallocation of capital financing through policy-based lending that has deprived its private sector of the requisite resources needed to sustain high levels of economic development. As economic conditions improved, the national savings rate in Vietnam experienced a steady increase from less than 20 percent in 1995 to 32 percent in 2005 (ADB 2006). This fact, coupled with the nation's high savings ratio, indicates that greater allocative efficiency of capital and banking network expansion may be the cornerstones for sustaining high economic growth.[45] Capital efficiency gains will require improved financial mechanisms to generate domestic resources, enhance investment decision making, and increase the transparency of the management and prioritization of limited resource allocation. Breaching this ceiling will require a deregulated and privatized banking sector that can efficiently raise and allocate capital financing to support the private sector in its preparation for the impending influx of foreign competition. Traditional network expansion will require significant investment to fund brick and mortar branch construction, secure monetary transfers between branches and less stringent criterion requirements for opening bank accounts.

This section examines the progression of Vietnam's banking sector reform, detailing its historical antecedents, highlighting particular issues relevant to the impending privatization and indicating potential consequences that may arise from its transformation. To address the historical antecedents of the banking sector reform, an institutional analysis of Vietnam's government structure and the effect of its propensity for control on the banking sector will be performed. Next, an evaluation at each of the following stages of the banking sector: pre-reform, throughout the course of reform and at present, will be conducted with particular emphasis on the industry's competitive environment and successes and failures therein. Throughout this assessment, attention is drawn to particular legal and regulatory changes that have supported privatization and encouraged the gradual uncoupling of dependence of state-owned enterprises on state-owned commercial bank (SOCB) capital financing. In the final section, potential consequences of the banking sector privatization on the sustainability of Vietnam's economic growth and development will be considered.

[45] Capital productivity remains low (with an incremental capital output ratio of 4.8:1) despite improvement efforts.

3.2. Institutional Analysis and the Banking Sector

Upon taking control of Vietnam in 1975, the new Communist government consolidated its banking system, which left the Hanoi-based State Bank of Vietnam in charge of most domestic financial business. The government dictated the objectives and modes of production under its centrally-planned economy, until embarking on the *Doi Moi* reform and transition to a market-oriented economy in 1986. Macroeconomic and fiscal crises such as hyperinflation provided the impetus for the comprehensive and coordinated restructure, which included fundamental changes to the banking infrastructure. The initial changes were drastic, highlighted by the shift from a mono-banking system to a two-tier banking system in 1988. Subsequent reforms, however, were nominal due to the sluggish privatization of SOEs and the legacy of policy-based SOCB-to-SOE lending that infused the banking system with inherently inefficient values, objectives and operations. The banking sector has become more the principle impediment to explosive economic development in its hampering of the facilitation of capital mobilization and efficient allocation as opposed to being a catalyst for growth in the modernizing economy.

At present, Vietnamese private enterprises, which appear to be more efficient than SOEs, have limited access to external financing and bank credit. In general, only the largest and most capitally intensive SOEs exist today and the SOCBs are still closely involved in supplying their capital. In fact, many of the SOCBs are so deeply invested in these inefficient SOEs that the prospect of abandoning them is less an option since keeping these SOEs running is the only way that SOCBs can stimulate loan repayments. As a result of the policy of directed lending to SOEs, many of Vietnam's SOCBs have high levels of non-performing loans (NPL) and bad debt. This in turn, complicates the mobilization of savings since the average Vietnamese saver, already traditionally wary of banks, will become increasingly caution, favoring high-yield government bonds or simply tucking money beneath their mattresses, over bank deposits (Nguyen et al. 2006). Although the five dominant SOCBs have been encouraged to avail themselves to a more competitive financial environment, in an attempt to prepare them for life in a market where foreign and domestic private banks covet their business, financial repression and ongoing lending to SOEs has significantly reduced the allocative efficiency of the SOCBs.

The State Bank of Vietnam (SBV), formed in 1951, operated under a mono-banking system and was entrusted with both central and commercial banking responsibilities. In its central bank capacity, the SBV regulated monetary policy, managed national reserves and issued banknotes. As a commercial bank, the SBV mobilized savings from the public and allocated credit to enterprises. Vietnam's post-war transition to a centrally-planned economy expanded the SBV's authority to manipulate financial and monetary policies in order to increase credit and ensure capital sufficiency for state sector business and production operations. In using the banking system to support the state sector and SOEs, the government created an environment wrought with disincentives to save, inefficient capital allocation, imprudent use of interest rate mechanisms and inflationary pressures, which led to financial disarray and contributed to Vietnam's deteriorating economic conditions (Freeman 2005).

Vietnam's mono-bank system originated under a market economy, in which banks would only lend if interest rates on credit exceeded the value of the interest rate on deposit accounts inclusive of transaction costs, and enterprises would only borrow if the benefits of borrowing outweighed the cost of credit. In 1975, Vietnam's ascendant Communist party transitioned the economy to a command-based system with the objective of redistributing wealth and income. Under the planned economy, the mono-banking system determined interest rates based on the needs of the state as opposed to the interaction between the supply and demand of credit (Nguyen 2002). To encourage state sector investment, authorities set lending rates at low levels to reduce the cost of borrowing capital. By artificially suppressing the lending rates, the authorities created excess demand for credit and a gap between official and market rates. As a result, interest rate in real terms reached negative levels and bank deposits lost value as inflation outpaced the interest earned on deposits, creating an environment hostile to bank saving. In response, households ceased to deposit their savings into state banks and instead, channeled their savings into real assets, such as real estate, gold and foreign currencies (Nguyen et al. 2006). SOEs, which were required to establish deposit accounts with the banks, took advantage of the loose supervision from banks to accumulate cash to purchase and hoard commodities in their inventories, which were then sold in the informal market at a profit. As a result, artificial credit demand increased, while the supply of credit fell sharply. By 1985, total credit outstanding stood at 36 billion VND while total savings comprised only 9.4 billion VND (Nguyen 2002).[46]

[46] Dong/Dollar exchange rate at an average of 11.960 VND to the dollar. Roughly US$3 billion and $786 million respectively.

The Vietnamese government compensated for the absence of external access to investment and credit by printing money, which sparked hyperinflation that lasted throughout the 1980s, at times reaching over 300 percent (Camen 2005).[47] The misuse of interest rates during this period resulted directly from the practice of credit rationing, a consequence of the centrally-planned economy's allocation of scarce resources to priority sectors. Under this policy, heavy industries received the bulk of available credit, while light industries, trade and service sectors remained credit starved. In the absence of market mechanisms, lending was premised on government directives and not based on efficient allocation, resulting in high levels of NPLs and bad debt.

The Vietnamese government's implementation of the *Doi Moi* reforms and consequent deviation from its centrally-managed economy necessitated fundamental changes to its banking structure. In 1988, the banking structure shifted from a mono-banking system to a two-tier system to complement the nation's push toward a market-oriented economy. In 1990, the government issued two ordinances on banking which established the objectives, duties and purposes of operations for each tier of the banking system. Under the State Bank Law, the SBV retained influence over facets of central banking, such as monetary policy, while the Commercial Bank Ordinance provided the legal framework for commercial banks, credit cooperatives and other financial institutions. Commercial banking responsibilities were conferred upon four newly created sector-specific state-owned banks. The first two SOCBs managed Vietnam's trade and infrastructure finance, with the Bank for Foreign Trade of Vietnam (BFTV) controlling foreign trade and exchange financing transactions, while the Bank for Investment and Development of Vietnam (BIDV) handled public works, infrastructure projects, and SOE equipment financing (Packard 2005). The other two SOCBs were in charge of industry and agriculture, with the Industrial and Commercial Bank of Vietnam (ICBV) dealing with industry-based commercial loans and the Agricultural Bank of Vietnam (ABV) monitoring agricultural credit.

In 1991, the government ended both the sector-specific distinctions and SOCB sectoral monopoly control with the intention of increasing management autonomy and accountability (Nguyen 2002). An additional aim of the government's transition to a two-tier banking system was to create a competitive banking structure that would respond more efficiently to the supply

[47] On November 5th of 1980, the Dong/Dollar exchange rate was 2.390 VND to the dollar, by December 1991 the dong traded at 11,900 VND to the dollar. International Economics – Historical Exchange Rate Regimes http://intl.econ.cuhk.edu.hk/exchange_rate_regime/index.php?cid=12

and demand of credit, which is fundamental to complex financial systems. The structural decoupling of commercial banking activities from central bank strategies and government's encouragement of new entrants into the financial sector led to a substantial increase in the number of representative offices and branches of foreign banks and joint-stock commercial banks (JSBs). In addition, joint ventures between foreign banks and SOCBs were established, and non-bank financial institutions, such as the Vietnamese bourse and insurance companies were created. Although competition was weak and dwarfed by the SOCBs in terms of capital,[48] the presence and gradual expansion of competitors was a crucial precursor to the banking sector's eventual privatization. The government's liberalization of competitive entry into the banking system forced the banking sector to diversify and offer a wider range of services. By end of 1996 the financial sector consisted of four SOCBs, 52 JSBs, 23 foreign branch banks, four joint-venture banks, 62 representative offices of foreign banks, 68 credit cooperatives, nearly 900 people's credit funds, two finance companies, and one state-owned insurance company (Packard 2005).

The gradual introduction of competition and international integration challenged the SBV's proficiency in exercising financial instruments to manage inflation and spur credit growth. From 1988 to the Asian Financial Crisis in 1997, the SBV proved adept at manipulating interest rate policies to mobilize capital and manage inflation (IMF 2006). The combined effect of the unification and massive devaluation of the exchange rate, legalization of gold trading, domestic price liberalization, sharp increases in deposit interest rates, imposition of harder budget constraints on most SOEs, and the curtailment of credit growth, culminated in lowering inflation expectations, which induced significant adjustments in the composition of household liquid assets. Moreover, the SBV's decision to raise the interest rate for household deposits increased investor confidence in the domestic currency and encouraged households to deposit their dong assets in the formal banking system over the informal sector (Nguyen et al., 2006).[49] Other important steps in the reform process have been the introduction of Treasury bill auctions in the mid- 1990s, open market operations in 2000, and the gradual launch of indirect monetary policy instruments. Money markets and financial markets in general, however, continue to be

[48] As of December 2001, the SOCBs held 75 percent of total bank assets, leaving foreign bank branches and joint venture banks with 18 percent, and joint-stock commercial banks holding the remaining 7 percent. During the 1994-2000 period, SOCBs accounted for 70-80 percent of all outstanding loans, with more than half of the SOCB credit being extended to SOEs.
[49] In 1989, real interest rates on household deposits rose sharply, and encouraged a steady rise in the value of household deposits at the SOCBs, from VND 207 billion in March 1989 to VND 1,348 billion by January 1990.

thin and segmented. Furthermore, the banking reforms only slightly improved private sector access to formal banking services, and overall, credit risk assessment in Vietnam remains elusive, leading to hesitant lending patterns of SOCBs to the private sector.

In theory, under the two-tier banking system, the SBV had the capacity to stabilize the economy and financial sector with its monetary policy, while the commercial banks were charged with assessing economic conditions in the context of the aforesaid monetary policies to determine the cost of borrowing and lending to best mobilize funds and allocate credit. Although the reforms of the late 1980s and early 1990s have had a positive effect on Vietnam's banking system, as evidenced by the steady rise in deposits and diversification in lending, in practice, the sluggish privatization of SOEs has caused many SOCBs to suffer from government-directed lending to large infrastructure projects and for propping up unprofitable and inefficient SOEs. The resultant high levels of bad debt incurred by SOCBs are visible sign of the persistent misallocation of capital, estimated in 2005 to be 20 percent of outstanding loans (EU ECC 2006). Of the loans that remained solvent, most yielded only low returns, thus propagating the credit crunch to further cripple the cash-strapped private sector. The Vietnamese financial system will need to undergo further deep structural transformation including the equitization of the SOCBs and the further development of financial markets to assist Vietnam in maintaining its economic growth.

In international scale and scope, Vietnam's state-owned banks appear insignificant, with a combined total capitalization of around US$1.2 billion. Moreover, lending remains their major source of income in the absence of more sophisticated financial products. As such, SOCBs will likely struggle when faced with increased international competition. Several attempts to equitize and list SOCBs on the Vietnamese stock market are already underway, but over the years delays and deferment of these goals have been the norm. Of recent advent, foreign banks have been allowed to participate, which has introduced international experience, capital and technology, though the limitation of 30 percent of chartered capital under the current draft legislation has slowed these beneficial exchanges.[50] Furthermore, stringent requirements and government approval on a case-by-case basis, coupled with the SBV's planned retention of majority stake in the to-be-equitized SOCBs, will likely discourage foreign investors and stifle their desire for technology transfer and investment.

[50] 10% maximum for individual stakeholders, and 20% for "strategic" investors.

The Vietnamese economy endured recurrent monetary crises and rising fiscal deficits throughout the 1980s and into the early 90s due to revenue growth failing to keep pace with rising expenditures. Concurrently, the state had great difficulty imposing fiscal discipline on its SOEs which operated under soft budget constraints. SOEs engaged in activities to circumvent credit rationing by creating unauthorized credit through check payment systems abuse or through the use of supplier credits as substitutes for borrowing in credit markets. These behaviors created substantial inflationary consequences and financial problems for the SBV, which had few options for recourse since it was responsible for ensuring that financial resources were allocated to economic units in accordance with the state economic plan. The SBV effectively functioned as the interface between state-planning, national budgeting, and the various state entities, which at times included over 12,000 SOEs. As the banking sector liberalized, new complications arose. Under the command system, lending decisions were not commercially-based, and for this reason the SBV and its SOCBs had little experience with standard commercial banking functions such as credit analysis or risk management.

SOCBs were required to allocate a substantial share of their credit to SOEs at concessionary interest rates and with collateral exemptions. This practice resulted in lending as matter of policy rather profitability and was reflected in the SOCB's high share of non-performing loans (IMF 2006). As of November 2001, NPLs made up 11.8 percent of the total SOCB loans outstanding, with 60 percent of the NPLs accredited to SOEs (VDR 2006). These SOCB fiscal inefficiencies have forced the government on several occasions to come to the rescue of troubled banks through government refinancing and recapitalization schemes: dipping into general revenues, selling government bonds to the public, or by the printing currency (VDR 2006). The resulting moral hazard created by this 100 percent deposit insurance system provided SOCBs with a safety net irrespective of whether the banks altered their behavior or continued to make bad loans to SOEs. This biased credit allocation from the SOCBs served to prop up inefficient SOEs, allowing them to endure at the expense of allocative efficiency and private sector development. The financial deterioration of SOEs accordingly placed excess strain on the SOCBs, since the government's blind backing induced SOCBs to risk increased credit allocations to these failing SOEs in the hope that the capital injection would revive the SOE, thereby generating income for the bank to recuperate its previous losses on loans. This vicious cycle of soft budgetary constraints among SOEs and SOCBs implies that banking sector reform cannot proceed without extensive further SOE privatization.

Despite the considerable portion of SOCB credit earmarked for SOEs, some capital financing remained for private sector investment. Access to these residual credits, however, was an additional obstacle for private enterprises due to the SOCB's inability to assess credit risk and disincentive to engage in private sector lending. The disincentive to lend stemmed in part from the inadequate accounting methods employed by small and medium private enterprises (SMEs), which further complicated performance assessment by the already inexperienced banks. Moreover, many of these SMEs acquired off-the-book costs in operation such as compensating corrupt officials to gain access into the market, which further reduced the legitimacy of their financial statements. Furthermore, many of the bank's branches were concentrated in the larger cities and provincial towns, which substantially distanced them from many of the private enterprises situated in rural areas, making onsite risk assessment costly both in terms of time and money. The most detrimental aspects to allocative inefficiency inherent in SOCB-to-SOE lending reside in the combined policy-based lending strategy and full government backing of SOE loans. Additionally, these guarantees hindered the urgency for the acquisition of banking skills to identify and manage risk, which are essential tools for private-sector lending. The result was complicated lending procedures that asymmetrically subjected private firms to credit checks and collateral requirements. This cumbersome procedure, coupled with the lack of skilled and motivated bank officials, created obstacles for private borrowers in the form of lengthy documentation and long delays between the submission of loan applications and the rendering of loan decisions by bank officials (Nguyen 2002).[51] What is more, borrowers incurred high transaction as well as prohibitive opportunity costs, which made SOCB credit potentially more expensive than that offered by the informal sector (Thanh et al., 2006). These aspects, in combination with the traditional Vietnamese mistrust of banks, explained the phenomenon of low bank usage and the low application rate of private enterprises. Compounding the issue was the requirement that private enterprises collateralize assets for loans whereas SOEs were exempt. Collateral requirements added an additional layer of costs for the banks in lending to private enterprises as compared to SOEs, since banks had to spend resources to assess and manage the

[51] Delays were oftentimes as long as 35 days.

collateral. The absence of regulation to enforce credit contracts and mechanisms to support the sale of collateralized assets in instances of default added to the reluctance of the banks to lend to private enterprises, even in the case of secured loans.

In Vietnam, only property and plant (land and buildings) are considered as collateral, whereas equipment and inventory are generally not counted as such. Land, however, has not readily been transferable due to weak and often vague property rights. There exists a tendency for banks to undervalue collateralized assets, in their attempts to obtain greater debt coverage. This comes at the expense of the borrower who suffers a further reduction in the amount of financing and assumes greater risk of default. In early December of 2000, the SBV finalized a decree which allowed all credit-lending institutions to make unsecured loans. From the perspective of enterprises, this policy should have led to better access to bank credit. The viability of this policy, however, has been greatly hampered by the slow improvement in risk assessment skills, information asymmetries, cumbersome lending procedures, weak contract enforcement and the continued existence of preferential lending to SOEs.

3.3. Banking Sector Competitive Analysis

State-owned banks continue to dominate the banking sector with an estimated share of 70 percent of total credits in 2006 (World Bank 2006). The credit market and other parts of the financial system continue to be segmented and allocative inefficiencies are still depriving the more profitable private sector of capital financing. The private sector, however is gaining in importance to the growth of the Vietnamese economy and the SOCBs have accordingly started to increase their allocation of financing to large and well established private firms. SMEs are still largely ignored by the SOCBs as a result of inadequate risk assessment expertise. In addition, the legacy of policy-based lending has produced a large number of NPLs which remain a principal issue for the Vietnamese banking sector. Furthermore, the asymmetric application of international banking standards for classifying and reporting on loans and financial statements persists.

Over the past five years, deposits have grown at an average of 22.6 percent per annum with loans outstanding increasing by 25 percent over the same period (USCS 2006). The SBV estimates NPLs to be around three percent of total loans outstanding, though this figure is likely to be much higher when held against international standards (VDR 2006). The SBV is looking to maintain credit growth steady at 18-20 percent through 2010 and hopes to meet Basle standards within the same time period by raising its capital adequacy ratio to eight percent while keeping bad debt at around five to seven percent (USCS 2006). The SBV acknowledged three major weaknesses in the Vietnamese banking sector that require address: limited capital, backward technology, and poor management skills, especially that which pertains to risk assessment (VDR 2006).

In Vietnam, hard currency and gold are still hoarded idly external to the formal banking system. This is significant since estimates of these resources range from US$500 million to the government's own approximation of around US$10 billion (Fang 2007). Cash remains the preferred mode of payment despite the availability and ease of access to alternative payment options such as checks. On the fund supply side, there are clear signals of higher demand from the public for saving vehicles. Life insurance policies with heavy savings components are gaining in popularity and secondary markets for unlisted equitized shares of SOEs are strong. Although the non-bank financial sector remains small, its development has been quite remarkable and important to the banking sector reform. Vietnam's nascent financial markets have put greater competitive pressure on the banking sector to achieve allocative efficiency and to improve risk assessment for private enterprises. The nation's stock market and portfolio investors, however, have been limited in growth due to their reliance on the rate and amount of privatization.

Nearly fifty percent of Vietnam's population is under the age of 25. Young adults, 21 to 29 years old, will play a large role in shaping Vietnam's small but growing retail-banking market. According to a recent McKinsey study, these young consumers are less wary of borrowing, more likely to use remote channels, and are more open to foreign banks than are their seniors.[52] This generation gap in banking-related preferences and attitudes has the potential to extend the growth in retail banking in recent years, which presently remains small. In Vietnam, banking assets amounted to about $75 billion (123 percent of GDP) at the end of 2006, with less than 10 percent of Vietnamese possessing in a banking relationship.[53] The McKinsey study suggests that retail-banking revenues could grow by more than 25 percent annually over the next five to ten years, premised on stable economic growth, sustained increases in household income and expenditure, and the current low penetration state of banking services. Presently,

[52] The McKinsey Quarterly March 2008
[53] Ibid.

Vietnamese banking consumers aged 21 to 29 hold, on average, more financial services products than their elders: 2.3 per respondent, as compared with 1.9. Ninety-one percent of the young adults have savings accounts, compared with 55 percent of the respondents 30 years or older. Moreover, these young consumers are also in the segment most likely to adopt technology. Young adults are generally much more willing than their elders to use remote-banking channels, such as telephones or the Internet, after banks address their security concerns. Young Vietnamese financial services consumers also responded favorably to engaging in future internet-based and branchless banking. Despite SOCBs holding more than two-thirds of Vietnam's banking assets, deposits, and loans, local private-sector banks, such as Asia Commercial Bank and Sacombank, have infiltrated the banking sector and stand to gain from exploiting the youthful and impoverished populations. Under Vietnam's World Trade Organization commitments, the foreign banks were permitted entry in 2007, and although foreign retail banks face significant obstacles, their target market can serve this latent demand once some of the restrictions on expanding their branch networks are eased.

The health of alternative savings vehicles will also continue to play a vital role in Vietnam's domestic savings mobilization efforts. The insurance industry in Vietnam has experienced remarkable growth in the past few years, stemming from the passage of the Insurance Law in April 2001, which allowed foreign joint venture insurance companies and wholly foreign-owned subsidiary branches to operate in Vietnam (IFC 2006). Presently, there are 28 insurance enterprises conducting operations in life insurance, re-insurance, and intermediary insurance, including two SOEs, 11 joint stock companies, and 15 foreign-invested enterprises (IFC 2006).

Although both the demand for and the supply of funds are growing with the economy, the current financial system is not keeping pace with the actual needs of the economy. Bank loans have grown rapidly, but still only represent about 60 percent of the financial needs of businesses (USCS 2006). Moreover, a large segment of Vietnamese savers remain wary and suspicious of banks due to past banking failures and negative deposit returns. Of the 86 million plus population, less than five percent are estimated to be using bank services regularly, and less than 20 percent hold bank accounts overall (USCS 2006). The Decree on Deposit Insurance, issued in 1999 stipulated the current maximum deposit insurance compensation level of 30 million VND, however, this level may not suitable in light of higher living standards and banking deposit increases (USCS 2006).[54] The SBV, in cooperation with the Deposit Insurance of Vietnam (DIV), has sought to remedy this traditional banking hesitance by seeking to raise its maximum deposit insurance compensation level from 30 million to 50 million VND (US$1,900 to $3,200) to provide greater debt coverage for depositors in instances of credit institution bankruptcy (DIV 2006). The Ministry of Finance has hesitated accepting the SBV's proposal, understanding on the one hand that the maximum compensation level should be sufficiently high enough to prevent depositors from withdrawal en-masse, but remaining wary on the other hand of keeping it low enough to ensure lender prudence. The current maximum deposit insurance level for all depositors is nearly three times that of the Vietnamese per capita income,[55] and at present, over 140 banks and credit institutions are insured under the DIV. The banking sector's ability to mobilize capital through stimulating bank deposit savings will require increased transparency and more efficient lending, aspects linked to the privatization and deregulation of both SOEs and SOCBs.

Since implementing the *Doi Moi* reforms, Vietnam has gradually allowed competition to seep into its banking market segments, which has weakened the monopoly grip of its SOCBs. Progressive shifts in national initiatives have resulted in private sector development and international integration, which in turn has served to increase the need for private financing. Today, Vietnam's banking sector liberalization policy has created multi-economic ownership

TABLE 2. FINANCIAL SECTOR: NUMBER AND TYPE OF FINANCIAL INSTITUTIONS

	2003	2004	2005	2006
Number of banks	69	69	70	78
Joint Stock banks	38	36	35	37
Foreign banks	26	28	30	31
State-owned Commercial banks	5	5	5	5
Joint venture banks	n/a	n/a	n/a	5
Development and policy banks	n/a	n/a	1	2
People's credit funds	n/a	900	n/a	917
Microfinance and credit	40	50	60	70

Source: Mekong Economics

[54] Ministry of Finance - http://www.mof.gov.vn/DefaultE.aspx?tabid=616&ItemID=26187
[55] Higher than current IMF recommendations.

sector participation, composed of dominant SOCBs and a gradually increasing competitive fringe of entrants. At present, five large SOCBs direct the majority of the total credit in the banking sector, followed by 37 JSBs that account for about 20 percent of banking credit and foreign lending entities providing the remaining 10 percent (IFC 2006). Vietnam's banking system is supplemented by two policy lending institutions: the Vietnam Development Bank (VDB), which channels policy lending on behalf of the government, providing credit to SOEs and SMEs and supporting infrastructure and trade development and the Vietnam Bank for Social Policies (VBSP), which provides development assistance to marginalized rural households. In addition, over 900 People's Credit Funds operate as a system of rural savings and credit co-operative.

Although progress across all facets of banking reform has been significant, some prior efforts aimed at restructuring compliance and regulatory standards of JSBs, phasing out policy lending for SOCBs, adopting International Accounting Standards audits and resolving existing NPLs, are today still largely unrealized. The pace of reform in all of these areas has picked up after an initially slow start, but this momentum will have to be encouraged if Vietnam's economy is to be prepared to meet the challenge of increased competition. As a prelude to WTO membership, Vietnam has accelerated its campaign to strengthen its banking system. The expertise required in market-based transactions and decision making are still largely lacking in Vietnam. Proficiency in credit assessment, risk management, accounting and auditing, asset valuation, business planning, and marketing are all essential to a market-based economy's efficient operation. Presently, detailed guidelines are being prepared by the DIV, to create a framework for risk-based classification of credit institutions and definitions of premium levels for the various categories of credit. The Accounting Law, passed in June of 2003, offers guidelines to modernize accounting in line with international practices, and although the framework is in place, the government has yet to fully adopt accounting and auditing systems that meet international standards (Fang 2007). These steps cannot be overlooked in the formation of a sound and efficient financial sector.

In May of 2006, the government issued a plan to uncouple the supervisory functions of the SBV from the management functions that it performs for SOCBs in preparation for its planned equitization of four SOCBs later this year. These equitization procedures for the SOCBs have been initiated to allow market participants to obtain a more accurate evaluation of their worth. Included in the proposed equitization are three of the four biggest lenders: Vietcombank, the Bank for Investment and Development of Vietnam, and Incombank, in addition to the Housing Bank of the Mekong Delta. In realizing that the renovation process of the banking that this system is lagging behind the general economic renovation process, the government stated equitization sale was an attempt to meet the requirements of international integration and to strengthen the ability of state-owned banks to compete.

TABLE 3. BANKING SECTOR: STATE-OWNED COMMERCIAL BANKS[56]

	Growth of loan portfolio	ROA	ROE	Cost/Income	NPL	Coverage Ratio	Capital Requirement
VCB	31	0.8	13.5	71	15	74	3
BIDV	14	0.1	2.7	71	15	72	4
ICB	24	0.2	4.6	45	16	92	4
VBARD	24	-0.2	-3.7	57	n/a	n/a	4
MHB	54	0.5	4.4	36	15	n/a	9

Source: IFC Vietnam: Financial Diagnostic

The Vietnamese government noted that it will retain a majority stake of 70 percent in all four banks, but did not specify the extent to which foreign investor participation will be allowed if at all in this equitization share sale. In considering that foreign investors are restricted to an overall 30 percent stake in Vietnamese banks, with no single foreign investor allowed to hold more than 10 percent, and that the top two publicly traded Vietnamese banks by assets, Asia Commercial Bank and Saigon Thuong Tin Commercial JSB, are already at their 30 percent foreign investor limit, it will be interesting to see if and how the Vietnamese government's strategy changes toward foreign investors when the banks being sold are former SOCBs. At present, Vietcombank and Mekong Housing Bank are in the final stages of hiring external consultants to value the banks in preparation for an IPO, while the Bank for Investment and Development of Vietnam has already issued a fixed-rate long-term bond to increase its capital, following Vietcombank's convertible bond issue to raise capital ahead of its equitization plan in late 2005.[57]

A number of significant challenges lie ahead for Vietnam relating to its promotion and adoption of measures that will accelerate the process of key institution building and human

[56] See Appendix for more specific bank information.
[57] Dow Jones Inside Indochina: Vietcombank IPO Opens Door for Growth Play. April 5th, 2007. Accessed on May 9th, 2007. http://www.privatizationbarometer.net/news.php?id=11130&PHPSESSID=42cccf41d05c83702b6b1825436c49c6

resource training within its financial sector. Additionally, the government must implement provisory mechanisms that meet and exceed the immediate funding needs of the economy while not contradicting or impinging on market-based financial sector development. Perhaps most central to Vietnam's economic viability and future growth will be improvements to its financial sector efficiency through deeper structural reform and privatization targets for both SOE and SOCB sectors.

3.4. Microfinance Institutions and Other Microfinance Providers

The microfinance industry in Vietnam is best characterized as fragmented and lacking in regulation and efficacy, which raises questions regarding the depth of outreach and industry sustainability. Despite the best intentions of the government and the support of international donors and of the stakeholders themselves, Vietnam has not yet formulated a coherent and comprehensive strategy for its microfinance sector. In fact, the sector only very recently began to consider its eventual integration into the formal financial sector. The absence of a cohesive strategy framework is fiscally costly, as it distorts the financial market for microfinance and breeds inefficacies in the allocation of resources. In addition, the overall lack of service downgrades the positive effect that the sector should hold for socially-inclusive economic growth. Despite a rapid increase in the number of microfinance initiatives and institutions, a large unmet need for access to the formal financial services for the poor still exists. Microfinance, as an access point for sustainable financial services that target the poorest segments of society, is not yet well established in Vietnam. At present, the industry is immature and heavily reliant on the Vietnamese government's subsidies of state-owned microfinance providers. As a result, microfinance in Vietnam has been relegated to a social tool to combat poverty or a policy lending instrument that is not deemed as fiscally self-sufficient nor sustainable in the long-term. These policy distortions, in combination with transitioning legal and regulatory frameworks, are in large part responsible for microfinance's institutional weakness in Vietnam (World Bank 2007).

Vietnam's formal financial services market penetration reaches between 70 to 80 percent of the poor via access to microfinance services. This segment of the population is primarily served by the Vietnam Bank for Agriculture and Rural Development (VBARD), the Vietnam Bank for Social Policies (VBSP) and the People's Credit Funds (PCFs). Together, these three microfinance institutions (MFI) reach approximately 14 million households (or about 61 million people).[58] In addition to these industry leaders, Vietnam's microfinance sector also includes a myriad of disparate players that operate under their own auspices and fragmented approaches. The impact of asymmetric subsidies on microfinance initiatives in Vietnam are twofold: 1) they result in a loss of efficacy in lending practices and 2) lead to the under-provision of expanded access to formal finance vehicles that can facilitate the efficient mobilization and intermediation of capital in the economy. Ultimately, MFI dependency on subsidies will reduce the capacity for the poor to sustainably protect, diversify, and increase their sources of income through microfinance.

As of the end of 2005, the dominant provider of deposit services to rural households (which composes the majority of the poorest segment), VBARD, reportedly held US$ 7.5 billion in customer savings deposits, up 31 percent from 2004. Of this 2005 total, 58 percent or around $4.35 billion were deposits derived from the bank's estimated 5.4 million individual and household customers, an average value per account of VND 12.8 million or US$ 805. The total savings deposit of the PCF network is much smaller, at around US$ 340 million over approximately 1 million accounts (average balance per account US$ 340), and the VSPC held US$ 44.6 million across 80,000 ordinary savings accounts (average balance US$ 557) and US$ 5.6 million in around 50,000 "collection accounts" with monthly deposit and withdrawal rights,

TABLE 4. ADJUSTMENTS AND ESTIMATES OF BOP LOANS

Provider	Total accounts to HHs/individuals reported	Adjustment for non-BOP and duplicate accounts	Total estimated BOP savings accounts
VBARD	7,000,000	4,900,000 (70%)	2,100,000 (30%)
VPSC	501,900	401,520 (80%)	1000,380 (20%)
VBSP	167,285	83,640 (50%)	83,645 (50%)
PCFs	1,000,000	600,000 (60%)	400,000 (40%)
MFWG members	335,400	0	335,400 (100%)
Total	9,004,585	5,985,160	3,019,425

Source: World Bank and DFC 2007

[58] This figure does not account for the degree of double counting involved and not all recipients of financial services can be considered as poor. If the international poverty line of US$ 1/day (VND 480,000/per capita/month) is applied, the percentage of poor people increases to around 24% of the population, or 20.3 million people in 4.6 million poor or Low-Income Households.

which better suit low-income earners, as illustrated by the average savings balances of US$ 112. The non-regulated (semi-formal) microfinance providers (MFPs) in Vietnam report a total of US$ 19.6 million in 335,408 voluntary savings accounts, an average balance of US$ 58 illustrating their depth in outreach. The policy lender VBSP, which targets poor and disadvantaged households directly, reported holdings of VND 935 billion or US$ 58.5 million in 167,285 savings accounts at year end 2005 (average balance US$ 350). Together these institutions provide savings services to slightly over three million individuals representing low-income households. This constitutes an impressive 65 percent of the total estimated number of poor households in Vietnam (World Bank and DFC 2007).

The demand among poor and low-income Vietnamese households today is for well-designed, affordable and customer-responsive financial products that are both flexible and convenient. Most current and potential customers prefer to use one provider for all their financial needs, however, as evidenced by extensive multiple borrowing, when customers compile suitable financial services packages from multiple sources and services for themselves because providers are unable to fulfill this broader and more sophisticated demand.[59] Multiple borrowing is an undesirable practice because it increases the likelihood of cross-default. In addition to inefficiencies in monitoring for multiple accounts, non-state backed MFIs in Vietnam suffer also from insurmountable competition from state-owned MFIs. Heavily subsidized state-backed MFIs squeeze the financial margins of non-subsidized microfinance providers (MFP),[60] making it difficult for these institutions to keep within costs, offer lower interest rates, achieve fiscal self-sufficiency, and realize objectives to serve the poor sustainably. As such, VBSP's subsidized credit practice must be gradually phased out to allow for the increase in quality of service and permanency of access to products appropriate to low-income and poor customers. To this end, it will be beneficial to the future of banking and microfinance in Vietnam for closures, consolidation, mergers and convergence to occur and create a fully-integrated financial sector. The key to success and survival for these MFIs and MFPs will be financial service provision to low income and poor populations based on well-developed risk management and efficient systems of delivery that are cost-effective in reaching a critical mass of clients while generating profit for the institution. In technical terms, this equates to maintaining sound

[59] Based on an interview with Professor David Dapice, KSG's Chief Economist for Vietnam.

[60] The term Microfinance Provider (MFP) is applied in the report to institutions providing microfinance services operating outside the "formal" financial system, while the term Microfinance Institution (MFI) is applied to those operating within the formal financial system. MFPs are also sometimes referred to as "semi-formal" MFIs.

portfolio quality (Portfolio at Risk (PAR)[61] of less than 5%), and achieving financial self-sufficiency. A feasible break-even point for Vietnamese microfinance providers lending at the current SOCB rates of around 12 % per annum is roughly estimated to be 3000-5000 customers or a loan portfolio of around US$ 1.5 million for institutions that mostly mobilize their own resources (for example, PCFs) at their current efficiency levels, and at least US$ 500,000 for MFPs that lend from resources mobilized externally through grants and unsubsidized loans (World Bank and DFC 2007).

4. POLICY RECOMMENDATIONS AND POTENTIAL CROSS-SECTOR CONVERGENCE

4.1. Introduction

The following sections offer policy recommendations for the telecommunications, banking, and microfinance industries addressing specifically: deregulation, privatization and increased exposure to competition. Policy proposals will have an overarching objective rooted in maintaining socially-inclusive growth. Vietnam's banking and microfinance sectors will be addressed separately since, at present, there has been minimal efforts made toward their integration. The section ends with potential cross-sector convergence and its potential impact on sustainable socially-inclusive economic growth.

4.2. Telecommunications Industry

The telecommunications playing field is starting to level and a capable competitive fringe is poised to claim market share from the state-owned incumbent. VNPT, the former monopolist telecommunications operator, has already posted revenue losses resulting from increased competition and this revenue gap is due to widen as its profitable segments are spun off and international obligations draw closer. Vietnam's universal service fund and development assistance will fall far short of the level of financing needed to generate the high levels of rural penetration and teledensity growth as achieved under VNPT's monopoly. The issue is compounded by the fact that the Vietnamese government also lacks a viable tax vehicle to

[61] Portfolio at Risk (PAR) is generally used in microfinance rather than the banks' equivalent Non-performing Loans (NPL) in keeping with the practice at CGAP.

finance its socially-inclusive projects. International obligations and treaty agreements will make it extremely difficult for the Vietnamese government to reclaim control over its telecom sector, even if the intention is purely socially motivated. Mobile and broadband services are already being targeted by foreign firms, accelerating VNPT's decline in monopoly power and revenue generation, which will ultimately arrest cross-subsidization to fund universal service expansion. To respond, Vietnam will have to determine alternative means through which to finance and further its universal services initiatives in a market-based environment. As competition increases and foreign firms enter the fray, the promise of profit will overtake incentives to maximize social welfare. Profit-oriented firms will then only provide services to the poor if they determine that sufficient demand exists and initial sunk costs of expansion can be recuperated. As such, low-income and poor individuals will need to prove that they have the capacity to pay for these services in addition to signaling demand. Income generation will be reliant on access to entrepreneurial opportunity and the strength of the private sector to create wage-based employment. In a market-based environment, universal services provision will represent a significant paradigm shift from VNPT's state-run monopoly budgeted program.

My policy recommendation involves interconnection pricing models, an access holiday and incumbent-friendly asymmetric regulation in complement to the universal service fund, development aid and subsidy packages. Overall, my proposal presents an arrangement of carrots and sticks that compels both the incumbent and competitive fringe entrants to abide by quality standards and achieve teledensity expansion targets. The objective is to foster competition and global integration while generating socially-inclusive growth. First, I propose the creation of an independent regulator to establish an official separation between the government and the Ministry of Posts & Telematics. This new entity should be governed by an updated Telecommunications Act that promotes international integration but provides non-anti-competitive "carrots" to the incumbent to allow it to continue funding universal service programs. In parallel, "sticks" will be implemented to assure efficiency in light of the incumbent's reinstatement of temporary monopoly power, by way of performance floors and minimum maintenance standards for its existing network. These measures should pacify international integration proponents and market competitors. The aforementioned independent regulator, will act as an intermediary in negotiation and concession mechanisms between stakeholders. Next, I propose that the incumbent remain a single vertically integrated state-owned firm, either a reincarnation of VNPT or a repackaged entity with management rights over the existing network infrastructure. This "new" market leader will be granted a temporary monopoly so that it can generate revenues sufficient enough to build-out rural infrastructure and capacity before being subject to competition. To ensure efficiency, the incumbent will be forced to maintain a certain percentage of total teledensity expansion and new rural network expansion, audited for quality by the regulator, in order to receive the pre-specified concessionary interconnection prices (based on the "efficient component pricing rule" (ECPR) pricing[62]). The incumbent will be provided with a three year access holiday in which it must provide access to at least one other entrant, but more only at its discretion. The intermediate service will be sold at its average-incremental cost, which is equal to the marginal cost plus the opportunity cost for existing and any newly built infrastructure. This scheme and schedule will encourage the incumbent to propagate its network as soon and as quickly as possible, without sacrificing quality.

To clarify, entrants will pay predetermined incrementally falling interconnection fees for the first three years under ECPR pricing conventions. Upon expiration of the access holiday, the incumbent will relinquish the right to limit the number of potential entrants. Entrants will pay interconnection fees based on their urban market share across the entire telecommunications sector. This tariff will also influenced by the incumbent's rate of rural network propagation. Interconnection pricing will then shift to the Total Service Long Run Incremental Cost (TSLRIC)[63] pricing model which incorporates a "correct" signal to the market about building or buying network infrastructure. TSLRIC prices will impose an interconnection premium which will oblige entrants to use the existing incumbent facilities only if it is deemed economically desirable to do so, leaving the incumbent indifferent as to whether it provides the service or allows the entrant to do so.

If we suppose hypothetically, that after the three year access holiday, the incumbent is growing the rural infrastructure at a rate of 15 percent in a particular quarter, and one particular

[62] The "efficient component pricing rule" (ECPR) can be implemented when an entrant/rival and the bottleneck monopolist both produce a complementary component to the bottleneck service, the ECPR specifies that the access fee paid by the rival to the monopolist should be equal to the monopolist's opportunity costs of providing access, inclusive of any forgone revenues from a concomitant reduction in the monopolist's sales of the complementary component.

[63] Total-service long-run incremental cost (TSLRIC) is a special case of incremental cost, where the relevant increment is the total volume of the service in question, and the time perspective is the long-run. TSLRIC is the additional cost incurred by a firm when adding a new service to its existing lineup of services (holding the quantities of all those other services constant). For an existing service, TSLRIC measures the decrease in costs associated with discontinuing supply of the service entirely, other things being constant.

entrant maintains a 5-7 percent share of the urban market during the same quarter, then the entrant must pay an interconnection fee of $4/min. This gives the incumbent a dominant strategy of maximizing its rate of network infrastructure growth, therefore the entrant's best strategy is to maximize market share. The actual rates will involve a flat fee that incorporates the cost of building and maintaining the network and a premium levied on the long-run incremental cost that will adjust according to the metrics outlined above. These asymmetric regulations, control rights and interconnection prices will be gradually phased out as network expansion becomes self-

TABLE 5. ILLUSTRATION OF THE PRICING STRUCTURE DURING THE THREE YEAR TEMPORARY MONOPOLY

Incumbent's Infrastructure growth	Entrant's Urban Market Share (Hypothetical)			
12%	$3/min	$3.50/min	$3.90/min	$4.20/min
15%	$3.50/min	$4/min	$4.40/min	$4.70/min
18%	$3.90/min	$4.40/min	$4.80/min	$5.10/min

propagating, i.e., when entrants become interested in competing for the rural infrastructure expansion. This approach will provide the incumbent with the incentive to maintain high rates of infrastructure propagation and permit the continuation of urban consumer revenue cross-subsidization for rural capacity build-out. For the incumbent, the temporary monopoly power, but threat of gradual dilution also provides investment incentives to upgrade or extend the existing network with new technologies as they become available. For the entrants, incentives to invest in an alternative infrastructure are reduced since the existing network will be modern and amenable to new technology. This method stimulates competition, without sacrificing universal service initiatives by incentivizing all industry players to operate efficiently.

Vietnam's government will require substantial financing to fund further rural network infrastructure rollout. To achieve its teledensity target of 50 lines per 100 population by 2010, from the current level of about 27 per 100 (fixed plus mobile), the country will require about $240 million per point (800,000 lines per point (one percent teledensity) times approximately $300 per line), or about US$3.6 billion in total.[64] The total infrastructure investment budget for VNPT for 2006 was only about US$300 million. This level of investment, if sustainable, and

[64] USAID & VNCI

spread over three years (2007-2010) would total about $900 million, a shortfall of $2.7 billion of what is required. With VNPT's main sources of profit, namely high priced leased lines, mobile telephony and international calling all dramatically on the decline, and universal service funds and development aid earmarked for universal service initiatives minimal, the Vietnamese government will have to heavily subsidize or asymmetrically regulate the industry to even approach these investment targets. Under its current structure, VNPT will likely have to raise funds through debt or equity issuance, as retained earnings increasing come under pressure. The issue then will be who will invest in VNPT if monopoly profits are reduced and social welfare maximization is its driving force? Shareholders, foreign and domestic alike, would much rather flock to the profit-maximizing joint-ventures and recently privatized domestic firms, which will further complicate VNPT's capacity to access financing. Another concern arises in that if VNPT lacks sufficient capital funding, the deterioration of service quality, maintenance and operation of the current network may result. Moreover, Vietnam currently spends only 2.4% of its GDP on ICT, which places even more emphasis on future financing problems, again, shifting the reliance from the state-to-private overseas capital flows. These financing issues clearly weigh in favor of increased international integration at the expense of socially-inclusive economic growth.

4.3. Banking Industry

Vietnam's privatization to date has claimed over 10,000 SOEs since 1990, however, the largest and most profitable SOEs are still operating, fully or in part, under state control. The Vietnamese government has been extremely cautious in its efforts to relinquish control over its SOCBs primarily due the sector's profitability and lender of last resort capacity, a valuable tool to wield should the recently privatized SOEs bend or break under increased competitive pressures. Vietnam's banking sector equitization process has been accelerated in response to the nation's accession to the WTO and the accordant obligations and imminent international competition associated with entry. Strategies are in place to reduce government control over the remaining SOEs and decrees have announced extensive SOCB equitization and operation under international standards by 2010 (VDR 2006). To initiate this campaign, the SBV is being converted into a modern central bank that has greater autonomy to conduct monetary policy, monitor the value of the currency, control inflation, ensure the stability of the monetary and banking systems, and foster favorable economic growth environments. Perhaps most important to the equitization of banks is the SBV's agreed surrender of its supervisory role over the SOCBs by 2010 (IMF 2006).

Banking institutions, both state-owned and private, have been positioning themselves to fulfill their intended roles as financial intermediaries and credit providers in Vietnam's nascent market economy. Equitization programs and recapitalization initiatives of the SOCBs have drawn both attention and interest from domestic and foreign investors alike. Significant recapitalization efforts have injected some 12.4 trillion VND (US$785 million) across the five SOCBs, bringing their total registered capital to 18.5 trillion VND (US$1.2 billion) and raising their capital adequacy ratio to 4.4 percent. Concurrently, bad debt settlements, in four out of the five SOCBs, have resolved 92 percent of the NPLs incurred prior to December 2000.[65] Concerns over remnants of the command-based system linger amid all of the optimism, causing SOCBs to be viewed as obsolete players in an increasingly dynamic environment. Thus far, the combination of interest rate liberalization, increased public confidence in the banking sector and the nation's overall economic performance have significantly improved the environment in which the banks operate, however, the road to reform that lies ahead will require nimble navigation through unfamiliar and potentially unsound territory.

Empirically, the performance of privatized banks in the late 1990s was significantly better than that of state-owned banks in other command-to-market transition economies, comparable, in fact, to that of foreign greenfield banks (Megginson 2005). Privatization attracts foreign investment interest, which in turn, generates FDI. Moreover, foreign control generally involves enhancements to infrastructure, human capital, experience, technology and the diversification of business risk. Furthermore, privatizing to a strategic foreign owner leads to quantity and cost advantages in the sourcing of loanable funds. In addition, previous experience in command-to-market transitions and operations under full market competition is extremely valuable to former state-owned firms managed for decades by soft budget constraints.

Under Vietnam's planned-economy, SOCBs allocated funds based on policy, oftentimes to the detriment of profitability and efficiency. Accordingly, partial equitization of the banking sector will not achieve the allocative efficiency necessary to finance Vietnam's private sector if SOCBs continue favorable lending to its existing SOEs. It is imperative then, that the

[65] Vietnam Trade Promotion Agency. "In fair shape" August 12th, 2006. Accessed on May 9th, 2007. http://www.vietrade.gov.vn/old/news.asp?cate=17&article=5116&lang=en

equitization of banks is supplemented by the privatization of SOEs so that the incentive of SOCBs to support underperforming SOEs is eliminated. Additionally, evidence has shown that banks in transition countries have strong motivations to fund former debtors that hold large amounts of NPLs (Martinez-Diaz 2007). SOCBs are often tempted to look past an SOE's inefficient past performance and risky future to the prospect that another capital injection might allow these indebted SOEs to turn around operations and service past debt. The lack of disincentives to lend to these SOEs is rational when considering the alternative, which involves pulling financing and accepting the loss upfront and wholesale. This activity results in sharp reductions to the productivity of investments and a greater concentration of risk.

Designing effective methods of dealing with bad loans prior to the equitization process will be essential for the SOCB's competitiveness post-equitization. Equitization of the banking industry without supplementary privatization of SOEs will not solve the problem of allocative inefficiency that is necessary for continued private sector development. In understanding that incentives to lend to former debtors are magnified in instances where the state retains some control over the banks or former debtor firms (or both) after acts of privatization, it is vital to sever these linkages to eliminate featherbedding[66] and maximize wage-based employment. In transition countries, poor performance alone is not a sufficient indicator for choosing candidate banks to be privatized. This fact is reinforced when governments only partially privatize or insist on retaining controlling stake in the bank, since politics are bound to interfere with privatization efforts. In Vietnam, the SOCBs own an extensive network of branches that employ vast numbers of employees. Grossly overstaffed state-owned banks tend to possess a layer of insurance when it comes to insulation against the degrees of privatization, since the requisite, but politically painful post-sale staff cuts reduces the political will to privatize. This occurs despite the significant reductions in productivity and increased burdens on operations cost structures caused by overstaffing. Additionally, state employees must pay into the only pension fund in the country, the payments of which are relinquished upon leaving the public sector workforce. This effectively confines state employees to future employment within the public sector, or excludes those not associated with the incumbent political party from access to pensions. This is a major issue when considering the thousands of public sector jobs at stake and the potential burden on

[66] Featherbedding is a term used to describe the practice of an SOE, or labor union, employing more workers than necessary for a particular task. This retention of workers, despite the existence of actual work for them to perform, leads to gross inefficiencies in operation and cost structure.

the youth to support their elders. As a consequence, larger banks are less likely than smaller banks to be privatized for similar political and economic reasons.

Empirical evidence has shown that partial privatizations are a burden on banks, the government, and national taxpayers (Megginson 2005). Moreover, the actual amount of power retained by the state will greatly affect the efficiency of bank operations post-privatization. The natural temptation for governments in transition countries is to retain effective control of banks after other non-financial firms have been divested in order to lessen the shock of transition by propping up former debtors with easy credit (Megginson 2005). The Vietnamese government's plan, at present, mirrors this strategy, as it looks to retain majority stake in all of its soon-to-be equitized SOCBs, indicating hesitance on their part to relinquish control over the banking sector. Furthermore, it is unclear whether the 30 percent stake that they are looking to equitize will be made amenable to foreign investor participation.

The Vietnamese government's continued involvement in the banking sector will undoubtedly affect both domestic and foreign investment, as well as bank valuations and allocative efficiency of capital. Moreover, government influence will prolong inefficient lending, resulting in great losses to the economy in general and to the private sector in particular in the form of increased opportunity costs and capital scarcity. Although full privatization is preferential, the government's partial retention of ownership can also work if there are enforceable assurances that it will act only as a passive investor in remaining SOEs. In order to achieve this passive role, it will be essential for the government to eliminate the culture and propensity of banks to continue to lend to SOEs post-SOCB privatization. This aspect is especially important in Vietnam, where a sizeable concentration of large SOEs remains. To this end, Vietnam has already taken steps to transform the SBV into an independent bank regulatory system that will be disengaged from the SOCBs, however, the next and more difficult step will involve insulating the regulator from political influence.

For the banking sector to operate effectively, it must acquire sufficient capital to lend. To do this, the SOCBs must sufficiently cleanse portfolios of bad debt and raise capital prior to privatization. This will maximize their IPO value and provide the best possible start to accumulate and disseminate capital. As mentioned above, independence from favorable lending to SOEs will help to alleviate further risks of amassing bad debt. Additionally, the banks will have to devise reliable means to check credit as well as assess and collect collateral from savers.

Lingering state interference and allocative inefficiencies stemming from loans to SOEs will affect the rates at which the banks pay lenders and charge borrowers, which is at the root of operational and allocative efficiency. This stresses the fact that many factors and not only SOCB privatization alone will be required to encourage savers to put their money and trust in banks. The public must be convinced that their principal outlay will be rewarded with interest at maturity and that these returns will come with unquestioned certainty.

Vietnam's current miniscule US$1.2 billion total banking sector capitalization raises concerns over the capacity of the nation's banking sector to weather further international integration and increased competition. Even if the Vietnamese banking sector were able to correct the domestic obstacles outlined above and dramatically increase their lending capital, it would still have to contend with issues relating to adverse government interference, private enterprises risk assessment and macroeconomic volatility. Inadequate risk management post-SOCB privatization will still result in insufficient capital flow to the private sector, as well as increased costs of financing and difficulties in collateral assessment. If banks cannot efficiently allocate funds to private and privatized enterprises, these firms will have difficulty competing effectively with the more efficient and experienced foreign firms. Furthermore, if these leveraged private enterprises and privatized SOEs fail, mounting NPLs and bad debt will significantly increase the likelihood of bank failure. These events will act as antecedents to a larger systemic collapse, the likes of which the government may be financially incapable of correcting on its own. Should Vietnam find itself in the dire situation outlined above, their only remaining option would be to recapitalize through the acquisition of sovereign debt, or the asset liquidation of national firms to foreign ownership and control, which is the very outcome that their partial privatization strategy sought to circumvent.

Additional problems that await the banking sector post-privatization are credit booms, which will increase bank exposure to unpaid loans, and concerns over counterproductive liberal bank-licensing policies that might encourage inefficient market entry. Vietnam's banking sector is already home to numerous small banks that will become increasingly undercapitalized and understaffed as domestic, foreign and joint-collaborations are subjected to increased competition. This precedent bears troubling implications for Vietnam's domestic firms and banks, and the issue is compounded particularly by the impending international obligations under WTO membership. In light of these concerns, are domestic firms being set up for failure? Will failure in turn apply crippling pressures on the government? Foreign firms and foreign-invested JVB and JSBs will have significant advantages in terms of more efficient operation as well as greater access funding and cheap costs of capital, which implies that "survival of the fittest" will potentially result in foreign domination of the formerly state-owned banking sector. Another potential consequence of excessive competition in the post-privatized banking sector involves the potential shift in risk orientation that will lead to imprudent lending. Again, the issue of SOCB unpreparedness in understanding of risk assessment and management will further weaken operational efficiency while increasing the chance of bank failure.

With increased foreign participation in Vietnam's banking sector on the horizon questions regarding lending priorities and foreign ownership of formerly state-owned banks will come into focus. It will be interesting to see whether foreign banks will have greater incentives to lend to private firms and the degree to which domestic firms and rural SMEs are provided access to funds. Moreover, foreign firms and banks will have access to cheaper funding in their home countries due to higher credit ratings, which presumes reduced incentives to procure local funding. Conflicts of interest are bound to arise in foreign ownership and control of former SOCBs and the issue will be further complicated if bankruptcy and the need for recapitalization arises. Vietnam's WTO obligations involve the further liberalization of foreign entry into its banking system, which has heightened the urgency for banking sector reform. While foreign bank entry is unlikely to threaten the survival of the SOCBs, increased competition through efficient operations and well established industry expertise will undoubtedly lead to the erosion of SOCB market dominance and profitability. Partially-equitized SOCBs will be more vulnerable to macroeconomic shocks if foreign investors are allowed to acquire shares. Under state control or 100 percent domestic ownership, these equitized domestic banks would enjoy government insulation against macroeconomic shocks and recapitalization in instances of bankruptcy. If a financial crisis were to afflict a partially privatized SOCB with partial foreign ownership, the principal financier responsible for the costly recapitalization is less clear. In this situation, the Vietnamese government would have little incentive to recapitalize a bank that is partially foreign-owned and the reverse will apply for the foreign investor. The size and reputation of the foreign investor may play a role in the probability of withdrawal from the market in instances of fiscal crisis, but these circumstances will most likely be resolved on a case-by-case basis. Full privatization might remedy the recapitalization issue, but this action in practice will most likely require large sales to foreign investors since domestic earnings and the number of educated investors are still modest in Vietnam's nascent financial market. National governments may not be so keen to the idea of actively and purposely relinquishing control of their banks to foreign control.

In operating more efficiently and having a comparative advantage in industry experience and access to cheaper and virtually unlimited capital, foreign banks tend to produce higher profits than domestic banks. Within the domestic market, as foreign bank shares increase, lower profitability for domestic banks ensues. As a consequence, it appears inevitable that foreign banks will play an increasingly larger role in Vietnam's banking sector, which raises concerns regarding foreign risk assessment and collateral-based lending to domestic firms. Foreign bank penetration should improve firm access to credit and allow borrowers to borrow loans over longer terms at lower interest rates, provided that risk assessment capacity is well developed. The implications of enhanced credit availability to SMEs as well as large firms are exceedingly crucial to continued private sector growth. Without parallel advances in accounting and auditing standards for these SMEs, however, these risk assessment instruments may be rendered useless. In terms of collateral, it is unlikely that the Vietnamese government, at this stage, will allow foreign banks to take land deeds as collateral due to the implications of foreign ownership of property in cases of default. Moreover, it is equally unlikely that foreign banks will accept land and property as collateral due to property right ambiguity.

Vietnam's continual adjustment of its legal and regulatory environment has allowed it to build a prosperous private sector and make strides in integration into the global economy. Economic development, in turn, has necessitated a modern financial system to support the dynamic economy. It is important to understand, however, that bank privatizations are only a step in the arduous process of disengaging state ownership and control from the banking system. A remedy for Vietnam's current banking sector limitations will require significant decreases in government support for SOEs, the restoration of public trust in the banking system and continued legal and regulatory reform aimed at encouraging competition and private sector development. Continued high economic growth and prosperity, however, will firmly rest on the Vietnamese banking sector's capacity to efficiently allocate funds to their most efficacious use. The overall gain in allocative efficiency of credit will make available improved access to loans and necessitate risk assessment metrics that will undoubtedly be vital to continued private-sector development.

4.4. Microfinance Industry

To face the potentially insurmountable challenge of capturing price sensitive low-income and poor customers from heavily-subsidized state-run MFIs, existing private MFIs and new entrants considering registration under the Microfinance Decree[67] will have to deliver a very demand-responsive, innovative and diverse service in a customer-friendly, flexible and extremely efficient manner, in addition to having capital availability sufficient enough to grow the portfolio to scale quickly. Achieving these objectives will likely also require extremely efficient internal management and operational systems that are capable of handling larger and more diversified portfolios. Non-state-run MFIs will need to enhance their financial management and streamline their recording and reporting to better demonstrate transparency and legitimacy to attract the capital necessary for portfolio growth and expand outreach. At present, few MFIs in Vietnam fully meet these requirements.

To facilitate rural market entry and expansion, MFIs will require better market information, appraisal tools and systems to meet the growing and diversifying demand of their customers more responsively, particularly since remaining un- and under-served markets are comprised of the lowest segments of the low income population and the poor. The development of a credit reference system can help to improve coordination and information sharing on customers and mitigate the high, but unreported, level of multiple borrowing in Vietnam, "poverty penalty" high interest rates, and the overall risk of portfolio failure. The compilation of credit histories can generate credit ratings/scores that MFIs can consult to reduce their risk of portfolio failure. MFI customers determined to have good credit, can be "graduated" to the formal banking sector where they can access more sophisticated financial products. To maximize the depth and breadth of outreach, the "graduation" of bank-ready clients can also originate from informal and semi-formal to formal microfinance institutions.

The greatest obstacle to enhancing efficiency in Vietnam's microfinance industry is the Vietnamese government's policy view toward microfinance as a social tool dependent on subsidy for survival. If non-state-run MFIs are to become successful, microfinance in Vietnam

[67] See Appendix for more detail.

must first be considered as a self-sufficient financial business segment with social underpinnings rather than a poverty lending instrument. If this hurdle can be cleared, the overall political and economic environment for microfinance in Vietnam will be stable and promising. The economic dynamism and the overall financial reform program in Vietnam provides a solid foundation for the integration of effective microfinance services into the overall financial system, which will ultimately enable the banking system to contribute to socially-inclusive economic growth through the promotion and creation of entrepreneurial and other income-generating opportunity.

4.5. Potential Impact of Cross-Sector Convergence

If the Vietnamese government can manage the successful privatization and deregulation of its telecommunications and banking sectors with socially-inclusive growth in mind, the resulting increase in access to connectivity and information exchange coupled with improved and efficient allocation of capital and credit will be instrumental in generating economic opportunity and enabling sustainable development. The intersection of telecommunications and banking has the potential to create affordable and convenient access to services that can significantly increase the income-generating capacity of low-income and poor populations. As this segment's aggregated purchasing power improves, industries will have strong incentives to target this traditionally risky and unattractive market segment. Profitability, in turn will attract competition, as poverty is linked to profit, leading to further expansion of offerings to these underserved areas with unserved populations. With time prices will come down and more value-added services will be offered, catering to the particular needs of this market segment, thus providing the poor with access to networks that can increase their productivity and capacity to generate income. The simultaneous narrowing of the digital divide and poverty gap will stimulate sustainable socially-inclusive economic growth.

There are two types of economic value can be derived from network externalities[68]: inherent value, which is an individual's personal value attributed and utility derived from using a service; and network value, an individual's increase in value resulting from other users' use of

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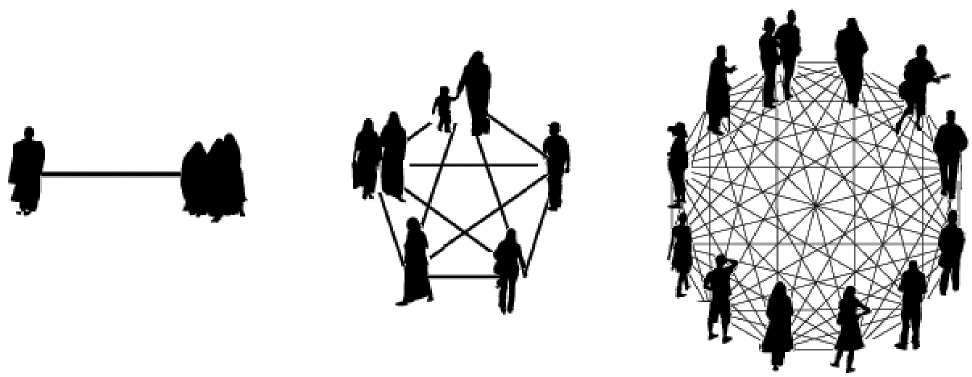
[68] A network effect is a characteristic that causes a good or service to have a value to a potential customer which depends on the number of other customers who own the good or are users of the service. The number of prior adopters is a term in the value available to the next adopter. One consequence of a network effect is that the purchase of a good by one individual indirectly benefits others who own the good. This side-effect arising from network effects are known as network externalities.

the same services (Sullivan 2007). For the poor, increased interaction and communication with one another can lead to greater productivity and choice. This can translate to alternative markets in which the poor can sell their goods and services in, which reduces some of the vulnerabilities they would otherwise face with price-gauging intermediaries. Also, network effects increase productivity in time and money saved in inefficacious travel. For industry actors, the marriage of telecommunications and banking is a practical strategy that can allow expansion into under-

FIGURE 8. RURAL NETWORK EFFECT



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served rural markets. Mobile phones can reach more users than would traditional brick and mortar or fixed-line infrastructure through their capacity to turn any location with access to a mobile signal and sufficient capitalization and velocity of funds, such as a petrol station or tourist stop, into a phone booth, bank branch or information terminal. Mobile phones can also immediately increase the efficiency of traditional microfinance by facilitating loan repayments and offering a safe and cheap way to access and transfer funds. By integrating bundled value-added services sufficient to generate value to individual users with the externalities of being part of the network, incentives are created for the poor to pay and industry to provide. Improved access and connectivity will increase productivity and drive growth in rural markets, thereby increasing the value and necessity of these services, which will further propagate the network.

The network effect will supply the telecommunications and financial services provider with a strong defensive positioning that will make joining its network attractive and costly to leave as the enhanced value-proposition insulates the service from substitutes and competition. Another potential synergy that can be had is the potential to aggregate and compile consumer data to create credit histories that will eventually generate credit ratings for future lending purposes. All transactions that originate and end on the phone can be easily tracked, measuring minutes used, text messages sent, money transferred, purchases made, bills paid and information scoured and downloaded. This is possible because all of these connections can be facilitated cheaply and conveniently through one interface and through a single integrated mechanism that hybridizes the diminishing marginal-cost-per-additional-user pricing model of telecommunications networks with the lower volume, higher margin pricing schematic of banking to reduce the overhead costs associated with traditional brick and mortar banking. In Vietnam, where much of the rural roads are poor, branchless banking can provide convenient access to financial services, where they would otherwise be too costly to provide due to high overhead costs for money transport, security and day-to-day branch operations. Both banks and telecoms encounter high sunk-costs to provide access which makes network expansion cost prohibitive. Mobile service requires towers to reach rural areas, while bank networks require branch establishment and trained staff. These high sunk costs make pushing into rural and impoverished communities economically unfeasible due to the low likelihood that sufficient revenues will be generated to defray sunk-costs. By merging the two pricing models, it is possible to create that aforesaid hybrid high-volume, low-margin transaction, making access to these services widely available to all levels of society. The poorest segments can rent these services or benefit from them as externalities, entrepreneurs operating micro- and small-enterprises can purchase goods in bulk at a discount, rural farmers can track weather patterns to determine the best time to plant, and migrants from the rural areas working in urban centers can cheaply remit earnings back to their families. Those who are non-entrepreneurial can benefit from loans as a means through which to smooth consumption, acquire an investment or access health information. The convergent strategy is attractive because of its potential to exponentially expand both banking and mobile phone networks simultaneously, facilitate the transfer of direct international remittances, disseminate vital health information to stem epidemics, integrate collaborative efforts of NGOs, governments and private industry to better the lives of the low-income and poor, and compile credit scores for credit-based lending that can eventually lead to securitization of pooled debt, which increases the total capital available to lend.

Since mobile infrastructure is generally underutilized and overly saturated in urban areas in Vietnam, telecommunications service providers have an incentive to extend value-added products and services to the poor to garner market share, first-mover advantages and ultimately deeply entrenched defensive positioning. Telecom operators will be attracted to the potential increase in teledensity expansion because the congestion point lies well within the total market size. Furthermore, these value-added services stand to strengthen human and physical security, creating healthier, more educated customers that can capitalize on entrepreneurial opportunity and generate income, thereby increasing their continued use and demand for these and more sophisticated services.

The following section details some particular enabling impacts of telecommunications, financial services and information exchange on socially-inclusive economic growth and entrepreneurial opportunity. In Vietnam, where bank branches are few and far between, a needs gap for domestic remittance transfers and ATM-like services exists. Reaching the "unbanked," those with no established credit, credit histories, formal addresses, or formal employment with easily accessible and affordable financial services presents a significant opportunity. Access to communication channels, financial services and information exchange are each beneficial to the poor, but they become invaluable when bundled in a convenient, accessible and affordable way.

Communication Channels

Mobile networks experience diminishing-costs-per-additional-user and escape the huge expenses incurred in making "last mile" connections. As a result, less infrastructure needs to be built and maintained, which in turn, reduces the network's exposure to natural disasters and difficulty in expanding service in inhospitable terrain. Connectivity allows users to be more productive in facilitating the cost of delivery of goods, provides entrepreneurs with the capacity to compare prices and vendors, and saves time and money by reducing inefficacious travel. Flexible mobile telephony pricing schemes can permeate all levels of society. Renting minutes or services can provide access to the poorest segments, pay-as-you-go models reach slightly more economically secure customers and termed contracts laden with extrinsic incentives can be offered to wealthier users and businesses. Moreover, the ease of use and affordability of the technology makes mobile telephony an accessible and easily disseminable service for oftentimes semi-literate and poor populations. Mobile phones have significant comparative advantages in cost and ease of use to computers, which significantly increases its capacity and speed to reach the rural poor.

Information Exchange

Mobile networks can easily and cheaply disseminate valuable information to the rural poor to significantly improve physical, human and economic capital. Educating the poor on best practices for farming, hygiene, disease containment and providing teacher training lessons can have great multiplier effects on the rural economy and future generations. Other non-financial community development programs can offer health and emergency notifications for disaster preparedness and relief. For entrepreneurs and farmers, access to information levels the playing field for local markets and empowers the rural poor by providing greater bargaining power. Market prices and farming best practices information is critical considering agriculture's role in economic development. Since the majority of the rural poor make their living from the land, rapid improvements to their welfare and consequent reductions in poverty require raising farmers' productivity in growing staple and cash crops in addition to bolstering the prices they receive for these crops. Information accessible via the mobile phone can allow farmers to sell their harvests at a fair price without making time-consuming and expensive trips to oftentimes inefficiently-run and corrupt markets. When coupled with mobile telephony, entrepreneurs and farmers will be able to purchase their goods and services from a wider range of vendors or sell and perhaps even advertise their goods and services to anyone with access to the network. When coupled with financial services, entrepreneurs and farmers can increase their capacity to acquire larger volumes of inventory at once, thereby lowering their costs of acquisition. This would allow the entrepreneur to reap greater margins and rural customers to purchase these goods for less. The impact of the free flow of socially-beneficial information has huge growth and distributive implications since the content can be specialized for other commodity sellers such as fruit vendors and fishermen. Moreover, public-private collaborations can be facilitated through these media to reach this market segment. An example might involve a public announcement sponsored by an NGO, that reminds customers to wash their hands with soap to avoid bacterial contamination. This message can be subsidized by an MNC that can then follow-up with an advertisement for its branded hand soap. In later phases, purchases of advertised products can be made through the phone, incorporating electronic coupon discounts can be reflected in the mobile-to-mobile purchase.

Financial Services

Branchless banking can provide customers with a safe place to save, allow them to generate interest phone minute balances, build credit history, facilitate cheaper monetary transactions and offer nearly instantaneous and secure movement and receipt of funds. Gaining access to instruments for savings, loans and investment allows consumption smoothing, which also aids in physical and economic security. This is particularly important in Vietnam's case since emergency room visits require sufficient cash-in-hand before any treatment is conducted. The instantaneous transfer of money can literally mean the difference between life and death. Increased speed and facility in transferring funds for emergency expenditures and drawing remitted capital from informal methods of saving to more formalized channels has the potential of creating greater allocative efficiency of loanable funds that can drive the rural economic growth.

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5. CONCLUSION

The sustainable provision of access to a bundle of telecommunications and financial services can have significant positive impacts on Vietnam's low-income and poor populations' capacity to generate income through entrepreneurial opportunity. Access to these services of productivity can empower and enable the poor, allowing them contribute to wealth creation and improve their own quality of life. This is a bold departure from the traditional view of the poor as cases for charity and dependents on development assistance. These services, in part or combined, can allow them to start, maintain or grow their micro-, small- or medium-enterprises, improve profits on the crops they bring to market, or form entirely new businesses that cater to network participants. When the poor do not participate in self-employment or the private sector is unable to employ, economies waste human capital and governments incur great expense in supporting poor, dependent populations. While the rapid increases in income will move poor families toward economic self-sufficiency, acquiring assets and accumulating savings is the key to achieving lasting economic security. Assets act as insurance against economic uncertainty and can be used to accumulate funds in preparation for future expenditure. The provision of services of productivity that can generate entrepreneurial and economic opportunity for the poor has the potential to allow them to convert small and variable savings into lump sums for a wide variety of more significant and efficacious use. The Vietnamese government is in the unique position of having considerable control over the sustainability of its impressive socially-inclusive economic growth achievements. If it can keep in sight and mind the basic tenets that it initiated over two decades ago and continue to base its economic decisions on sustainable development objectives it will be able to privatize and transition effectively to maximize and maintain socially-inclusive economic growth. Economic growth premised on foreign investment and global integration alone will create dependencies not only on the health of Vietnam's domestic economy, but also on the strength and wellbeing of its trade partners. This embeds vulnerabilities and volatility over which Vietnam will have much little or no control. Instead, if Vietnam is able to orchestrate a comprehensive privatization, prepare its industries to compete effectively and engage in cross-sector convergence of its telecommunications and banking sectors, it has the potential to bolster entrepreneurial upstarts of all sizes, create employment, link and strengthen the private sector and continue to generate a sustainable virtuous cycle of socially-inclusive economic growth.

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7. APPENDIX

7.1. Competitive Analyses Annexes

7.1a. Banking Sector

Five major state-owned commercial banks (presented in order of largest to smallest in terms of assets):

The Vietnam Bank for Agriculture and Rural Development (VBARD) finances agriculture and commodities.[69]

- Agribank is the largest bank in Vietnam in terms of capital, assets, staff, operating network and number of clients. Its credit rating was recently raised to "D/E" from "E".
- End of year 2004, total assets totaled 182 trillion VND (US$11 billion) with 2,000 branches operating nationwide and employing over 30,000 employees.
- Signed strategic partnership with JSB An Binh Bank in March of 2007
- Looking to provide credit line to AB Bank to fund major energy projects
- Part of a bank agent network of 950 banks in 113 countries.

The Bank of Foreign Trade (Vietcombank - VCB) is the main import-export and trade-financing bank.[70]

- Year end 2005, Vietcombank reported assets of 136.7 trillion VND (US$8.5 billion), and profit of 1.29 trillion VND (US$80 million). According to estimates, the bank may be worth more than $3 billion after equitization.[71]
- Vietcombank is planning a share sale for the second quarter of 2007.
- Plans to move into investment banking
- Strong capital mobilization, generating profits, regulating the interest rate and term of credit on a flexible basis, increasing marketing, exploiting different channels of capital mobilization, offering attractive capital mobilization-related products, and improving service quality.
- Offers new services such as online bill paying, Internet and insurance charges through ATMs, as well as electronic banking service.
- A leading credit card issuer.
- Diversified range of products/services and good adoption of advanced technology.
- Target implementation of transformation to a JSB, potentially with Credit Suisse Bank

[69] VietNamNet – Agribank and An Binh Bank become strategic partners. May 18th, 2007. Accessed on May 10th, 2007. http://english.vietnamnet.vn/biz/2007/03/674522/
[70] Vietnam Economic News Online – Vietcombank Hanoi Ready for Equitization. April 13th, 2007. Accessed on May 10th, 2007. http://ven.org.vn/English/?news=835
[71] According to an estimate last year by PXP Vietnam Asset Management

The Vietnam Industrial and Commercial Bank (Incombank - ICBV) is the primary financier for industrial development.[72]

- Registered capital of 10 trillion VND (US$625 million), expected to list its shares on the Vietnamese bourse. Credit rating recently raised to "D/E" from "E".
- Bad debt ratio stands at 1.38 percent, the lowest among the SOCBs.
- 137 branches and 500 transaction points nationwide, with assets approaching 138.26 trillion VND (US$8.6 billion) for 2006, posting a gross profit of 780 billion VND (US$50 million) for the same year.
- IPO planned for October 2007, currently entertaining bids from consultants, official equitization consultant choice to be made public on May 21st, 2007.
- Government to retain 70 percent controlling stake.
- Funded several telecom, energy and construction projects such as Vietnam's first telecoms satellite launch and four power plant projects

The Vietnam Bank for Investment and Development (BIDV) is the primary lender to infrastructure projects.[73]

- BIDV functions as a universal commercial bank providing a full range of currency, credit, banking and non-banking services to fund development investment.
- As of end of year 2004, total assets at 104 trillion VND (US$6 billion), with 8,000 employees.
- BIDV signed a US$200 million term loan with Austrian RZB bank, to use as a 5-year loan to adjust the structure of its capital sources and assets prior to implementing the first phase of its equitization slated for the end of 2007. Credit rating recently raised to "D/E" from "E".
- Joint venture between BIDV and Russian partner SJC Vneshtorgbank, granted by SBV in late 2006. The resulting Vietnam-Russia Bank (VRB) JVB will be 51 percent capitalized by Vietnam.

The Mekong Housing Bank (MHB) finances housing loans in the Mekong Delta region.[74]

- MHB is the fifth largest bank in Vietnam with assets totaling 18.7 trillion VND (US$1.1 billion), a 50 percent increase against 2005.
- Year-on-year profit rose by 41% and strong growth is expected.
- Extensive investment in technological upgrades and institutional development.
- MHB will issue bonds worth a total of 700 billion VND (US$43 million), its second bond issuance within the year. The earlier issue was for 800 billion VND (US$50 million).

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[72] Thanh Nien News Daily – State bank opens bids for IPO advisory. Tuesday, May 8th, 2007. Accessed May 10th 2007. http://www.thanhniennews.com/business/?catid=2&newsid=27837

[73] BIDV News – BIDV secures loan for US$200 Million from Austrian Bank. December 1st, 2006. Accessed on May 10th, 2007. http://www.bidv.com.vn/English/News_Detail.asp?News=1025

[74] Vietnam News Agency – Mekong Housing Bank to issue 700 billion VND in bonds. October 19th, 2006. Accessed on May 10th, 2007. http://www.vnagency.com.vn/Home/EN/tabid/119/itemid/167577/Default.aspx

7.1b. Key Microfinance Providers

Formal (regulated) Microfinance Service Providers
(excerpted from World Bank and DFC 2007)

The Vietnam Bank of Agriculture and Rural Development (VBARD)

VBARD is mandated to serve the rural financial market, and is the largest bank in Vietnam. It has a nationwide network of 2,096 branches up from 1,881 as of end 2004, covering some 600 districts in all of the 64 provinces. In some areas, VBARD also operates mobile units, financed under the World Bank Rural Finance Project I. Through its inter-communal branch network, VBARD is responsible for over 50% of all loans made to rural households, and VBARD's clientele consists of 68% rural borrowers, primarily farmers. The average loan size is around VND 21.1 million (US$ 1,320), reflecting its primary focus on small rural enterprises and middle-income earners.

While VBARD does not directly target low income-earners, donor-funded programs and targeted credit lines (from the World Bank, ADB, KfW and ADF) and framework agreements with the Mass Organizations (in particular the Women's Union and Farmer's Union) have provided the bank with a substantial rural credit portfolio also reaching BOP. VBARD estimates 47% (end 2003) of its rural borrowers or some 2.8 million households to be poor, making VBARD the largest provider of the full range of microfinance services (savings, credit, money transfers etc.) in rural Vietnam. Mobilizing a significant US$12.5 billion in deposits from the public, VBARD intermediates 60% as loans. The removal of government restrictions on interest rates in May 2002 has enabled VBARD to operate on a more commercial basis and has increased its profitability in recent years. However, the policy that institutions are required to provide loans at subsidized rates to households living in remote (Zone 3) areas continues to restrict the commercial operation of formal financial institutions. While the subsidies are funded by the Government, reimbursement is reportedly delayed, which may have reduced VBARD's incentive to expand lending in remote areas. A significant part of the loan portfolio for poor rural households is financed through the 82 projects implemented with donor funds at a total value of US$ 2.8 billion of which $ 2 billion is loan capital to be disbursed through VBARD.

The Vietnam Bank for Social Policies (VBSP)

The only formal financial institution directly mandated to deliver microfinance in Vietnam today is the Vietnam Bank for Social Policies (VBSP). In 2002, the Vietnam Bank for the Poor, which used to operate through the VBARD branch network, was reconstituted as the VBSP with its own nationwide branch network of 64 provincial branches, 662 transaction offices at district level and 8,076 commune-level transaction points, all subsidized by and often co-located with the Local People's Committees (LPCs). As the key government vehicle to channel social transfers as subsidized credit for policy purposes, VBSP is fully guaranteed by the Government, and is exempt from taxes, state budget remittances, and the deposit insurance scheme (DIV). One of the few good outcomes of the creation of VBSP as a policy lender has been the consolidation of the many credit lines to the poor formerly administered through line ministries; VBSP has taken over preferential lending schemes from MPI, MOLISA, People's Committees at all levels, and from the SOCBs. As of June 2006, the VBSP' reported a total outstanding portfolio is VND 18 trillion (US$ 1.1 billion) to a total of 4,4 million clients, of whom 3,8 million are LIC holders (poor) – or more than the total number of low-income households in Vietnam as per the latest GSO estimate (24% of the population in 2004), but these figures are unadjusted for multiple loans to the same customers and to some extent cumulative, as VBSPs capacity to effectively collect old outstanding debt and track active versus frozen loans is limited. The average loan size to poor households has increased since 2004 to around VND 4.6 million (US$ 293). VBSP mobilizes some 53% of its loan capital from public deposits (end 2005) and receives additional capital for lending from donor funds (IFAD, OPEC, WB) and a mandatory contribution of 2% of the deposits of the SOCBs, with the balance coming from the State budget in yearly tranches. Given the low level of resource mobilization and VBSP's dependence on government transfers, it must ration its provision, resulting in poor clients often not being eligible for a second or subsequent loan. The interest rate has recently (January 2006) been raised from 0.5% to 0.65% per month, but it is still well below the market rates applied by practically all the other MFPs. The heavily subsidized nature of its lending renders it financially unsustainable and unfairly undercuts competitors in the market, including VBARD and any MFI presently operating in Vietnam or to be established under Decree 28. Hence, VBSP distorts the micro-credit market and in competitive areas, it represents a threat to any sustainable microfinance institution in the market. Its basic assumption that the poor are not able to afford market interest rates is increasingly under questioning in Vietnam and has been proven consistently wrong everywhere in the world; permanent access to sustainable financial services that are provided reliably has proven to be more important to customers than low interest rates loans provided by unsustainable institutions. Because of the social policy mandate, VBSP is not only likely to continue to operate in the immediate future, but may actually increase and expand operations if provided with sufficient government resources. As cautiously indicated by the current management and as it is widely believed necessary by most policy-makers in Vietnam, VBSP may gradually start to align its interest to market rates, thus reducing both the level of distortion and the drain on government budgets. Other options include the transformation of (a part of) VBSP away from retail microfinance provision in an increasingly crowded and competitive market and into a wholesale refinancing institution serving the current and future microfinance providers under Decree 28, meeting their interim need for low cost capital and funds for capacity building until such time as they reach the scale and proficiency levels that will enable them to cover costs and access commercial capital.

The Vietnam Postal Services Company (VPSC)

As a provider working exclusively on the savings side, The Vietnam Postal Services Company (VPSC) was established in 1999 and is operated under the authority of Vietnam Post and Telecom (VNPT). As of July 2006, the Company, which only has 150 staff, operates through 816 outlets (post offices) of which 186 are on-line, and pay a commission to VNPT per transaction carried out. Its main functions are to mobilize resources, 15-25% of which are on-lent at sub-market rates, to the Vietnam Development Bank (formerly the Development Assistance Fund) to provide medium term lending at subsidized interest rates to finance public development investment projects by SMEs and exporters. A second function of VPSC is to provide basic financial services for the under-served (rural, women, and poor) population segments. 60-70% of time deposit customers are women, but at an average balance of US$812/account, these customers do not generally fall within the BOP population segment. Some 80,000 individual savings accounts at an average value of US$500 are held primarily by civil servants, while the VPSC offers a "collection account" product with small monthly deposits (average balance of US$ 278) aimed at and well-suited for poorer farmers. Currently, some 20,400 depositors utilize this service.

While the VPSC is a for-profit company and did report a small profit in 2005, its resource mobilization is governed by targets set by MPI. Perhaps as a result of these targets and the margins obtainable for the company, the VPSC does not appear to market the savings services widely, and the number of deposit accounts has remained stable since 2001, at around 500,000 (501,902 by July 2006), but the total value of savings mobilized has increased over the past three years to VND 6,511 billion (US$ 382 million) as at mid 2006, the vast majority (80%) placed in time deposits of 3-24 months bearing an interest of 7.2-8.8% p.a., similar to the SOCBs. In 2005, a PMO Decision opened up for the expansion of basic financial services to be offered by VPSC through the extensive postal network to include remittances, utility bill payments, checks and POS cards) and two pilot projects are ongoing to test the market for IC cards, and utility bill payments, but VPSC requires an SBV license to operate these services, which has not yet been granted.

With its very limited current product range, popularity in the market, and staffing structure, it is not evident that the VPSC will grow to become a major player in microfinance, and the company plans for the future also appear to go in a different direction: VPSC aims to become equitized through international (minority) shareholding as a bank serving the Post and Telecom sector. It is questionable whether the financial sector in Vietnam needs another sectoral banking institution in addition to the five 'financial companies' serving the industries of construction, shipping, rubber, textiles and petroleum respectively.

People's Credit Funds (PCFs)

People's Credit Funds (PCFs) are community-based financial cooperatives that are owned, operated and governed by shareholding members, modeled after Desjardins (caisses populaires) and established by Decree in Vietnam in 1993 following the collapse of the old cooperative system in 1989. PCFs are licensed under the Cooperative Law and supervised by the SBV on their adherence to set standards regarding financial management, and member capacity. The SBV appraises new PCFs prior to licensing, and supervises and classifies the performance of the PCFs based on on- and off-site inspections. In 2000, some 40% of operating PCFs were classified as 'weak'. Since then, a total of 120 have closed down, and 60 new PCFs have been established. As of June 2006, the SBV considers the system as financially strong and regards only 6 of the 926 existing PCFs to be underperforming.

The average value of total assets of a PCF is VND 8 billion (US$ 500,000). An initial share contribution of VND 50,000 makes members eligible to save and take individual loans. As of June 2006, the 926 PCFs operating at the commune level have a total of 1,046,472 members (approximately 35% women) of which 30-40% are estimated to be poor. Savings mobilized As of March 2006 totaled VND 5,441 billion, providing some 80% of loan funds. The total outstanding loan amount by June 2006 was VND 8.5 trillion (US$ 531 million), with an average loan size of VND 8.1 million (US$ 508), indicating a portfolio of primarily less poor members. Acting as an apex in the PCF network, the Central Credit Fund (CCF) attracts and mobilizes capital from shareholders (the PCFs and the 4 SOCBs), donors and public deposits, serves commercial and urban customers from its 24 regional branches (loans from the CCF branches average US$ 750), and supervises and intermediates funds to the local PCFs at a near-market rate of 8% p.a. The CCF was established with a one-off contribution from GoVN of 80 VND billion in 1995 and is regulated by the Credit Institution Law, and is supervised by the State Bank of Viet Nam. CCF is receiving TA from GtZ for institutional strengthening, and with TA from DID, CCF is piloting a modernization process for 7 PCFs, and aims to establish a central reserve fund to cover losses from any failing member PCFs to enhance the overall sustainability of the network. In 2005, a new association of People's Credit Funds (PCFs) was established to coordinate and standardize the operational policies of the PCFs, including credit risk management and accounting.

In addition, some 300 of the approximately 900 Agricultural Production Cooperatives in Vietnam began to provide limited savings-based credit services following the adoption of a Decree106 allowing for internal savings and credit services. 100 of these were recently reviewed by the Ministry of Agriculture (MARD) and reported a total number of borrowers around 16,500 of whom about 20% also saved with the cooperative. The average savings balance of $ 163 per account indicates that cooperative savers are not generally among the poorest, but a number of these cooperatives do provide loans to poorer members within the range of $ 50-500 against partial collateral and at rates of 12% p.a. Some cooperatives also provide loans in kind (input, seeds, seedlings) to members.

Semi-formal providers

Mass Organizations (MOs)

Both VBARD and VBSP have signed Framework Agreements with *Mass Organizations* (MOs) in many areas to reduce their cost and risk, which has made it easier for many poor to access the banks. MOs organize their (poorer) members in groups, provide crucial legitimacy in the loan application process, and act as informal guarantors for the clients. The group leader assists in the loan transactions, for which the MO and the group leader receive a small commission. The loan documents are signed with the borrower as an individual. This linkage system has clear advantages for all parties. The banks get easy access to mobilized borrowers that repay, the MOs retain their members, and the more enterprising MO members that want to expand and grow their businesses get access to the full range of banking services, including increasing loans.

Informal providers

There is a long tradition of informal *Rotating Savings and Credit Associations (ROSCAs*) in Vietnam. These groups are referred to as 'Phuong", 'Ho' in the North and 'Hui' in the South. In the ROSCAs, periodic (weekly, monthly or more frequent) contributions in cash or in kind (rice) from members are pooled and disbursed to one member at a time on a rotating basis sometimes with, but usually without interest. Normally, members come from the same ward or village and membership averages 10-15 persons. Interest rates, membership and loan amounts are decided on either jointly, by a bidding process or by the organizer (group leader). The life cycle of a ROSCA ends when every participant has had at least one loan. ROSCAs are commonplace in Vietnam and build on trust-bonds among members living in close proximity or e.g. trading in the same market place.

Within all of the Mass Organizations, a slightly more formalized version of ROSCAs exists at the village level. As part of the membership 'requirements', members contribute a fixed sum per year (VND 20,000 – 50,000) and these funds are lent out to members in difficulties for 1-3 years at a time, with (WU, YU at 6-12% p.a.) or without (VVU, FU) interest. In addition, staff from Vietnam Social Insurance (VSSA) who disburse pensions and benefits at village level will often collect a share of the disbursement and lend them to pensioners in need. These savings and credit groups are well established in almost all communes, and appear well appreciated by people as part of the collective social safety net.

As in most other developing countries, *money lenders* have been an important source of informal credit in Viet Nam. By nature, the money lender tends to be the richer people in the communities, who provide character-based short-term credit at high interest rates (2-4% per month). Interestingly, there are reports that money lenders have started to reduce their lending rates as a consequence of the increasing outreach of formal and semi-formal financial service providers. In addition, *pawn shops* exist in most towns. *Traders* in the local markets and to some extent input suppliers and bulk-buyers of produce will provide informal pre-financing for producers or sell on credit to established customers.

7.2 Benefits to Increased Access to Credit and Connectivity

7.2a. Banh's Roadside Stand

I encountered Banh, approximately 800 meters down the road from my grandmother's house in Tay Ninh, a southwestern town in Vietnam on the Cambodian border. Banh, was a 24 year-old woman, who operated a tiny consumer goods, bottled drinks and packaged snacks stand on the side of the road. Her entire inventory of goods amounted to roughly US$30. She noted that on a good day she could make $5, but on an average day she made $2-3 dollars. Her cost of acquisition of these goods averaged nearly 60% of her sale price. She had mentioned that much of this cost stemmed from transport fees and her inability to buy in bulk. If Banh had access to a loan, even a tiny one, she could lower her cost of acquisition of goods and increase her margins on sales.

7.2b. Ut's Motorbike Transport Service

Ut has two children, one 7 and the other 11, both girls. His wife operates a small noodle stand front of their first floor apartment on a street packed with shacks. Ut parks his motorbike in front of the Central Post Office in Ho Chi Minh City and solicits tourists to take his special guided tour of the city. He advertises, "20 sites more, 8 hours, tour in English, just $6!" Most of his revenues come from shuttling locals around the city, but his income significantly increases for the day if he can convince a tourist to take a tour. His costs fluctuate based on gasoline prices, which at times, approach $4 a liter. Ut also carries a mobile phone to keep in contact with tourists that seek his services for lengthier stays. The current "pay as you go" cost of a mobile phone call is nearly 20 cents a minute and regardless of whether he uses his phone or not, he'll have to pay a 12 cent per day service charge. Ut revealed that his family's combined income is insufficient to reliably send his children to school and that the family saves in order to send the girls to school whenever it is financially possible. For Ut and his family, access to financial services and reduced mobile phone costs can free up and provide access to the $62 dollars per year that a public school tuition costs per child.

7.3. Synopsis of the Laws That Will Affect Entrepreneurial Opportunity

The Microfinance Decree (2005)[75]

Only Vietnamese NGOs, social-political and social organizations, charity funds and social funds are eligible to apply for a microfinance license from the central bank. Applicants should have prior approval from the provincial or city-level People's Committees, the main government authorities. Minimum capital requirement for MFIs that cannot accept voluntary savings is 500 million VND (around $32,000). Minimum capital requirement for MFIs that can accept voluntary savings is 5 billion VND (around $320,000). MFIs should have experience with compulsory savings and audited financial statements for the last three to apply for license as deposit-taking MFIs. Management boards, audit committees, and executive directors of MFIs will have to be approved by State Bank of Vietnam.

The Law on Credit Institutions (2005)[76]

The Law on Credit Institutions (LCI) regulates the organization and operation of credit institutions, and the banking activities of other organizations. It outlines general provisions and other regulatory norms for a credit institution, including the ways and means to develop the banking system so as to serve different sectors of the society. It also has guidelines regarding the issuance of licenses and regulatory laws, the organizational structure of institutions, issues relating to internal governance, management and auditing of these institutions and the operating methodology of these institutions i.e. credit mobilization, lending activities, payment and treasury activities. It establishes for the first time equal opportunities for all commercial banking activities in Vietnam. The amended law strengthens prudential and capital adequacy requirements, requires that state-owned commercial banks meet the same standards as private commercial banks, eliminates language favoring state leadership, and allows foreign banks to set up 100-percent foreign-owned subsidiaries.

The Common Investment Law (2006)[77]

The Common Investment Law (CIL) intends to create universal regulations for foreign and domestic investors. The law contains a number of changes to the present investment regime that have been criticized for retaining old restrictions and creating new burdens through a complicated multi-tier, multi-step system of registration and licensing for enterprises, which add bureaucratic burdens on domestic investors.

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75 Accessible from http://www.microfinancegateway.org/files/25507_file_Decree_on_org_and_op_of_MFIs_in_Vietnam.pdf
76 Mazur, Eli and Vu, Thanh Tu Anh, The Unified Enterprise Law and Regional Equality in Vietnam. Downloaded from http://www.fetp.edu.vn/research_casestudy/FacResearchlistE.htm on December 4th 2006.
77 Vietnam New Investment Law, Freshfields Bruckhaus Deringer. March 2006. Downloaded from http://www.us-asean.org/Vietnam/New_Investment_Law_Sector_Update.pdf on December 3rd, 2006.

The Unified Enterprise Law (2006)[78]

The Unified Enterprise Law (UEL) attempts to further regulate corporate governance and level the business playing field. The intended benefits of the UEL are uniform regulations and rules for all kinds of enterprises, regardless of ownership, the removal of set ownership limits for foreigners and a 4 year time frame for the full conversion of SOEs to limited liability or share-holding companies.

[78] Mazur, Eli and Vu, Thanh Tu Anh, The Unified Enterprise Law and Regional Equality in Vietnam. Downloaded from http://www.fetp.edu.vn/research_casestudy/FacResearchlistE.htm on December 4th 2006.