SECO PROJECT

FOREIGN TRADE UNIVERSITY

REPORT

ENHANCING CAPACITY OF VIETNAM'S FINANCIAL SYSTEM TO FULFIL ITS COMMITMENTS ON FINANCIAL LIBERALIZATION UNDER GATS

Project leader **: Dr. Mai Thu Hien**

Hanoi, May 2013

ACKNOWLEDGMENT

The authors would like to express their gratitude to SECO-WTI Academic Cooperation Project for supporting the visiting fellowship during which this research was carried out. Special thanks to Professor Pierre Sauvé from World Trade Institute for his supervision in this working paper, and Professor Juan Marchetti from the World Trade Organization, Professor Nguyen Dinh Tho and Professor Dang Thi Nhan from the Foreign Trade University for all their indispensable effort and support.

Mai Thu Hien and Nguyen Thi Minh Hanh

Foreign Trade University, May 2013

TABLE OF CONTENTS

LIST OF ABBREVIATIONS

ADB	Asian Development Bank
CRE	Private Credit provided by banking sector (% GDP)
FDEI	Financial Development Index
FDI	Foreign Direct Investment
FLI	Financial Liberalization Index
FPI	Foreign Portfolio Investment
GATS	General Agreement on Trade and Services
GDP	Gross Domestic Product
IMF	International Monetary Fund
JSCBs	Joint Stock Commercial Banks
MA	Market Access
MAR	Total value of Market capitalization (%GDP)
MFN	Most Favored Nation
NPL	Nonperforming loans
NT	National Treatment
SBV	State Bank of Vietnam
PCA	Principal Component Analysis
SOCBs	State Owned Commercial Banks
SSC	State Securities Commission
WTO	World Trade Organization

LIST OF TABLES

LIST OF FIGURES

PREFACE

1. Rationale of the research

Financial liberalization is often associated with strong financial development, rapid financial deepening, better resources allocation. However, financial liberalization doesn't simply imply a rosy picture for countries since literature and empirical findings show that after making liberal openings of financial market, countries have had to suffered greater incidence of risk.

Vietnam is a developing country and the accession to WTO marked an important signal for the country's financial liberalization. It engenders the removal of entry barriers for foreign participation under international commitments as well as a series of domestic reforms to make the financial market financially healthy and more competitive. The recent robust financial development is largely attributed this process. However, the downside of financial liberalization is more evident in Vietnam, especially since the burst of global financial crisis in 2008. Banks and securities companies rise in numbers, instead of quality. Unfettered credit growth and external liabilities raise concerns over bad debts and liquidity of the system. Vietnamese stock market volatility increases and there is eroding confidence in the VND. Clearly owing to financial liberalization, Vietnam now has become more vulnerable more than before.

So, to what extent Vietnamese financial market has changed due to financial liberalization? The understanding of such process and its implications are really important for understanding the recent proliferation of Vietnam financial market and may shed light on the future prospect. We hope to find the answers for the above questions by choosing the research subject as: "*Enhancing capacity of Vietnam's financial system to fulfil its commitments on financial liberalization under GATS*".

2. Research objective

By studying the overview of financial liberalization and GATS, looking through Vietnam' implementation of liberalization commitments under GATS framework, and using a series of indices, indicators and quantitative methods, the research's objective is to measure the level of financial liberalization and then derive the dual impacts of financial liberalization as promoting financial development and increasing the risk of financial fragility. The research goes on to make appropriate proposals to enhance further financial liberalization in Vietnam.

3. Research scope

The research will research on the impacts of financial liberalization of Vietnam under GATS on the performance of banking sector and securities market from 2007 onwards. In some parts of research, for analysis the scope may be extended to before 2000s in order to have a full view of selected components of financial liberalization.

4. Research methods

The research is mainly based on quantitative methods. For measuring financial liberalization degree, aggregate indices are used with principal component analysis. For quantifying the impacts on financial development and financial volatility, descriptive analysis through different indicators is used and econometric analysis is employed too.

5. Structure of the research

Chapter I Overview of financial liberalization deals with basic information related to financial liberalization, GATS and Vietnam commitments of liberalization under GATS. The chapter also introduces the background for quantitative methods.

Chapter II Facts of Vietnam financial liberalization under GATS and impacts on financial development and volatility provides data on current status of liberalization as wells as quantifies the impacts, using indices, indicators and quantitative methods introduced in Chapter I.

Chapter III Proposals to improve financial liberalization of Vietnam makes proposals to improve further financial liberalization, from looking at experience from other countries and outlining the outlook for Vietnam financial liberalization.

CHAPTER 1. OVERVIEW OF FINANCIAL LIBERALIZATION

1.1. Introduction of financial liberalization

1.1.1. Definition of financial liberalization

Financial liberalization has recently become a buzzword and somehow, a must-follow trend. However, it is highly debated that the process of financial liberalization reserves two-sided effect. One the one hand, financial liberalization has been hailed to promote robust financial market development, increase savings, foster the quality of financial intermediation, thereby contributing to a better resource allocation as well as create opportunities for international risk sharing.

On the other hand, the idea of deregulation, reduction of capital controls and exposure to cross-border capital flows, which arguably increases system's vulnerability to any abrupt speculative capital flight, might trigger excessive risk taking and an inclination to solvency, overall results in a higher level of financial fragility.

Despite a handful of opposing views which are either in favor of or against the effects of financial liberalization; still, financial liberalization is included as one of priority and significant parts of promoting financial growth package policy, especially for developing countries. So what is financial liberalization by nature?

The researches of McKinnon (1973) and Shaw (1973), which was reviewed by Balassa (1989), pointed out financial liberalization as a mainstay of economic reforms in developing countries. They placed much importance on the role of higher interest rate on the increase of saving and financial intermediation. Balassa (1989) summarizes that higher real interest rates increase the extent of financial intermediation while increased financial intermediation raises the rate of economic growth in developing countries.

It is also the first time that the term "financial repression" comes to practice. Initial works in the early 1970s showed that "the financial system is … repressed by a series of government intervention that have the effect of keeping very low (often at negative levels) interest rates that domestic banks can offer to savers. The most common forms that these interventions would take were interest rate regulations, directed credit schemes and high reserve ratios" (Ucer, 2008). The mechanism could be summarized as follows. Restrictions on interest rate in the context of inflationary economic climate result in negative real deposit rates, which in turn reduce the availability of loanable funds through the organized banking system. When it is hard to mobilize capital from the surplus area, more emphasis would be placed on self-finance for production activities and if yes, savings will flock to inflation-free assets such as gold, rather than at banks. Overall, the liquidity of business and the accumulation of capital suffer.

So, their literature generally put a pivotal emphasis on the role of interest rate in distributing savings and a below equilibrium interest rates might therefore trigger an unfavorable capital flight. The conclusive economic implication was that removal of controls over interest rates should be the center of financial liberalization.

However, from today perspective, financial liberalization doesn't just involve reduction of government intervention in regulating interest rate. Financial liberalization is defined in a much broader term, including a more varied set of measures.

Based on works of McKinnon (1973) and Shaw (1973), Williamson and Mahar (1998) gave six dimensions of financial liberalization: the elimination of credit control, the deregulation of interest rates, free entry to banking sector (more generally, the financial services industry), bank autonomy (in making decisions on their business, which is consistent with government's or central bank's prudential regulations), private ownership of banks, and liberalization of international capital flows.

Kaminsky and Schmukler (2003) considered financial liberalization as the elimination of controls on three components: the capital account, the domestic financial sector and the stock market (the stock market is viewed separated from the domestic financial sector). Agree with Kaminsky and Schmukler (2003), Arestis and Caner (2004) also deal with the deregulation in these three sectors. To be more specific, for stock market liberalization, liberalization refers to unrestricted acquisition of domestic equity by foreign investors and freely repatriation of capital, dividends and interest. Liberalization of domestic financial sector means no repression on lending and borrowing interest rates, on credit allocation (i.e. no subsidies to certain sectors or certain credit allocation), and on foreign currency deposit. Finally, concerning capital account transactions, the liberalization of the capital account is characterized by deregulations on offshore borrowing by financial institutions and non-financial corporations, on multiple exchange rate markets and on capital outflow controls (Kaminsky and Schmukler, 2003, Table A1).

For each sector, three regimes are defined: full liberalized, partially liberalized and repressed. Full financial liberalization occurs when at least two of the three sectors are fully liberalized and the third one is partially liberalized. A country is partially liberalized when at least two sectors are partially liberalized. Otherwise, the country is considered as financially repressed (see Kaminsky and Schmukler, 2003, Table 1 and Tale A1).

Abiad and Mody (2003) and Abiad and Mody (2005) had six dimensions of financial liberalization. It excluded prudential regulations, but following Williamson and Mahar (1998), it included a measure of government's operational restrictions, such as control over managerial and staff appointments, or restrictions on banks' operating procedures (e.g., on advertising and branch opening).

Following the earlier version, while constructing IMF financial reform index, Abiad et al. (2008) added one factor, i.e. prudential regulations and bank supervision, to study of Abiad and Mody (2003) and recognized seven major dimensions of financial liberalization: (i) credit controls and excessively high reserve requirements, (ii) interest rate controls, (iii) removal of entry barriers, (iv) privatization of state owned banks, (v) capital account restrictions, (vi) prudential regulations and bank supervision, and (vii) securities market policies.

- **Credit controls and reserve requirements:** primarily involves the elimination of directed credit schemes to priority sectors, offers freedom for financial intermediaries in terms of credit operation, and removes excessively high reserve requirement (a threshold of 20 percent to determine the excess of reserve requirement).

- **Interest rate controls:** refers to minimizing government intervention on the movement of interest rates. The restrictions could be in form of ceilings, floor or interest rate bands.
- **Removal of entry barriers:** refers to entry deregulation for foreign banks and/or non bank intermediaries to tap into domestic financial markets. This component is often aligned with international agreements such as WTO commitments of liberalization under GATS framework.
- **Privatization of state owned banks:** is essential to increase banking competition and totally minimizes government framing of credit allocation.
- **Capital account liberalization:** aims at liberalizing international capital transactions by promoting the acquisition and conversion of financial assets in one country by residents of another, eliminating multiple exchange rates for various transactions, as well as transactions taxes or outright restrictions on inflows and/or outflows. Capital account flows entail Foreign Direct Investment (FDI), Foreign Portfolio Investment (FPI), external borrowing and changes in reserve accounts.
- **Prudential regulations and bank supervision:** unlike other components, more government participation is regarded as a plus point for financial liberalization. Risk supervision is often in form of Basel standards on prudential areas. In a generous sense, this involves the introduction of market-based control instruments, through which government could monitor the financial market.
- **Securities market policies:** refers to government policies to encourage the capitalization and development of securities market as a way to channel funds to production.

In general, financial liberalization can be understood as decreasing and gradually removing governmental controls on the national financial system; and therefore, making a more freely-operating and efficient system. Financial liberalization includes liberalization in interest rates, exchange rate changes, commercial banks' lending, financial institutions' operations and ownerships, the autonomy of the Central bank, the complete mobility of capital inflows and outflows, the full convertibility of the currency, the full freedom for foreign ownership, and so on. We can see that with financial liberalization, the role of financial repression is transferred from the government to the market.

In this research, financial liberalization could refer to measures aiming at liberalization of domestic financial markets and capital account. The former relaxes financial repressions on domestic financial markets, mainly repressions on banking sector, insurance sector, and stock markets while the latter deregulates cross-border capital transactions, including direct investment, foreign portfolio investment, capital market securities, money market instruments, collective investment securities, derivatives and other instruments, commercial credit, financial credit, guaranties, sureties and backup facilities, real estate transactions, and personal capital movements.

In the following parts, the process of Vietnam financial liberalization will be examined in light of commitments under GATS, activated officially after Vietnam joined WTO in 2007. These commitments of liberalizing trade in financial services forces the economy to comply with financial liberalization trend, both in domestic sectors and capital account transactions. For example, the allowance for foreign participation in banking sector means government should lift its intervention in credit allocation by terminating directed credit programs or deregulate entry barriers. The allowance for foreign participation in stock market implies government should make free the purchase and sale of equity. Such liberal trade in financial services inevitably leads to cross-border capital flows, especially FPI to Vietnamese stock market or FDI to set up foreign branches/100% foreign owned banks. This means that, sooner or later, restrictions on capital flows will be eased.

1.1.2. Impacts of financial liberalization

The study of financial liberalization, its economic impacts on the development of financial markets and the increased risk of financial volatility has gained quite a lot of interest in academic research. Many works such as Balassa (1989), Singh (1997), Williamson and Mahar (1998), Henry (2000), Kaminsky and Schmukler (2003), Arestis and Caner (2004), Bakaert et al. (2004), Abiad and Mody (2003), Abiad and Mody (2005), Klein and Olivei (2006), and Abiad et al (2008) have conducted different surveys and come up with different empirical measures, using econometric analysis to quantify the relationship between financial liberalization and financial sector outcomes, such as functioning of financial system, number and quality of financial intermediation, availability and allocation of credit, allocation and efficiency of investment, financial deepening, monetary control, and prudential regulation and supervision, and macroeconomic outcomes such as economic growth, productivity, saving and consumption, cross-country risk diversification, crisis vulnerability, and even poverty, thereby deriving positive/negative impacts of financial liberalization.

- **Change in savings**

McKinnon (1973) and Shaw (1973) concluded that an increase in real interest rates in the context of financial liberalization will increase savings. It is explained as follows. The composition of GDP is $Y = C(Y) + I(r) + G + CA(RER, Y, Y^*)$. Move $C(Y)$ to the left, we get $Y - C(Y) = I(r) + G + CA(RER, Y, Y^*)$. Set $Y - C(Y) = S(Y)$, then we have savings function: $S(Y) = I(r) + G + CA(RER, Y, Y^*)$. We can see that saving is an increasing function of real interest rate and real output growth rate and that investment is a decreasing function of the real interest rate and an increasing function of the growth rate. At the initial repressed stage, the nominal interest rate is administratively fixed by keeping the ceiling on loan interest rates below the equilibrium rate so that credit is allocated on nonmarket criteria, and thus the real interest rate is kept below its equilibrium level. Low interest rates encourage current consumption, discourage saving, and reduce the average efficiency of investment. Thus, investments with lower returns, that would be unprofitable under the higher equilibrium interest rate, are now profitable. Following financial liberalization, removing the ceiling on interest rates leads to an increase in savings. The average return to investment increases, as the low-yielding projects are no longer profitable. Rising efficiency of investment leads to increased output, which further increases savings. Therefore, according to this theory, in an environment where investment opportunities are plentiful but the financial system is repressed, the key to higher and more efficient investment is to raise the return to savers, i.e. the real interest rate (see Arestis and Caner, 2004).

However, Williamson and Mahar (1998) and Bandiera et al (2000) showed countries' experiences which do not support this original McKinnon-Shaw claim that interest rate liberalization will increase savings. Arestis and Caner (2004, p.7) showed in the literature the explanation for this criticism.

- **The economic growth**

Financial liberalization has positive relationship with economic growth as follows. First, higher investment as increased capital inflows to earn higher returns and increased investment efficiency leads to increase in output. Second, improved risk allocation through global diversification of risk reduces risk premium, thereby lowering the cost of capital, thus higher expected return projects, and then output. Third, technology and managerial know-how transfer can raise aggregate productivity and in turn increase output. Fourth, higher competitiveness following financial liberalization can help improve the regulatory and supervisory framework for domestic financial sector as well as introduce a variety of new financial instruments and techniques, thereby improve the quality of domestic financial services, and thus output. Bekaert et al (2004), Klein and Olivei (2006), and Abiad et al (2008) showed evidence of positive effects of financial liberalization on economic growth. Besides, Arestis and Caner (2004, pp.6-9) showed in the literature that it is possible for the financial liberalization process to have a negative effect on growth in theory. The findings from empirical literature testing the relationship between financial liberalization and economic growth are mixed and inconclusive.

- **The development of financial markets and allocation and efficiency of investment and credit**

Some works, such as Stulz (1999), Henry (2000), Kaminsky and Schmukler (2003), Arestis and Caner (2004), Klein and Olivei (2006), Abiad et al (2008) asserted that financial liberalization helps to develop more effectively financial markets. The survey of Williamson and Mahar (1998) showed that financial liberalization places a positive impact on financial depth, though this result is largely driven in developed countries. They also showed the evidence of the gain in investment efficiency after financial liberalization is financial development. Indeed, by offering a wide range of financial assets, removing credit controls, and granting more freedom for financial intermediations, they could develop their services in order to attract more funds, increase financial transactions since the exchange of financial assets are more easily and increasingly, and use the funds effectively to earn high return. However, it is unanimous that credit allocation is more efficient after financial liberalization.

- **Removal of entry barriers helps to increase competition and institutional reforms**

Financial liberalization under WTO agreements, which opens financial market to foreign entry, could help to reduce unfair competition and promote a fair playing field. New entrants overseas are therefore expected to "foster competition; raise the efficiency and the standards of compliance with international regulations" and the sophisticated foreign management technique is likely to result in "innovation among firms and more efficient operations and processes" (Mutrap, 2010, p.27). In fact, in face of increasing competition pressure rooted from foreign banks/securities firms with better risk management and higher quality financial services, domestic entities have to upgrade their performance, their products and internal risk control to keep up with foreign competitors.

Foreign investor's participation also makes significant changes to macro policies as well as corporate governance. They call for transparency in the government actions and their equity contribution in domestic forms could give them the determining voice (to some extent) and the chance for institutional reform.

- **Capital account liberalization with more foreign investment, international risk sharing**

The free-from-restrictions movement of cross-border capital is believed to have positive impacts on economic growth in 2 main ways. Firstly, foreign capital inflows from developed countries might flock to seek for investment chances in emerging nations. Secondly, by allowing free cross-border capital flows, investors could diversify their portfolio investments, so that they could create a shield for their investment from country specific adverse events. In a nutshell, "improved risk allocation reduces risk premium, thereby lowering the cost of raising capital" (Arestis and Caner, 2004, p.4). The effects of capital account liberalization on growth used to be tested; however, mixed results were found depending on the growth stage of individual economy, unlike domestic financial liberalization, which often results in positive findings.

- **Financial liberalization increases fragility**

McKinnon and Pill (1997) studied the issue of how financial liberalization can lead to financial crises. They use a simple two-period model of borrowing and investing. "It is shown that capital markets could go wrong when uncertainty about payoffs to new investments increases as a country moves from repression to reform. When there is moral hazard in the capital market and international financial flows are unrestricted, with the presence of deposit insurance, banks lend exuberantly, which sends overoptimistic signals to firms about the outcome of the reforms. Thus, overborrowing and overinvestment occur. Savings decline and the current account deficit grows rapidly. If the outcome of the reform turns out to be less favorable than expected, firms have trouble repaying investment loans and this puts the banking system in serious trouble" (Arestis and Caner, 2004).

The study engendered by Demirgüç-Kunt and Detragiache (1998) also found out the positive relationship between financial liberalization and banking crises. It means that financial liberalization increases the likelihood of banking systemic crisis risk. The study also specified a diminishing impact of financial liberalization on banking fragility with a strong institutional factor. Focusing on the link between currency and banking crises, Kaminsky and Reinhart (1999) found that financial reform enhancing liberalization often precedes banking crises. Williamson and Mahar (1998) showed evidence in literature that financial liberalization leads to crisis. Kaminsky and Schmukler (2003) found that financial liberalization produces financial crises. They also concerned with the impact of financial liberalization on financial crises.

The reason for such systemic crisis risk is not inherent in financial liberalization itself. The underlying engine is poor institutional quality, lax government regulations and market failures. The freedom of credit action, moral hazard and asymmetric information can induce to higher level of risk taking. Additional pressure comes from fierce competition following financial liberalization. “Since competence related to the control of borrowers and the management of risky borrowing can be acquired only progressively, the risk of bank insolvency and generally the risk of systemic crisis might be higher for the recently – liberalized financial systems” (Kammoun et al, 2011).

- **Speculative capital flows and bubbles**

Financial liberalization opens domestic market to foreign flows, thus raising the chance of exposing to speculative capital flows, shifting away financial resources from productive areas to speculative with higher and also riskier returns.

Chapter 2 might place a stronger emphasis on the analysis of positive impact of “financial development: higher level of financial deepening and better resources allocation” and the negative impact of “financial fragility”.

1.1.3. Evolution of financial liberalization

The financial liberalization commenced at different time periods and to varying degrees in different continents. In general, there are 2 episodes of financial liberalization: in the 1970s and the second in the late 1980s. In developed countries, stock market liberalization were liberalized in the early 1970s, domestic banking sector deregulation and capital account liberalization were taken place until the early 1980s. Liberalization of the domestic financial sector precedes the opening of capital account in the rest of the 1980s. By the mid-1980s developed countries liberalized, at least partially, their domestic financial sector. By the late 1980s and early 1990s capital account liberalization had taken place in all developed countries (Arestis and Caner, 2004).

In developing countries, domestic financial sector was liberalized along with capital account in the 1970s. However, the stock market was repressed for foreign investors over the period. In the aftermath of the 1982 debt crisis, controls (especially capital account controls) were re-imposed that remained until the late 1980s. The major developing countries turned to financial liberalization in the early 1980s-1990s, which took place in Asia and then in Latin America. By the early 1990s, the domestic financial sector and stock market had been jointly deregulated in developing countries. Capital account liberalization commenced in the early 1990s (Kaminsky and Schmukler, 2003, Arestis and Caner, 2004). The common trend is that domestic financial sector liberalization precedes the freeing of capital account movements.

In East Asia, the major countries liberalized in the 1980s at different times and to different degrees. In South Asia, financial repression began in the 1970s with the nationalization of banks in India (1969) and Pakistan (1974). Interest rates and directed credit controls were subsequently imposed and tightened, but for much of the 1970s and 1980s real interest rates remained reasonable. Liberalization started in the early 1990s with a gradual freeing of interest rates; a reduction in reserve, liquidity, and directed credit requirements; and liberalization of equity markets. In Latin America, financial liberalization occurred in the 1970s but financial repression returned, continued, or even increased in the 1980s, with debt crises, high inflation, and government deficits. In the 1990s, substantial financial liberalization occurred, although the degree and timing varied across countries. African countries turned to financial liberalization in the 1990s in the context of stabilization and reform programs supported by the IMF and WB, as the costs of financial repression became clear (World Bank, 2005).

The process of financial liberalization in the early 1980s-1990s on global scale was attributed to various reasons (World Bank, 2005 and Mutrap, 2010): (i) *Financial repression and poor performance of financial sector.* Limited mobilization and inefficient allocation to low-yielding government guaranteed investment projects. Government borrowing to make up for budget deficit crowded out lots of potential investors; (ii) *Highly fiscal cost of bank recapitalization.* As mentioned above, financial resources in a repressed market were primarily channeled to low productivity, inefficient activities so it would be no surprise that financial markets faced with weak loan repayment; (iii) *Globalization pressure.* Financial liberalization is a must follow trend due to globalization pressure. The cross-border trade acceleration, international integration and technology transfers made countries hard to resist to financial liberalization. WTO and IMF pushed up the process, too; and (iv) *An incentive to enhance the domestic sector competitiveness and national growth targets.* Once foreign participation is allowed, the liberalization of domestic market is an essential step. Not only it increases the quality the platform to sustain the investment flow of foreign investors, but also make country more protective against sudden external shocks that speculative financial flows could trigger. Also, foreign investment is vital to achieve national development targets.

Williamson and Mahar (1998), Kaminsky and Schmukler (2003), and Arestis and Caner (2004) showed evidence of the pace and sequence of financial liberalization. Out of developed countries carrying out comprehensive financial deregulation such as Australia, New Zealand, France, and Japan, Australia and New Zealand liberalized their financial sector rapidly, whereas France and Japan chose a more gradual approach. Latin American had a faster pace of financial liberalization than that in other developing countries, although there were more instances that the reform was reversed in Latin America. Turkey and South Africa also chose a rapid financial reform, whereas East and South Asia adopted a gradual path.

All the G-7 countries liberalized stock market first. 75 percent of European countries deregulate the stock market first. 25 percent liberalize the domestic financial sector first, focusing on interest rate liberalization first and the same to Latin America. Asian countries follow a mixed strategy; some deregulate the domestic financial sector, while some others free the stock market. For instance, Korea liberalized equity market first while in South Asia, initial emphasis in the 1990s placed on freeing the government influence on interest rates. Capital account liberalization in all Asian countries takes place subsequently.

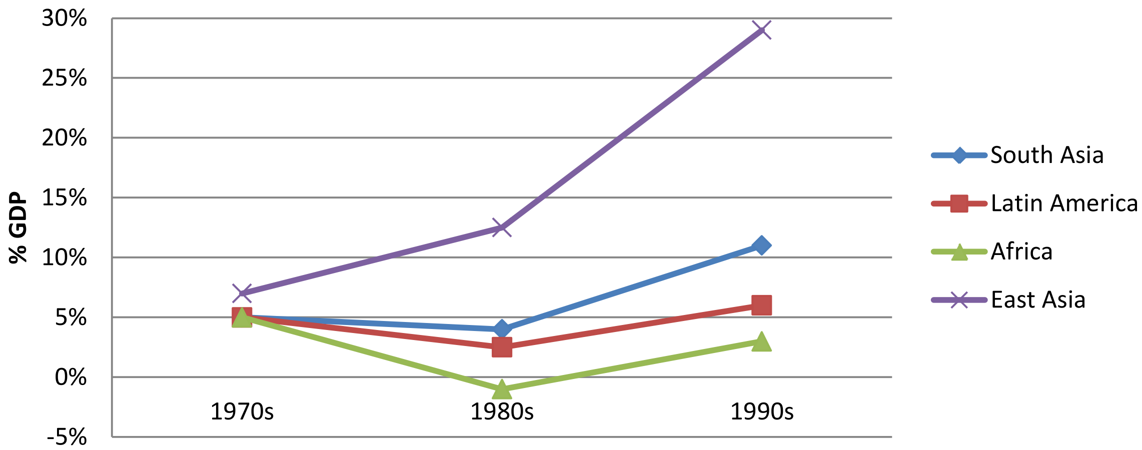
- **Domestic sector liberalization**

The initial policies adopted were mainly liberalization of interest rates. Following is the raise in deposit rates, indicated by a substantial increase in Average Deposits/GDP in 4 regions from 1970s-1990s.

Figure 1 illustrates the growth in volume of banks deposit as a percentage of GDP. The economic implication was that bank deposits gradually contributed a larger proportion to the gross domestic product. The East Asia underwent the most substantial soar in bank deposits from around 7% to a peak of nearly 30% in the beginning of the 2000s. There was an abrupt decline in deposit volumes in Latin America, albeit a strong recovery until 1990s ensued: bank deposits accounted for, on average, one tenth of GDP in Latin America region. A common pattern was shared by South Asia and Africa, bank deposits went down constantly to nearly a negative low point, before picking up again.

It could be explained the slow growth rate and even downward movement in bank deposits from 1970s to 1980s was attributed to the financial repression policies which kept a negative low deposit rates. The interest rate liberalization in the early 1980s and 1990s considerably raise bank deposit interest rates and more loanable funds have then been accessible through the system. Apart from positive real interest rates, the reason for deposit growth was supplements from non bank deposits, and the permission of foreign currency deposits. Thus, for interest rate liberalization as a representative mark, financial deepening was rather achieved. By the early 1990s, the domestic banking sector and stock market had been partially liberalized in developing countries.

Figure 1. Increase in Average Deposits/GDP, 1970s-1990s



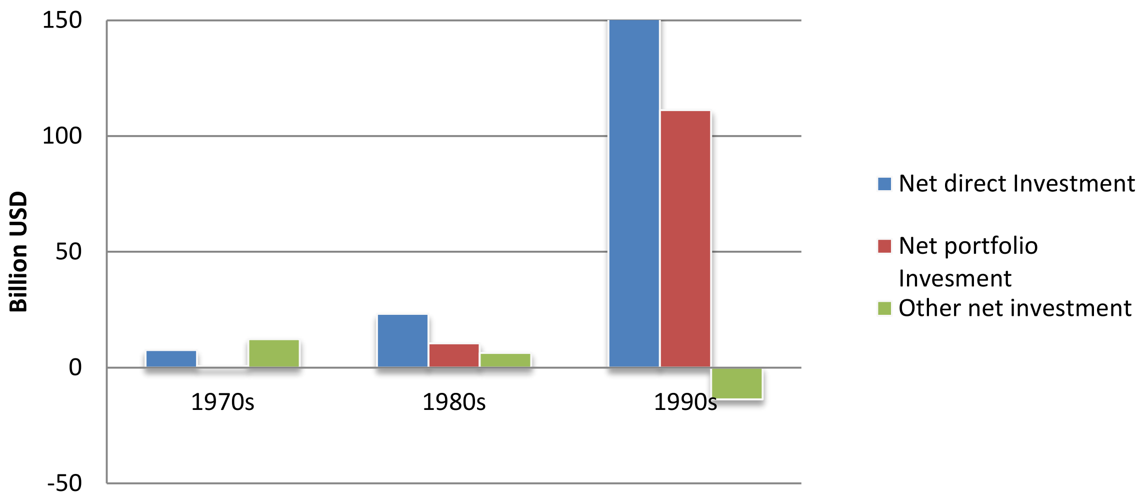
Source: Author’s adaptation from World Bank (2005), p.208

- **External Financial Liberalization**

The process has also been reflected through strong financial integration with great waves of cross-border capital flows experienced by various countries

Figure 2. Worldwide average capital flows, 1970s-1990s

Unit: USD billion



Source: IMF

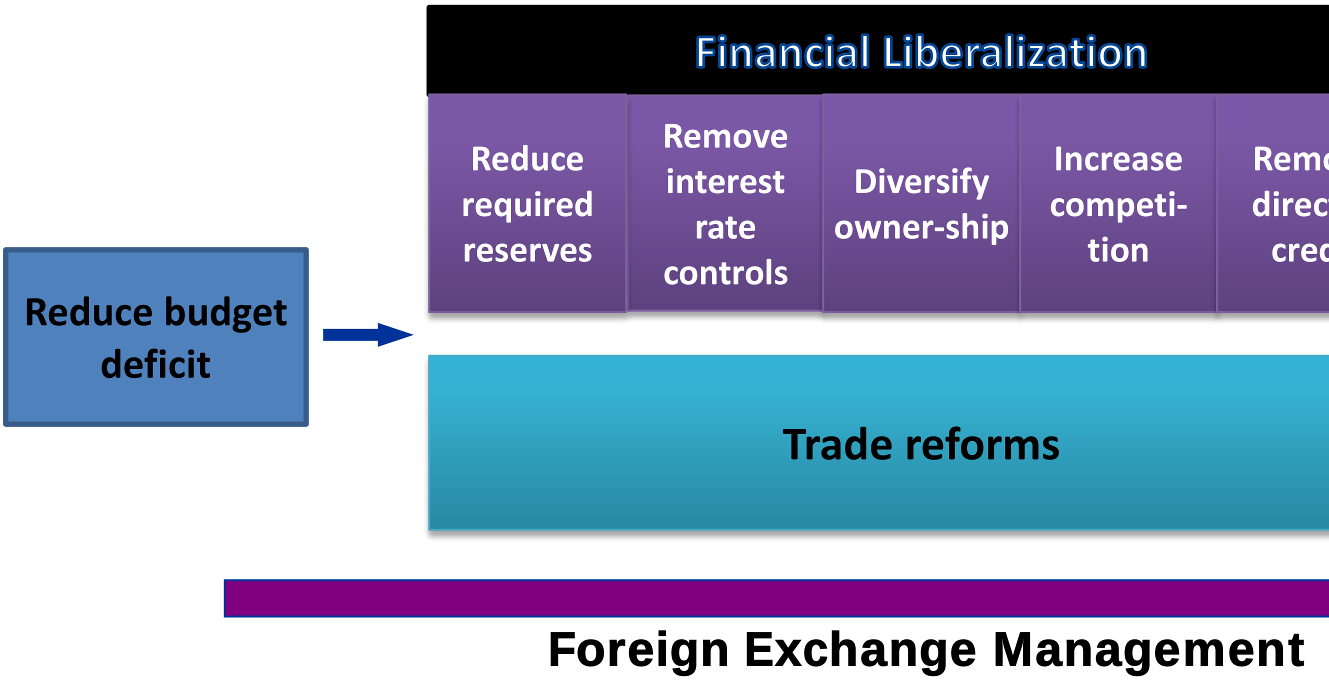
The general trend was upward for all types of investment from the early 1970s to 1995. However, as the Asian financial crisis 1997-98 casted a negative impact on the operation of financial system, other net investment flow experienced a significant fall of approximately USD80 billion. The flow of net portfolio investment also decreased, though by a smaller margin. Net direct investment still bucked the trend as the FDI.

Currently, most developing countries have partially liberalized their domestic financial market; however still exert a level of precautionary restrictions on capital account. Fully liberalization is hard to find after Asian crisis and some countries in Africa even experienced reversals in financial liberalization.

1.1.4. Process of financial liberalization

Based on individual economic conditions and objectives, each country must design its own procedures for sequencing financial liberalization policies. Johnston et al (1997) and Ishii and Habermeier et al (2002) studies the sequencing capital account liberalization with financial reforms. Capital account liberalization adds an external dimension and urgency to financial sector reforms. The pace and sequence of capital account liberalization depends on each country's domestic reforms as a result. Therefore, as figure 3 suggests, the common paradigm follows as domestic financial liberalization first and capital account liberalization as the final step.

Figure 3. Sequencing financial liberalization



Source: Author's adaptation from various sources

First, policymakers need to control budget deficit. It helps to control inflation rate as well as gain more independence for government finance without relying on interest rate. Structural reforms should aim at reforms at the state-owned sector, public finance and banks in order to reduce budget deficit.

Second, among many domestic financial reform policies, interest rate liberalization takes the lead as it is the primary determinant of savings and investment.

Third, other financial reforms to liberalize domestic markets including reduce required reserves and other controls to expand credit, establish market-led interest rate which could offset inflation to raise funds supply, deregulate entry and privatize state-owned financial sector (diversify ownership) to increase competition, eliminate directed credit schemes should be incorporated with securitization since state financial resources are curtailed.

Forth, attention should also be focused on exchange rate regime. The uniform policies are often: managed exchange rate (fixed/pegged exchange rate), allow for gradual movement (within widened band throughout time) and finally give rise to free movements under market principles.

Finally, capital account reform, aiming at management policy (lift capital controls) for FDI and FPI. On all the way, trade liberalization should always remain open.

Capital account liberalization brings about some benefits for the economy, but it also entails risks, for instance, precipitating a crisis, if opening capital account is not accompanied with necessary and eligible changes in macroeconomic policies and structure of the financial system. Therefore, capital account liberalization needs to be accompanied and coordinated with an appropriate sequencing of other reforms. Some principles help to guide an orderly sequencing and coordination of capital account liberalization with other policies. However, it is important to note that these principles do not help protect the economy from macroeconomic and financial system weakness and also do not imply that liberalization should be unduly delayed. Countries can benefit from access to international capital markets; and orderly capital account liberalization can stimulate desirable changes in financial system as they develop their ability to effectively manage the risks associated with international capital flows (Ishii and Habermeier et al, 2002):

(i) Capital account liberalization should be carried out on the basis of sound and sustainable macroeconomic policies. In addition, exchange rate regime must be consistent with other macroeconomic policies before removing controls on capital account.
(ii) Specific financial sector reforms that support and reinforce macroeconomic stabilization should be prioritized to reform early, such as market-based monetary arrangements and central banking reforms. Well-functioning monetary arrangements and strong public debt management practices are essential to managing the risks from short-term capital flows.
(iii) Financial sector reforms that are operationally linked and mutually reinforcing should be implemented together. For example, measures to introduce market-based instruments of monetary and exchange rate policy should be taken in parallel with measures to develop money and exchange markets, with reforms of payments and settlements systems, and with improved public debt management.
(iv) Prudential regulation and supervision and financial restructuring policies should be implemented to complement other financial reforms in order to help manage risks in liberalization and foster financial sector stability.
(v) The liberalization of capital flows by instruments or sectors should be sequenced to take into account the concomitant risks. For instance, liberalizing long-term flows should precede short-term flows because the long-term capital flows are more stable than short-terms ones. If distress happens, the investor cannot immediately withdraw the long-term capital flows, thereby mitigating the adverse effects of capital flows reversals.
(vi) The pace of reforms should consider conditions relating to the financial structure of non-financial corporations and other entities (for example, debt-equity ratios, and foreign currency exposure) and their effects on the quality of the loan portfolios and capital base of financial institutions. These are crucial factors determining the speed with which financial markets and especially foreign borrowing can be liberalized.
(vii) Reforms that require substantial lead time for adequate technical preparations and capacity building should be started early. For example, systemic bank restructuring and reforms of accounting practices and standards may take a long time.
(viii) Reforms need to take into account the effectiveness of the controls on capital flows currently in place. For instance, existing controls on capital flows may be

ineffective, because a country lacks the administrative capacity to fully enforce them.

(ix) The pace, timing, and sequencing of liberalization need to take account of political and regional considerations.

(x) The operational and institutional arrangements for policy transparency and data disclosure need to be adapted to support capital account opening.

1.2. Introduction of indices, indicators and quantitative measures

1.2.1. Financial liberalization indices

Discerning academics have voiced the importance of constructing financial liberalization index. Apart from individual measures to assess how open financial sector is, an aggregate index may provide a generalized glimpse of the financial sector liberalization.

Usually, the strand of research on liberalization index could be divided into those based on international commitments (GATS sector-specific commitment, for instance), the popular of which is Mattoo Liberalization Index (1999). The index measures the degree of financial sector openness across 3 modes of supply: cross-border supply, consumption abroad and commercial presence. Analysis of specific commitments in each mode helps to determine whether the stage is not liberalized/partially liberalized/fully liberalized.

On the other hand, another different cluster of ideas focus on the multi-faceted nature of financial liberalization. The general perspective is that financial liberalization could be measured by looking at how each component is free of restrictions. The interested components are subject to change in each study, but as a normal rule, they are often the following: *domestic financial liberalization* (interest rate control, credit and reserve requirement, entry deregulation, privatization, regulatory measures, stock market reforms) and *external liberalization* (liberalization of current account transactions, FDI, foreign portfolio investment, foreign loans and other flows in terms of capital accounts).

Liberalization indices adopting component-based measure are IMF reform index and Bandiera et al (2000) index. However, these approaches differ from each other in the way they treat partiality of liberalization by assigning different values to different phase of liberalization.

There are some liberalization indices built to quantify the level of international financial opening such as IMF and SHARE. In this research, we employ Mattoo /Adjusted Mattoo Index and a phase-wise method based on IMF approach. The theoretical background and computation of IMF financial reform index will be performed in Appendix A.

1.2.1.1. Mattoo Index

The Mattoo Financial Liberalization Index is a frequently used measure. It is introduced due to its simplicity and its focus on WTO commitments and GATS framework, which is quite standardized.

- **Methodology**

The groundwork of Mattoo's idea is Market Access limitations on each mode of supply for each financial activity. The score ranges from 0 as the lowest degree of financial liberalization (so called financial repression) to 1 as the highest degree of financial liberalization or financial liberalization (fully open market). So, the general rule is if a specific country's entry is noted 'unbound'-no commitment, the assigned score is 0 while if it is noted 'none'-full commitment, the assigned score is 1.

The question is to how to measure partial liberalization. For modes 1 (cross-border supply) and 2 (consumption abroad), Mattoo's research demonstrated "*in the case of the first two modes, restrictions often take the form of excluding certain subsectors from the scope of the commitment. It is difficult to judge the economic significance of these exclusions. Therefore, a distinction was not made and a value of 0.5 was attached in all cases of restrictions on the first two modes*" (Mattoo, 1998, Annex 1). For mode 3 (commercial presence), a more sophisticated scale is constructed to reflect different levels of partial liberalization. Firstly, the most *restrictive* measure is determined among the list of market access restrictions and then the score for this mode might be assigned according to a tailor designation.

Liberalization index mainly encompasses commitments on insurance and banking services. For the latter, two of the most crucial activities are the acceptance of deposits and lending to others. The research may focus on the finding of banking liberalization indices for deposit and credit activities only. After each activity is given a score for each mode, a modal weight is applied to calculate the aggregate index. The modal weight here is derived from Mattoo's work. The final result is:

$$\mathbf{L} = \Sigma \boldsymbol{w_i} \times \boldsymbol{r_i}$$

where i = 1, 2, 3; w_i is the modal weight

r_i is the numerical value of the most restrictive measure applied by country j to mode i.

Mattoo Index is quite simple and straightforward to employ, it is however misleading as it doesn't consider national treatment. Mattoo argued that "*most entries in the national treatment column are highly correlated with those in the market access column*" (Mattoo, 1999). Besides lacking national treatment limitations, the index considers only 2 activities of banking and insurance services.

Table 1. Restrictiveness scale by commitment types for modes 1, 2, 3

Score	Mode 1 &2	Mode 3
0	Unbound	Unbound
0.1	unbound	no new entry or unbound for new entry
0.25	unbound	discretionary licensing for new entry or economic needs testing for new entry
0.25	unbound	reciprocity condition
0.5	partial liberalization	exemption of certain sub-sectors
0.5	partial liberalization	ceiling on foreign equity at less than 50%
0.75	partial liberalization	ceiling on foreign equity at more than 50%
0.75	partial liberalization	limitation on the legal form of entry

0.75	partial liberalization	other minor limitations
1	full liberalization	full liberalization

Source: Mattoo (1999) and Prica (2010)

Table 2. Modal weights in banking and insurance

	Mode 1	*Mode 2*	*Mode 3*
Banking			
Deposits	0.12	0.03	0.85
Lending	0.2	0.05	0.75
Insurance			
Life	0.12	0.03	0.85
Nonlife	0.2	0.05	0.75

Source: Mattoo (1999)

1.2.1.2. Adjusted Mattoo Index

The adjusted Mattoo Index differs, yet retains some features: the same number of modes of supply (as in Vietnam, the 3 modes constitute the largest value of trade), the same weights (weights for other banking activities apart from these 2 mentioned above shares the same pattern with that of lending). Updated adjustments in the new approach are: all activities are considered, all limitations in regard to market access and national treatment. While Mattoo helps to work on the degree of liberalization, the adjusted one may lose sight of degree (*qualitative merit of limitation*) to cover all limitations (*quantitative*) in the measure.

1.2.1.3. Phase-wise method on IMF approach

Suggested by Abiad (2008), an aggregate financial liberalization index is constructed based on *de facto* assessment of liberalization policies in 7 different components. Bandiera et al (2000) applied a phase-wise method on a scale of 0-1 (the score could be normalized to different scale at one's own discretion). Bandiera et al (2000) summarize all the information available on the liberalization process by a single index. One way of building the overall index of financial liberalization is to use principal components methods. The idea is to associate a dummy variable to each reform measure. Its value equals one in the years characterized by the liberalized regime, and zero otherwise. They collect all the dummy variables as columns of a matrix X, and then compute the principal components of X. In their study, they use two different indices. One is just the first principal component (i.e. the vector that explains the greater portion of variance). The second one is computed as a weighted average of the more relevant components that explain, cumulatively, 95% of the total variation of X. They use the fraction of the total standard deviation explained by each component as weights, so that the first principal component is weighted more than the second and so on. The steps are summarized as follows:

Step 1: Select desirable components among 7 components (all or some).

Step 2: Assign the score based on the number of liberalization stages. For example, on a 2-phased liberalization process, the first phase scores 0.5; on a 3-phased liberalization, the second phase scores 0.66. 1 means full financial liberalization while 0 means full repression.

Step 3: Use Principal Component analysis (PCA) to calculate the aggregate index.

Shrestha and Chowdhury (2006) also use principal component methods and assign values to reflect the partiality of financial liberalization in Nepal. To capture the scenario of partial and phase-wise gradual liberalization of a particular sector, partial values like 0.33, 0.50, and 0.66 have been assigned. A value of 0.50 indicates the first phase of partial deregulation in a two-phased deregulation process, whereas a value 0.33 and 0.66 indicate the first and second phase, respectively, in a three-phased deregulation process. The two-phased process takes a value of 1 in the second phase and the three-phased case takes a value of 1 in the third phase. In other words, if a sector is fully liberalized in a single phase, the value assigned in this case is 1. But if the liberalization is completed in two phases, then 0.5 is assigned for the first phase and 1 for the second. Similarly, if the liberalization takes place in three phases, then the number assigned is 0.33 for the first phase, 0.66 for the second phase and 1 for the last phase.

1.2.2. Indicators of financial development and volatility

1.2.2.1. Financial development indicators

- **Banking sector**

(i) Broad money (% GDP): sum of (i) M1-demand deposits other than those of central government and currency outside banks, (ii) M2-time and savings deposits, foreign currency deposits, repurchase agreements, plus travelers' checks, other securities such as CDs and commercial paper. The indicator offers a sight on the financial depth of a country.

(ii) Domestic credit created by banks (% GDP) provides useful information about the level of financial development. If it develops sufficiently, funds could be transferred to the private sector and nonfinancial public sector appropriately while if financial system pertains to weakness and closure, the accessibility to funds by these sectors would suffer.

$$\frac{Private\ credit\ from\ banking\ sector}{GDP}$$

(iii) Interest rate spread (included above) is also an indicator to evaluate the competitiveness and efficiency of the financial sector. Higher interest rate spread generally indicates that there is either a lack of competition or serious inefficiency in commercial banks operations.

- **Securities market**

Because of Vietnam thin bond market and vibrant stock market, in the research, we focus indicators of the latter.

(i) The size of stock market development: Market capitalization (also known as market value) is the share price times the number of shares outstanding. It measures the size of the stock market.

$$\frac{Total\ capitalization\ from\ stock\ market}{GDP}$$

(ii) Liquidity of stock market: Indicative of the level of activity and the efficiency of stock market.

$$\frac{Transaction\ volume}{Stock\ market\ capitalization}$$

and

$$\frac{Transaction\ volume}{GDP}$$

1.2.2.2. Financial volatility indicators

According to the IMF approach, vulnerability indicators under close monitoring could be categorized as follows: ***external vulnerability indicators*** (targeting reserve adequacy and the stability of external short term debt exposure of a country) and ***financial soundness indicators*** **(**an assessment of capital adequacy, asset quality and sensitivity to market of a country's financial sector).

- **External vulnerability indicators:** Including reserve-related and debt-related vulnerability indicators

  (i) *Reserve-related vulnerability indicator*

The primacy of reserve adequacy is explained by IMF (2002) that "*reserves maintain liquidity and allow time to absorb shocks. In addition, reserves provide confidence in the authorities' commitment to the timely discharge of external obligations and to supporting the value of the domestic currency*".

In total, there are three dominant indicators. The first one measures the relation of appropriate reserves needed in tandem with the current account. The second and third indices are built in relation with the capital account, geared toward the two main sources of possible pressures, broad money and short term debt (by remaining maturity).

Indicators	**Implication**
Reserves/Imports	How much a country's reserve could support the level of imports, given limited access to capital markets
Reserves/ Broad money	How possible of a resident-based capital flight from the currency from unstable demand of money and weak banking sector
Reserves/Short term debt	How a country would be forced to adjust given a cut off from external borrowing

  (ii) *Debt-related vulnerability indicator*

IMF (2000) suggests that "*high ratio indicates a greater burden of servicing the debt…And a growing ratio, especially if the level of debt is already high, may suggest that a country is on an unsustainable path*".

Indicators	**Implication**
Debt Service/ Exports	How exports as a source of debt repayments could service the external debt
External Debt Stock/ GDP	The potential to service debt by switching resources from production of domestic goods to the production of exports

- **Financial soundness indicators**

According to IMF (2002) "*Financial soundness indicators are indicators compiled to monitor the health and soundness of financial institutions and markets, and of their corporate and household counterparts*". By examining the financial soundness indicators of Vietnam financial markets before and post liberalization, we could identify the underlying vulnerability of the system, especially to market risk and banking crisis.

(i) *Capital adequacy:* regulatory capital to risk-weighted assets
(ii) *Asset quality:* non performing loans to total loans

1.2.3. Introduction of quantitative measures

1.2.3.1. Principal component analysis

Principal component analysis (PCA) is a popular method employed to reduce the dimensionality of a set of highly correlated variables into a smaller number, fresh, uncorrelated components. The reason for using PCA is that index based on a group of different financial dimensions often yield high correlation. In fact, when one nation implements financial liberalization policy in 1 component sector, it tends to do in other sectors as well. For example, indices of stock market liberalization and capital account liberalization are highly connected.

To put as simply as possible, the technical background for PCA is that we have k correlated explanatory variables: $x_1, x_2, \dots\dots x_k$. The combination/correlation matrix of these variables might show high pairwise coefficient correlation. However, it fails to reflect the variation of the group. PCA adopts the linear transformation, finding a new space vector, through which those variables could be explained the most.

In the new space, newly found components are independent linear combinations of original data:

$$P_1 = a_{11} \times x_1 + a_{12} \times x_2 + \dots\dots\dots + a_{1k} \times x_k$$

$$P_2 = a_{21} \times x_1 + a_{22} \times x_2 + \dots\dots\dots + a_{2k} \times x_k$$

$$P_k = a_{k1} \times x_1 + a_{k2} \times x_2 + \dots\dots\dots + a_{kk} \times x_k$$

a_{ij} : coefficient to be calculated, coefficient of jth explanatory variable in the ith explanatory on the condition that: $\sum a_{ij}^2$=1 (Sum of squares of the coefficients for each component is 1). For each principal component, there is a corresponding eigenvalue, λ_k , indicative the percentage of variation that the component can explain the group variation. Often, first principal component explains the largest amount of variation in the data, ≥ 75%), hence the eigenvector of the first component is chosen.

PCA could be calculated using Eviews4. After entering the variables, click View/Principal components for results.

1.2.3.2. Granger causality test

- **Reasoning for Granger causality test**

Results obtained from regression analysis may identify the degree of dependence of one variable on a group of other variables; however, the implication doesn't equal to causation. It means that through regression, on the one hand, the increase in a dependent variable could be estimated given a unit increase in the independent variable; on the other hand we are not sure that a unit increase in the independent variable *causes* the corresponding increase in a dependent variable.

Hence, the **causal relationship** is examined by Granger causality test, promoted by Granger (1969) and Sims (1972) to check whether changes in 1 variable causes change in another or both of them are endogenously determined. The much-discussed connection between financial development and financial liberalization is the same. Often, we might assume that a country to open its domestic market to foreign participation and free capital account transactions should enjoy higher degree of development. And at the same time, some argue that financial development forces government to liberalize more. Therefore, it's interesting to decipher the causality issue here.

- **Procedure***:* consists of 3 steps, in total:

a/ ADF test: to test the stationarity of a variable

Null Hypothesis: $\delta = 0$, unit root, non stationary

Alternative Hypothesis: $\delta \neq 0$, no unit root, stationary

Decision rule: ADF test statistic> critical value, do not reject null hypothesis

ADF test statistic < critical value, reject null hypothesis

b/ Cointegration test : to check for cointegrated variables

Now that general assumption holds if regression runs on 2 non stationary time series, the estimation result may be "spurious regression." For example, the regression may indicate a relationship between two nonstationary variables where one does not exist actually.

However, as Engel and Granger (1987) pointed out that "*2 series of nonstationary same order integration, which have stationary linear combination, calls a cointegration equation*". Such cointegration equation helps to "*mitigate the spuriousness of the regression and investigating the long term relation*" of the 2 variables. To sum up in simple words, the 2 variables individually could be non stationary and then the resulting regression could be spurious. However, if there is a stationary linear combination between the 2 variables, the regression could be true again. The cointegration test to be employed is

Johansen Cointegration test, only available for non stationary time-series. The mechanism works like this:

2 hypotheses: Null hypothesis 1: None, no cointegration (most important)

Null hypothesis 2: at most 1 cointegration equation

Decision rule: Trace statistics < critical value (5% level), do not reject null hypothesis

Trace statistics > critical value (5% level), reject null hypothesis

c/ Granger causality test

As mentioned above, Granger causality test is for causality relationship. Overall, in common sense, "a time series *X* is said to *Granger-cause Y* if it can be shown on lagged values of *X* (and with lagged values of *Y* also included), that those *X* values provide statistically significant information about future values of *Y*.

The estimation equations are:

$Y_t = \alpha_0 + \sum_{i=1}^{p} \alpha_i Y_{t-i} + \sum_{j=1}^{q} \beta_j X_{t-j} + u_t$ (1)

$X_t = \alpha_0 + \sum_{i=1}^{m} \alpha_i X_{t-i} + \sum_{j=1}^{n} \beta_j Y_{t-j} + u_t$ (2)

X_{t-i}, Y_{t-i} : lagged values of X, Y, i: i^{th} lag

Equation (1) and (2) are called unrestricted regression. The objective here is to find out respectively, whether lagged values of X could explain for Y (X Granger cause Y) and lagged values of Y could explain for X (Y Granger cause X). In short, we test the null hypothesis:

H_0: $\beta_1 = \beta_2 = \beta_3 = \ldots = \beta_j = 0$

(There is no causality relationship)

Restricted regressed equations are, thus, defined as:

$Y_t = \alpha_0 + \sum_{i=1}^{p} \alpha_i Y_{t-i} + u_t$ (3)

$X_t = \alpha_0 + \sum_{i=1}^{m} \alpha_i X_{t-i} + u_t$ (4)

F-test computed as follows:

$F_c = \frac{(ESS_{(3)} - ESS_{(1)})/q}{ESS_1/(N-k)}$ N: number of observations

k: number of parameters in equation (1) and (2)

Decision rule: F_c > F-critical value under (q, N-k) degree of freedom, reject null

F_c < F-critical value under (q, N-k) degree of freedom, do not reject null

With 2 unrestricted regressions, there are 4 results:

(i) Unidirectional X *Granger-cause* Y, lagged values of X explains Y, but vice versa doesn't exist
(ii) Unidirectional Y *Granger-cause* X, lagged values of Y explains X, but vice versa doesn't exist

(iii) Bidirectional X *Granger-cause* Y and Y *Granger-cause* X , lagged values of Y explain X and lagged values of X explain Y

(iv) No causality relationship found, lagged values of Y fail to explain X and lagged values of X fail to explain Y

1.3. Introduction of GATS

1.3.1. Overview of GATS

GATS, as the full name is General Agreement on Trade and Services was negotiated during the Uruguay Round (1986-1994) and represents the "*only set of multilateral legally-enforceable rules that govern international trade in services of 149 country-members and to provide framework for multilateral negotiations"* (Prica, 2010, p.2). The structure of GATS includes: (i) general guidelines (rules and disciplines), (ii) Annexes to regulate specific sector specificities and (iii) the Schedule of Specific Commitments that show specific obligations a particular Member has undertaken in the particular service sector.

<u>a/ General information</u>

One of the most important guidelines is Most Favored Nation (MFN), however GATS encourages the participation of developing economies into the trade agreement. Therefore, it leads to the addition of a special section as the list of Article II (MFN) exemptions. This list shows the sectors in which the Member is temporarily not going to apply MFN. Many countries have made use of this exemption for a variety of financial services sector which they believe still need state protection and as financial services represent a prime sector of the economy.

The GATS negotiations in the financial services sector include 2 broad categories of services: insurance and insurance-related services, banking and other financial services. Insurance and insurance-related services cover life and non-life insurances, reinsurance, insurance intermediation such as brokerage and agency services, and services auxiliary to insurance such as consultancy and actuarial services. Banking includes all the traditional services provided by banks such as acceptance of deposits, lending of all types, and payment and money transmission services. Other financial services include trading in foreign exchange, derivatives and all kinds of securities, securities underwriting, money broking, asset management, settlement and clearing services, provision and transfer of financial information, and advisory and other auxiliary financial services.

GATS recognizes specific aspect of services and defines trade in services by way of 4 services supply modes:

-Mode 1: Cross-border supply: the services are delivered across the country border, the service provider resides abroad while the consumer remains in the home country, similar to trade in goods (when financial credit is extended or insurance policy purchased from a bank/insurance company located abroad)

-Mode 2: Consumption abroad: The consumer travels into the country in which the services are delivered b the foreign services supplier (obtaining financial services when travelling abroad)

-Mode 3: Commercial Presence: Service supplier of 1 country supplies a service in another country by establishing, through foreign investment, a commercial presence in that country (commercial presence of foreign banks or insurance companies)

-Mode 4: Presence of Natural Persons: This applies to the temporary movement of individuals (which are natural, not legal persons as is the case in the previous mode) and arises when a service is delivered in a foreign market; these individuals may be independent service providers (such as consultants) or foreign employees of a service-supply company.

Among the 4 modes of supply, mode 3 (commercial presence) represents more than half of value of total service traded while the share for mode 1 (cross-border supply) and mode 2 (consumption abroad) is quite modest, respectively, 30% and 15% of the total value of service trade. It is due to this reason that mode 3 also records highest number of commitments. The frequent entry for mode 2 and mode 4 is none, which means that this economy makes no commitment and when/to which extent the opening of services would be implemented at the country's own discretion.

b/Financial Liberalization under GATS

So by opening trade in financial services, GATS promotes financial liberalization. It could be understood that GATS represents an international binding for signors to commit to open their domestic markets to foreign participation Refers to the 7 different components of financial liberalization: commitments under GATS could directly be related to "*entry deregulation*". The removal of entry barriers to foreign investors could lead to other domestic financial reforms.

GATS in financial services provides a multilateral framework which (i) fair competition as MFN allows the most efficient suppliers to gain market share; (ii) allows concessions in one area to be traded against liberalization in other areas in partner markets; (iii) offers a neutral forum for dispute settlement and enforcement; (iv) guarantees market access by binding liberalization; and (v) provides for an systematic process to negotiate further liberalizations.

From an economic perspective, trade in financial services, like trade in other goods or services, can have strong positive effects on income and growth for both participants of the trade. The level of foreign trade in services liberalization could be measured against Market Access Limitations (MA) and National Treatment (NT) Limitations.

Article XVI, GATS, MA limitations refer to all measures which restrict the access of foreign trade of services in domestic markets, except for those on: (i) the number of foreign suppliers, (ii) total quantity of services supplied, (iii) total value of services traded, (iv) total number of natural persons working in a particular service sector, (v) specific applicable business types of legal entity in order to provide services, (vi) the cap rate on foreign ownership/ equity contribution, on both individual and collective basis. Article XXVIII, GATS, NT limitations refer to all measures which restrict the equal treatment of foreign trade of services in domestic markets, except for those on: (i) discriminatory taxes,

(ii) discriminatory incentives/subsidies, (iii) government procurement policies, (iv) local content requirements, (5) nationality, citizenship or resident requirements.

According to Sorsa (1997), (referenced in Qian (2003), pp.3) "*in most countries the actual level of liberalization of financial sectors differed from that undertaken in the GATS framework. There has been little correlation between GATS commitments and the level of financial sector development or actual openness, especially in the developing country Members*".

The degree of financial liberalization commitments under GATS also differs. There are 3 levels to commit: (i) commit at the current level, (ii) commit more than the current level, and (iii) commit below than the current level. Some developed economies have chosen the (iii) like Korea and Singapore due to cautious reasons. For example, in case of foreboding crisis, a reversal in liberalization is necessary for government control, the approach (iii) may be used. Those countries could withdraw their commitments. On the hand, some economies with less sophisticated financial system made liberal openings, made more commitments than their current level of foreign participation. The reason is that some countries, especially developing ones wish to use these commitments as a collaboration effort to implement domestic financial reforms.

1.3.2. Vietnam's commitments of financial liberalization under GATS

As other developing countries, Vietnam is characterized by the weakness of its financial sector in financial sector due to long period of state subsidization. The policy of financial repression had seriously undermined the efficiency of financial sector. Since the 1990, Vietnam started to lift interest rate ceilings, gradually privatized state-owned corporate and financial sector, boost cross-border trade, made liberal opening of capital market to domestic and foreign investor. The process of international integration of Vietnam is subject to mainly WTO accession and BTA (Bilateral Trade Agreements) with the US.

1.3.2.1. GATS framework

WTO accession- Vietnam commitments related to banking and other financial services. WTO accession covers <u>4 modes of supply</u> and <u>2 major restrictions</u>: National Treatment and Market Access. After negotiations, level of commitment is either '*unbound*' or '*none*'. Unbound means Vietnam doesn't have any commitment yet, which means how and when to liberalize and the degree of liberalization is up to domestic market conditions and economic needs.

On the other hand, none means Vietnam has entered commitments with WTO members and has to adhere what it has committed. The opening of domestic financial market to foreign participation should reach at least the commitment level and the scheduled timeline. Besides, the process of liberalization of one sector denoted as 'none' implies that Vietnam also has to comply with general rules and disciplines specified of GATS.

1.3.2.2. Banking sector liberalization commitments

Appendix B summarizes Vietnam commitments in the banking sector. There are 5 key features to be covered:

a/ List of banking and other financial services

Liberalization commitments are restricted to 11 activities. Activities not listed mean Vietnam could regulate its opening at free will.

b/ Market access limitations

-During 5 years (from 2007-2011), limitations on foreign bank branch's rights of accepting deposit in VND from Vietnamese natural persons with no credit relationship.

The deposit should be restricted to a ration of branch's paid-in capital as follows:

1 Jan 2007: 650% of legal paid-in capital

1 Jan 2008: 8000% of legal paid-in capital

1 Jan 2009: 900% of legal paid-in capital

1 Jan 2010: 1000% of legal paid-in capital

1 Jan 2011: Full national treatment

-Foreign branches of commercial bank not allowed to open other transaction points outside its branch offices.

- Equity participation:

State owned Commercial Banks: national treatment

Joint Stock commercial Banks: participation by foreign and individuals <30% of the banks' chartered capital

c/ National Treatment limitations

-For a commercial bank branch: the parent bank with total asset > 20 billion USD

-For a joint venture or a 100% foreign-owned bank: the parent with total asset> 10 billion USD

d/ Period business practice

Vietnam doesn't have any commitment yet, which means 'unbound'. So it gives Vietnam freedom to regulate the time to which foreign credit institutions could sustain their financial business in Vietnam's territory. Pursuant to current stipulation in Vietnam, the maximum period for foreign banking services are as follows:

Joint venture bank and 100% foreign owned bank: not exceeding 99 years

Branches: not exceeding business years of the parent bank and not exceeding 99 years

Representative office: not exceeding business years of the parent bank

Joint venture finance company, 100% foreign invested finance company, joint venture financial leasing company, 100% foreign invested financial leasing company: not exceeding 50 years

e/ Applicable prudential measures

Given the nature and the importance of financial sector to the whole economic system, it is allowable for member countries to adopt prudential measures in order to stabilize macroeconomic scenario in face of large influx of foreign participation. The prudential norms could be legal forms, capital restrictions, limitation on equity participation, etc.

Other applicable prudential regulations that Vietnam could adopt to partially protect its weak and transition financial sector are reserve requirements exerted on foreign commercial banks (branches, joint venture and 100% foreign owned banks), capital requirements as well as technical prerequisites, human resources. Those prudential measures are introduced and conducted in practice on MFN basis (most favored nation treatment).

1.3.2.3. Securities sector liberalization commitments

Appendix C summarizes Vietnam commitments in the securities sector. There are 3 key features to be covered:

<u>a/ List of securities services</u>

Foreign securities suppliers could provide to Vietnam domestic investors and in Vietnam domestic securities market the same with banking activities except for 5 first activities.

<u>b/ Market Access Limitations</u>

Branches of foreign securities companies are allowed to operate as from 11/1/2012, however, confined to asset management, settlement and clearing services for financial assets, provision and transfer of financial information, advisory, intermediation and other auxiliary financial services.

<u>c/ National Treatment Limitations</u>

No specified limitations as Vietnam entry in the column is noted 'None'.

1.3.2.4. Other commitments

The liberal opening of financial services sector to foreign penetration inevitably leads to the surge of foreign capital movement. Vietnam commitments of financial liberalization under GATS are in compliance with Article 8 of the Regulations of IMF. The general moves are summed up below:

Current account transactions: On June 1, 2005, Vietnam <u>removes </u>restrictions on current account transactions, in compliance with Article 8 of the Regulation of the IMF.

Capital account transactions: Vietnam has gradually <u>lifted</u> restrictions on capital account transactions of foreign investors and foreign borrowing (Ordinance No.28/2005/PL-UBTVQH11 on foreign exchange control).

1.4. Brief introduction to financial liberalization under ASEAN

In the process of globalization and international economic integration, financial liberalization is an indispensable trend and brings more benefits to each country, especially developing countries as ones in ASEAN.

Thanks to financial liberalization, many developing countries have attracted a huge amount of capital investment and received a modern technology platform from industrialized countries to expand production and promote export. Moreover, financial service liberalization facilitates the establishment of a more effective macroeconomic policy in accordance with the conditions of an open economy; on this basis, implement effectively resource distribution, maximally domestic and global economy advantages.

However, increased capital inflows also make it difficult for the authorities to maintain stable currency value and prevent a possible escape of investment flows. Financial liberalization can increase the likelihood of financial crisis if the liberalization process was carried out impatiently, in a wrong order or lack of a synchronism in macro management measures at both the national and international levels

Some financial crisis after the financial liberalization in some nations has made ASEAN countries to be more cautious in their financial liberalization process.

Since 1990, with the expansion of ASEAN, the tendency of economic integration in ASEAN is more strengthened. Besides, the birth of multilateral organizations and forums such as ASEAN + 3, ASEAN Regional Forum (ARF), Asia-Europe Meeting (ASEM), many countries realized the need for a roadmap an integration plan in commerce, investment… areas.

At the 7th ASEAN Finance Ministers Meeting in August 2003, Ministers approved the Roadmap for Integration of ASEAN in Finance (RIA-Fin) which included 4 main contents: (i) Capital Market Development, (ii) Financial Service Liberalization, (iii) Capital Account Liberalization, and (iv) Monetary Integration in ASEAN. Based on these foundations, 3 groups responsible for capital market development, capital account liberalization, and financial service liberalization and the group responsible for exchange rate mechanism were built. ASEAN nations continue to implement and perfect their FL process.

1.4.1. Capital market development

The target is to build capacity and set up a long-term basis for ASEAN capital market development, with long-term goal is to gain cross-border cooperation among different capital markets in ASEAN. The group responsible for capital market development was built whose main role is to supervise and speed up activities and report to the Finance Ministers and Vice-Ministers Meeting.

Important achievements are to enhance market approach, enhance integration and liquidity through innovations such as integrating bond market, promoting the comparison of credit ratings among domestic and foreign credit ratings agencies.

1.4.2. Financial service liberalization

Negotiation rounds on financial liberalization in ASEAN have been carried out on the basis of AFAS, with the goal of completely liberalizing service flows among ASEAN countries by 2020. The activities of the Working Group aimed at the financial service liberalization in accordance with the principles and objectives of the AEC Blueprint, harmonizing objectives of the AEC Blueprint for the RIA-Fin, and facilitating to have financial services negotiations between ASEAN and its partners.

1.4.3. Capital account liberalization

The goal of capital account liberalization is to spare favorable conditions and further liberalize capital flows stated in AEC by 2015. According to the roadmap, capital account liberalization must ensure an orderly liberalization suitable to plans of each nation.

1.4.4. Monetary integration in ASEAN

To achieve a closer monetary cooperation through promoting intra-regional trade and further integrating economy and financial sector in 2020, ASEAN countries agreed to set up a group responsible for the exchange rate mechanism.

1.5. Introduction to financial liberalization under TPP

1.5.1. General information about TPP

The 2005 Trans-Pacific Strategic Economic Partnership Agreement is a free trade agreement that aims to further liberalize the economies of the Asia-Pacific region. In 2007, negotiations began for the Trans-Pacific Partnership (TPP), a significantly expanded version of the agreement, encompassing a larger group of countries. The TPP is a proposed free trade agreement whose members currently include Australia, Brunei Darussalam, Chile, Canada, Malaysia, New Zealand, Peru, Singapore, Vietnam, Mexico, and the United States. Japan has expressed its desire to become a negotiating partner, and South Korea has been officially invited to join the negotiations. The TPP is intended to be a “high-standard” agreement specifically aimed at emerging trade issues in the 21st century. These ongoing negotiations have drawn criticism and protest from the public, advocacy groups, and elected officials, in part due to the secrecy of the negotiations, the expansive scope of the agreement, and a number of controversial clauses in drafts leaked to the public.

- **History**

The TPP was previously known as the Pacific Three Closer Economic Partnership (P3-CEP), its negotiations launched on the sidelines of the 2002 APEC Leaders' Meeting in Los Cabos, Mexico, by Prime Ministers Helen Clark of New Zealand, Goh Chok Tong of Singapore and Chilean President Ricardo Lagos. Brunei first took part as a full negotiating party in the fifth round of talks in April 2005, after which the trade bloc became known as the Pacific-4 (P4). Although all original and negotiating parties are members of the Asia-Pacific Economic Cooperation (APEC), the TPP is not an APEC initiative. However, it is considered to be a pathfinder for the proposed Free Trade Area of the Asia Pacific (FTAAP), an APEC initiative.

The original agreement was signed by Brunei, Chile, New Zealand and Singapore on June 3, 2005, and entered into force on May 28, 2006. It is a comprehensive free trade agreement, affecting trade in goods, rules of origin, trade remedies, sanitary and phytosanitary measures, technical barriers to trade, trade in services, intellectual property, government procurement and competition policy. Among other things, it called for reduction by 90 percent of all tariffs between member countries by January 1, 2006, and reduction of all trade tariffs to zero by the year 2015.

Several more countries – Australia, Malaysia, Peru, Japan, United States, Vietnam, Canada, and Mexico – are now negotiating to join the group.

On the last day of the 2010 APEC summit, leaders of the nine negotiating countries endorsed the proposal advanced by United States President Barack Obama that set a target for settlement of negotiations by the next APEC summit in November 2011. However, negotiations have continued well into 2012.

- **Membership and accession**

The negotiations initially included three countries (Chile, New Zealand and Singapore), and Brunei subsequently joined the agreement. The original TPP agreement contains an accession clause and affirms the members' "commitment to encourage the accession to this Agreement by other economies."

In January 2008 the United States agreed to enter into talks with the P4 members regarding liberalization of trade in financial services. Then, on September 22, 2008, U.S. Trade Representative Susan C. Schwab announced that the United States would begin negotiations with the P4 countries to join the TPP, with the first round of talks scheduled for early 2009.

In November 2008, Australia, Vietnam, and Peru announced that they would be joining the P4 trade bloc. In October 2010, Malaysia announced that it had also joined the TPP negotiations.

On June 18, 2012, the Office of the United States Trade Representative (USTR) announced that Mexico had been invited to join the negotiations, pending completion of Mexico's domestic procedures. Mexico's interest in joining was initially met with concern among TPP negotiators about its customs policies.

On June 19, 2012 Canada announced that it had joined the TPP negotiations. Two years earlier, Canada became an observer in the TPP talks, and expressed interest in officially joining, but was not committed to join, purportedly because the United States and New Zealand blocked it due to concerns over Canadian agricultural policy - specifically dairy - and intellectual property rights protection. Several pro-business and internationalist Canadian media outlets raised concerns about this as a missed opportunity. In a feature in the *Financial Post*, former Canadian trade negotiator Peter Clark claimed that the Harper Government had been strategically outmaneuvered by the Obama Administration, Wendy Dobson and Diana Kuzmanovic for The School of Public Policy, University of Calgary, argued for the economic necessity of the TPP to Canada.*Embassy* warned that Canada's position in APEC could be compromised by being excluded from both the US-oriented TPP and the proposed China-oriented ASEAN +3 trade agreement (or the broader Comprehensive Economic Partnership for East Asia).

1.5.2. Brief introduction to financial liberation under TPP

Legal texts related to financial liberation

The legal texts will cover all aspects of commercial relations among the TPP countries. The following are the issues under negotiation and a summary of progress.

Competition

The competition text will promote a competitive business environment, protect consumers, and ensure a level playing field for TPP companies. Negotiators have made significant progress on the text, which includes commitments on the establishment and maintenance of competition laws and authorities, procedural fairness in competition law enforcement, transparency, consumer protection, private rights of action and technical cooperation.

Cross-Border Services

TPP countries have agreed on most of the core elements of the cross-border services text. This consensus provides the basis for securing fair, open, and transparent markets for services trade, including services supplied electronically and by small- and medium-sized enterprises, while preserving the right of governments to regulate in the public interest.

E-Commerce

The e-commerce text will enhance the viability of the digital economy by ensuring that impediments to both consumer and businesses embracing this medium of trade are addressed. Negotiators have made encouraging progress, including on provisions addressing customs duties in the digital environment, authentication of electronic transactions, and consumer protection. Additional proposals on information flows and treatment of digital products are under discussion.

Financial Services

The text related to investment in financial institutions and cross-border trade in financial services will improve transparency, non-discrimination, fair treatment of new financial services, and investment protections and an effective dispute settlement remedy for those protections. These commitments will create market-opening opportunities, benefit businesses and consumers of financial products, and at the same time protect the right of financial regulators to take action to ensure the integrity and stability of financial markets, including in the event of a financial crisis.

Investment

The investment text will provide substantive legal protections for investors and investments of each TPP country in the other TPP countries, including ongoing negotiations on provisions to ensure non-discrimination, a minimum standard of treatment, rules on expropriation, and prohibitions on specified performance requirements that distort trade and investment. The investment text will include provisions for expeditious, fair, and transparent investor-State dispute settlement subject to appropriate safeguards, with discussions continuing on scope and coverage. The investment text will protect the rights of the TPP countries to regulate in the public interest.

Market Access for Goods

The TPP countries have agreed to establish principles and obligations related to trade in goods for all TPP countries that ensure that the market access that they provide to each other is ambitious, balanced, and transparent. The text on trade in goods addresses tariff elimination among the partners, including significant commitments beyond the partners' current WTO obligations, as well as elimination of non-tariff measures that can serve as trade barriers. The TPP partners are considering proposals related to import and export licensing and remanufactured goods. Additional provisions related to agricultural export competition and food security also are under discussion.

Rules of Origin

TPP countries have agreed to seek a common set of rules of origin to determine whether a product originates in the TPP region. They also have agreed that TPP rules of origin will be objective, transparent and predictable and are discussing approaches regarding the ability to cumulate or use materials from within the free trade area in order to make a claim that a product is originating. In addition, the TPP countries are discussing the proposals for a system for verification of preference claims that is simple, efficient and effective.

Textiles and Apparel

In addition to market access on textiles and apparel, the TPP countries also are discussing a series of related disciplines, such as customs cooperation and enforcement procedures, rules of origin and a special safeguard.

Trade Remedies

TPP countries have agreed to affirm their WTO rights and obligations and are considering new proposals, including obligations that would build upon these existing rights and obligations in the areas of transparency and procedural due process. Proposals also have been put forward relating to a transitional regional safeguard mechanism.

Tariff Schedules and Other Market-Opening Packages

The TPP tariff schedule will cover all goods, representing some 11,000 tariff lines. The nine countries also are developing common TPP rules of origin, and are weighing proposals now for how to do this most effectively and simply.

Services and investment packages will cover all service sectors. To ensure the high-standard outcome the nine countries are seeking, the TPP countries are negotiating on a "negative list" basis, which presumes comprehensive coverage but allows countries to negotiate specific exceptions to commitments in specific service sectors.

Government procurement packages are being negotiated with each country seeking to broaden coverage to ensure the maximum access to each others' government procurement markets, while recognizing each others' sensitivities.

CHAPTER 2. FACTS OF VIETNAM FINANCIAL LIBERALIZATION UNDER GATS AND IMPACTS ON FINANCIAL DEVELOPMENT AND VOLATILITY

2.1. Background on Vietnamese financial market

Vietnam is characterized as an emerging economy, experiencing significant transition from a poor country with centrally-planned, heavy subsidy, hyperinflation and other social issues to a middle income country. From 2007 to 2011, Vietnamese GDP annual growth rate has always maintained from 5% to more than 8%; the figure was even slightly higher for the previous years (2003-2006), on average at 7.9% per annum; GDP per capita reported in 2011 was approximately US $1400. Total volume of exports and imports in 2011 has reached US $96.3 billion and US $105.8 billion respectively, signifying 33.3% and 24.7% growth rate.

Nevertheless, the swift emerging prosperity has revealed new structural problems. Typically, emerging nations could experience fast growth rate from financial openings; however, given major government influence and stagnant progress in reforming state-owned sector, Vietnam is thus vulnerable to domestic imbalances or external shocks. In fact, inflation rate has been constantly high from 2007 to 2011, showing sign of escalation, from 8.4% to nearly 18.7% in late 2011. In addition, there has been consistent deficit in current account balance and volatility in foreign investment flows.

One of the features that stand out is the rapid development of financial market. Up to 2010, net domestic credit reportedly reached above VND 2,500 trillion and total deposit was VND 2,450 trillion. Broad money has expanded on average at 30% annually and entry for foreign investors has been substantially eased. Generally, banking sector has gone through marked transformation, from merely 3 banks with the monopolistic influence to a more sophisticated system with both domestic and foreign participation. Securities market also witnesses unprecedentedly vast development. Since 2000, the securities market has grown to nearly 600 listed companies and over US $ 20 billion in market capitalization value.

2.1.1. Vietnamese banking sector

a/ Regulatory framework

Banking sector activities in Vietnam undergoes the regulation of State Bank of Vietnam. Today, SBV is more of a monitoring body with little direct involvement in market business. The major legal stipulation is Law on Credit Institutions (2010), Law on State Bank of Vietnam (2010), Ordinance of Foreign Exchange (2005).

b/ Market structure

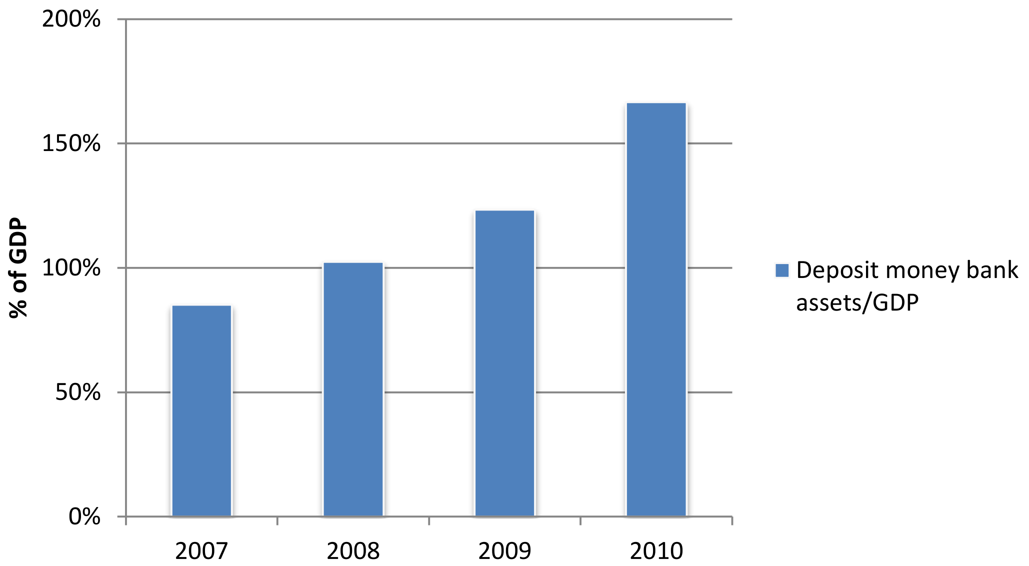
According to SBV statistics 2011, Vietnam currently banking sector consists of: (i) 5 state owned banks, (ii) 35 Joint stock commercial banks, (iii) 5 100% foreign owned banks, (iv) 50 foreign bank branches, (v) 4 joint venture banks, (vi) bank representative offices, finance companies and financial leasing companies.

c/ Performance

In general, the development in banking sector is significant. The range of banking services has been continually enlarged and diversified, ATM growth at 17.4% and credit/debit card growth at 46.1% in 2010. Besides, for 2 main activities, the growth rate of deposit and credit during the period 2007-2010 has been almost above 20%. Total bank assets in the system more than doubled between 2007 and 2010, from VND 1,097 trillion (US $52.4 billion equivalent) to VND 2,690 trillion dong (US $128.7 billion equivalent), assuming larger part relative to the economy (see figure 2.1 below).

Concerning the pattern of banking sector, while more funds are now drawn to JSCBs, SOCB banks still account for the largest share of credit market. For example, in 2010, SOCB accounts for 51.36% of total lending while JCBS slightly outshone with a share of 48.21% of total capital mobilization. Foreign bank presence in Vietnam accounts for smallest part. Frequently, the group has assumed a modest share of 10-11% in both mobilization and lending market. Interbank market has also grown strongly, interbank transactions stood at VND 1,498 billion and US $114,036 million in 2010.

Figure 4. Deposit money bank assets/GDP, 2007-2010



Source: SBV annual reports, IMF WEO

The performance the whole sector is demonstrated by some indicators below. The general trend is more expansion in activities (more loans offered relative to total assets and total deposits, in 2010, 130.7% of deposits transmitted to lending), yet more volatility in profitability indicators (ROA, ROE, NIM).

Table 3. Performance indicators of Vietnamese banking sector, 2007-2010

	NIM	ROA	ROE	Loan/Deposit	Loan/Asset
2007	2.31%	1.735%	16.67%	97.03%	75.70%
2008	1.94%	1.972%	19.49%	99.86%	76.65%
2009	1.61%	2.259%	22.66%	120.88%	76.64%
2010	2.70%	1.90%	16.60%	130.68%	75.65%

Source: BMI Commercial Banking Report 2011, IMF WEO

2.1.2. Vietnamese securities market

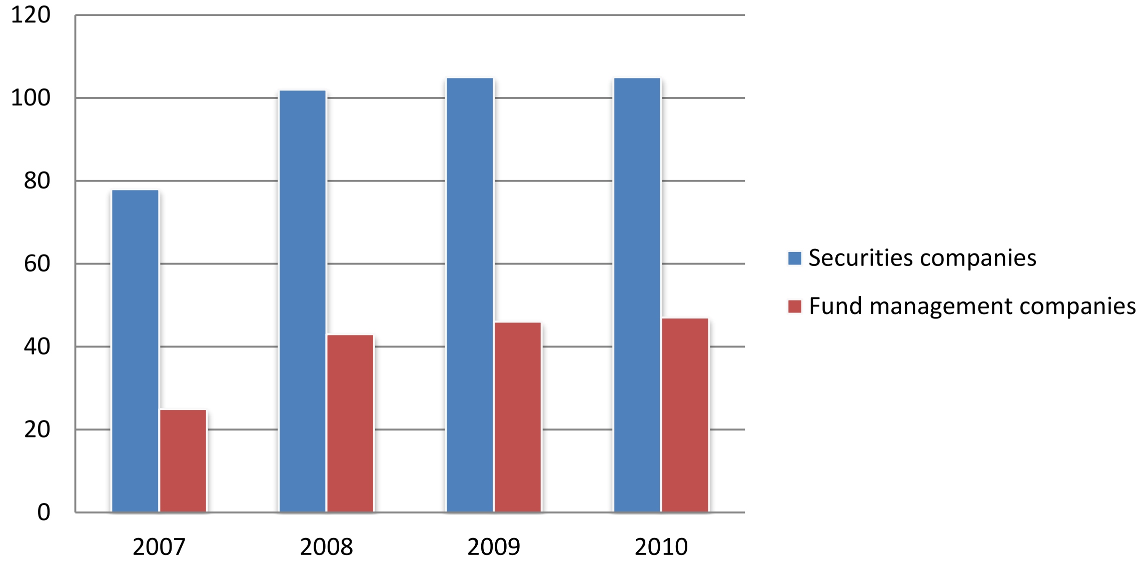
a/ Regulatory framework

The Vietnamese securities market was first launched on July 28th 2000. The State Securities Commission (SSC), established in November 1996, is the primary supervisory body over the capital markets and their participants. The key component of the legal framework on the securities market in Vietnam is Securities Law and other legal documents (in total 37 up to 2010).

b/ Market Structure

The securities market is positioned at organized exchange system, namely HOSE and HNX. The composition, by and large, comprises 105 securities, of which there are 105 securities laws and 47 fund management companies.

Figure 5. Securities market, number by types, 2007-2010



Source: Mutrap Report (2002), pp.11

c/ Performance

Due to promising prospect and strong *bull* tendency prevalent in the whole market, domestic entrants joined in bulk, giving a sharp rise in the number of new securities companies. The number of trading accounts has risen steeply to more than 1 million by late 2010. Market capitalization reached US $20 billion and accounted for 20% of GDP.

In terms of the quality of market innovation, addition and increasing diversification of products is encouraged besides key brokerage and proprietary trading business. Easing conditions on margin lending, T+4 to T+2 regime, and multiple trading accounts for investors, derivative products are also advocated. Foreign participation is evident in Vietnam securities market with foreign investors amounting for a large share of trading volume and playing a major role in orienting the market.

2.2. Status of implementing financial liberalization commitments

2.2.1. Banking sector

GATS commitments of opening Vietnamese banking sector primarily deal with 4 key areas: (i) the scope of financial activities, (ii) the legal structure that foreign banks could establish upon tapping into Vietnamese market, (iii) the licensing requirement for presence of foreign banks with regard to paid-in capital of parent banks and (iv) the extent of foreign equity participation in securitization of domestic banks.

Hence, the analysis of Vietnam implementation of commitments in this research will be examined on first, <u>the improvement in legal platform</u> based on the above 4 key areas and second, <u>application in practice</u>.

2.2.1.1. Vietnam's implementation in legal respect

Upon the accession of Vietnam to WTO, there has always been an urgent need in upgrading the legal system to cover and make effect the latest liberalization commitments. One of the main role of SBV is to review the current legislation concerning credit and banking activities and compare these with WTO commitments in order to amend and supplement the current system with appropriate legislation. The objective here is to build a system of Vietnamese banking laws and regulations in line with international commitments.

Up to 2006, the overarching legal documents in banking sector was Law on the State Bank of Vietnam No.01/1997/QH10 and Law on Credit Institutions No.02/1997/QH10. Those legal documents proved to be obsolete in regulating the open and dynamic banking sector in the presence of GATS commitments and increasing foreign participation. As a result in 2010, National Assembly ratified 2 new versions: Law on Credit Institutions No.47/2010/QH12 and Law on the State Bank of Vietnam No.46/2010/QH12. Besides the 2 key legal documents, a number of policies have been promulgated in preparation for Vietnam's liberal opening of financial sector.

<u>a/ Legislation on the range of activities</u>

Overall, the range of banking activities offered to foreign credit institutions is practically the same as their domestic competitors, except for market limitations on accepting deposits in VND in the initial 5 years of opening. Appendix D summarizes the key legal framework related to each subsector of activities.

In conclusion, Vietnamese legal framework for each banking activities in accordance with WTO has been insufficient and should be subject to further review. Although several commitments are upheld by governments in WTO accession documents, impediments or gaps in current legal framework prevail. Thus, many banking activities, money broking for instance, are not fully employed. Therefore, there should be a more comprehensive and consistent legal foundation for each activity and related issues.

b/ Legislation on the licensing criterion and applicable legal structure

According to WTO scheduled accession, foreign banks are entitled to conduct business in Vietnam in the form of branch, joint venture and 100% foreign owned bank. In 2006, the ratification of Decree No.26/2006/NĐ-CP officially enforced the establishment of foreign entry in domestic banking sector. Article 8, specifies the licensing criterion and procedures including the paid-capital requirement for parent bank in establishing branches (20 billion USD) and in establishing joint venture and commercial entities with 100% foreign capital contribution (10 billion USD), which practically fits the WTO commitments. Circular No.40/2011/TT-NH specifies the participation of foreign capital contribution (less than 50% of foreign capital contribution in case of Joint venture and more than 50% in case of 100% foreign owned bank).

Regarding foreign finance companies, the key legal amendment in conformity with WTO commitments is the promulgation of Decree No.81/2008/NĐ-CP, article 8 specifying 10 billion USD as the required charter capital for parent company to conduct business in Vietnam. For foreign financial leasing companies, Decree 95/2008/NĐ-CP amended article 8, Decree No.16/2001/NĐ-CP related to the licensing criterion for foreign suppliers (from 5 million USD to 10 billion USD).

c/ Legislation on foreign equity participation in domestic banks

Decree No.69/2007/NĐ-CP on foreign investors buying stocks of Vietnam trade banks, Article 4 delivers the same restriction that foreign equity participation in domestic banks to be less than 30% of the charter capital of those banks. National treatment in state-owned commercial banks is specified clearly in Section 6, Article 4. In a nutshell, current legislation requires foreign credit institutions to have at least US $20 billion asset to apply for the purchase of shares of domestic commercial banks.

2.2.1.2. Vietnam's implementation in practice

Up to date, Vietnam has generally committed to the *status quo.* Key implementation steps are follows:

(i) Licensing more financially sufficient foreign credit institutions
(ii) Allow the installation of ATM outside branch offices
(iii) Relax deposit restrictions based on committed schedule
(iv) Curtail impediments on credit growth for credit institutions

Permit the foreign purchase of shares in domestic banks

Relevant reforms of domestic banks

a/ Growing foreign bank presence (i-v)

Foreign presence has experienced recent boom after Vietnam's accession to WTO as a result of numerous relaxation of restrictions. Regardless of the early existence in domestic market, foreign credit institutions prior to WTO were, overall, restricted to engaging in limited range of banking activities, conventionally wholesale banking and foreign customers for foreign exchange needs or trade finance.

Licensing

In 2008, SBV decided to issue business license to the 2 first 100% foreign owned banks in Vietnam, HSBC and Standard Chartered Bank. The licensing criterion is also subject to change as WTO commitments prohibit economic needs test upon granting entry to foreign credit institutions. Prior to WTO, Vietnam's licensing for credit institutions is often based on economic needs, instead of prudential criterion like current practice.

Size and operation network

The key trend is the increasing foreign participation. The figure has constantly picked up from 41 to 53 banks in 2010. In 2011, Shinhan bank bought original joint venture Shinhanvina, making the number of joint venture banks down to 4 in late 2011.

Figure 6. Banking sector, number by types, 2007-2010

Source: SBV annual reports

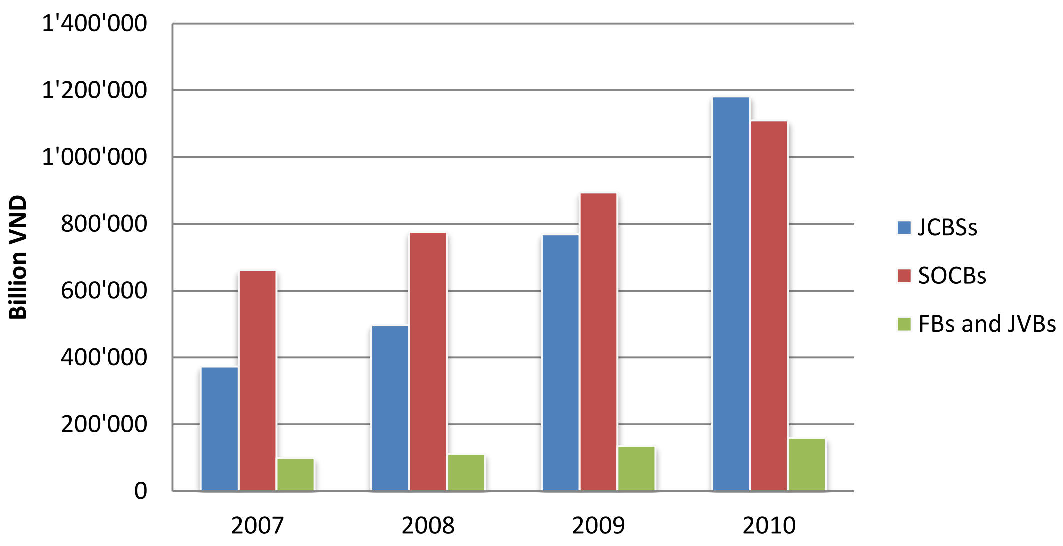
In regard to operation network, although foreign banks receive national treatment in installing ATM and issuing credit card, the group still lags far behind their domestic counterparts. HSBC and ANZ take the lead with respectively 146 and 102 ATMs up to 2011; the others only have 3-4 at most.

Market share, deposit growth and lending

Despite the robust growth in the number of foreign banks that establish commercial presence in Vietnam, in terms of total banks assets share, foreign banks still account for around a modest 12% of the total market share. The year 2011 marked the liberal opening for foreign banks to join in a level playing field with domestic banks.

Nonetheless, since the operation network of foreign banks is limited in scope, there is small likelihood for any substantial change in the deposit structure. However, the overall trend in number of deposits is upward from 2007 to 2010, amount of deposit nearly doubled, though still modest compared to JSCBs and SOCBs.

Figure 7. Deposit growth, by types, 2007-2010

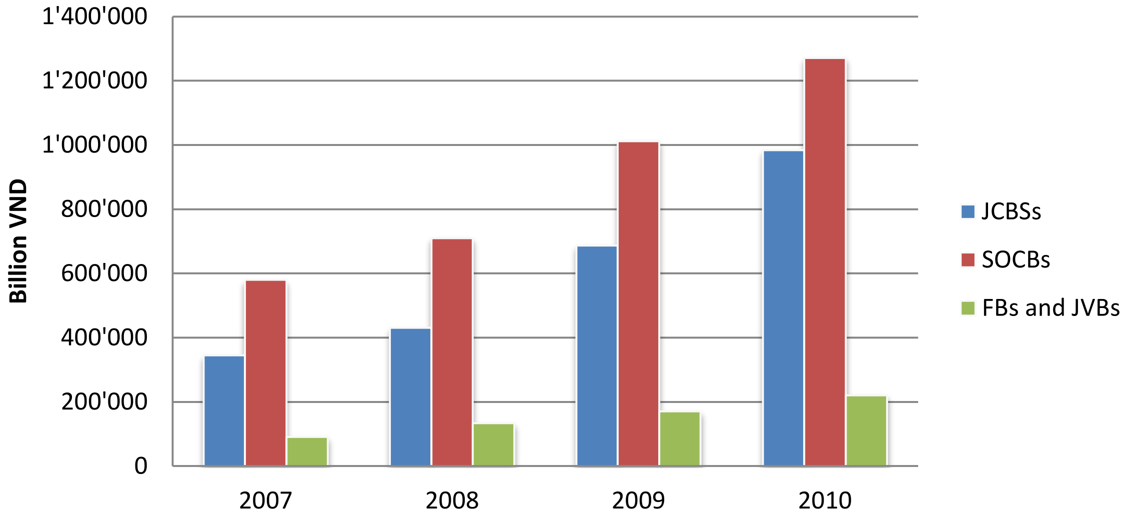


Source: SBV annual reports

With regard to credit growth, from the figures below, although foreign bank group has witnessed a slow credit growth rate, the general movement is still positive year by year. Earlier in 2012, despite the change from a much-criticized "*one-size-fits-all*", policy to a more varied one on the basis of bank performance, the foreign group is, however, "*liable to expand credit tantamount to charter capital*".

This is viewed as a credit imposition of restrictions on credit growth of the foreign bank group, especially 100% foreign owned bank as they are considered to be a part of the whole system.

Figure 8. Credit growth, by types, 2007-2010



Source: SBV annual reports

As current market share of foreign bank is small (figure 2.5 above shows that although credit growth for FBs and JBs roughly doubled, the absolute value of increase was only VND100 billion) and the common association with good risk management, they should then be allowed to grow at more than 10 times the charter capital. It is reasonable to assign a higher index to truly promote level-playing platform.

Purchase shares of domestic commercial banks:

Foreign credit institutions are entitled to purchase collectively 30% and individually not more than 15% of charter capital. Since then foreign banks constantly increased its stake in joint stock commercial banks and the cap ratio has been revised up to 20%.

In conclusion, regarding foreign banks' entry and business in Vietnam, Vietnam has complied with its commitments, relatively imposed same deposit and lending rules on domestic and foreign credit institutions.

Table 4. Foreign banks' stake in JSCBs, 2010

JSCBs	Foreign banks	Stake
ACB	Standard Chartered	11.47%
Sacombank	ANZ	9.78%
Eximbank	Sumitomo Mitsui	15%
Techcombank	HSBC	20%
VIBank	Common Health	20%
Habubank	Deutsche Bank	10%

Source: Quach Thuy Linh (2011), p. 6

b/ Domestic banking sector reform (vi)

The increase in foreign presence and WTO commitment directly forces the domestic banking sector to change, accelerates the process of domestic financial liberalization.

Regulatory measures

Legal framework for SBV to implement regulatory and supervising measures is Decision 83/2009/QĐ-TTg on rights and obligations of bank regulatory commission at SBV. Besides, SBV has issued legal documents specifying prudential ratios to manage credit risk (Decision 18/2007/QĐ-NHNN), liquidity risk, operation risk, interest rate risk (Decision 437/2006/QĐ-NHNN) and oblige credit institutions to adhere to.

Change in bank ownership

Vietnam's accession to WTO leads to the need of privatizing big and dominant SOCBs. Indeed, major state engagement into such banks possibly creates an unfair treatment in credit market as well as adherence to capital adequacy requirement. Most conspicuously, Vietinbank has involved in selling 10% of its shares to IFC and the other anticipated business deal is between Vietcombank and Mizuho, which converts 15% of bank capital structure to foreign ownership. BIDV is going to securitize in 2012.

Table 5. Privatization of State-owned banks

Unit: VND billion

Bank	State's stake	Legal background	Issuance Date	Charter capital
Vietcombank	90.72%	Decision 1289/QĐ-TTg	26/12/2007	19,698
Vietinbank	80.31%	Decision 1354/QĐ-TTg	25/12/2008	20,230
BIDV	95.76%	Decision 2124/QĐ-TTg	Quarter I 2012	12,947
Agribank	100%	Decision 214/QĐ-NHNN	-	20,708

Source: Banks' annual reports 2011, 2010, 2009

2.2.2. Securities sector

2.2.2.1. Vietnam's implementation in legal respect

The key legal framework for the securities market operation and in anticipation of WTO requirements is The Securities Law No.70/2006/QH11 and the Amending and Supplementing Securities Law No.62/2010/QH12. Besides, a total number of more than 40 effective legal documents are ratified, specifying in detail market regulations, for example Decree No. 14/2007/NĐ-CP and the Amending and Supplementing Decree No.84/2010/NĐ-CP.

a/Legislation on foreign participation

Within the first 5 years from the date of accession, the applicable legal forms for foreign securities service suppliers to establish commercial presence are representative offices and joint venture with foreign participation capped at less than 49%. Decision No.124/2008/QĐ-BTC provides the legal background as well as specifies the licensing procedures for foreign participation in the form of representative offices. With regard to joint venture efforts between foreign and Vietnamese companies, Decision No.55/2009/QĐ-TTg, article 3 allows for the equity contribution and restricts to 49%, which is appropriate with WTO commitments.

However, in anticipation of the entry of branches and 100% foreign owned securities service suppliers in 2012, it's essential to promulgate an implementation document on the organization and commercial operation of these types of business forms as current legal framework lacks detailed regulations, focusing mainly on domestic securities firms.

Regarding foreign investors' participation in securities market, Decision 121/2008/QĐ-BTC, article 2 specifies the scope of foreign investors (100% foreign invested organization and investment funds) and chapter II denotes applicable investment activities in Vietnamese securities market (purchase/sale of shares or equity participation). The quota on investment space of foreign investors is stipulated on Article 2, Decision No.55/2009/QĐ-TTg (at maximum 49% for listed companies and 30% for non listed companies in specific sectors). Foreign ownership of bond issuance is as specifically imposed.

b/ Legislation on the range of activities

The key legal framework is the Securities Law 2007, article 60, section 1,3 and Article 61, section 1,3 (amended by Securities Law 2010) regulates the legal scope of activities: (i) brokerage services, (ii) proprietary trading, (iii) underwriting and placement of issues as an agent, (iv) advisory and other auxiliary financial services (supplements to fund management companies since 2011), (iv) asset management/ portfolio management (supplements to securities firms since 2011). Besides, Decision 27/2007/QĐ-BTC on the establishment and operation of securities firms and Decision No.35/2007/QĐ-BTC (amended and supplemented by Decision No. 2529/2007/QĐ-BTC) on the establishment and operation of fund management companies, add more details to the applicable range of activities. In principle, the scope of securities business specified under current Vietnamese legal system is in accordance with WTO commitments and specific regulations and guidelines for the activities could be referred to Appendix D.

c/ Legislation on regulatory bodies and prudential measures

As stated in Section 2.1, State Securities Commission (SSC) bears the highest responsibility for monitoring the securities market. So a large number of legal documents are issued in order to provide SSC with adequate powers as well as effective assistance. Decision No.112/2009/TT-TTg specifies the organization, responsibilities and authorities of SSC and Decision 127/2008/QĐ-BTC specifies the securities market surveillance. In addition, authority power of SSC is also reflected by Circular No.37/2011/TT-BTC on administrative penalties.

In order to guarantee the transparency and prudential issue required by GATS general principles and guidelines, legislation on the regulation of Vietnamese securities market is issued and constantly revised. For example, Circular No.74/2011/TT-BTC shows regulation on securities transaction, Circular No.38/2011/TT-BTC on fee charging (fixed rate imposed by government), Circular No.226/2010/TT-BTC on financial prudential ratios, and Circular No.09/2010/TT-BTC on disclosure of information.

In conclusion, the legal groundwork for Vietnamese securities markets has been rather developing. Legislation on different aspects such as licensing, supervision, settlement and clearing services procedures has been issued in tight compliant with WTO commitments. However, the prime concern here is the entry of 100% foreign invested securities firms the rights and scope of which are not clarified enough yet.

2.2.2.2. Vietnam's implementation in practice

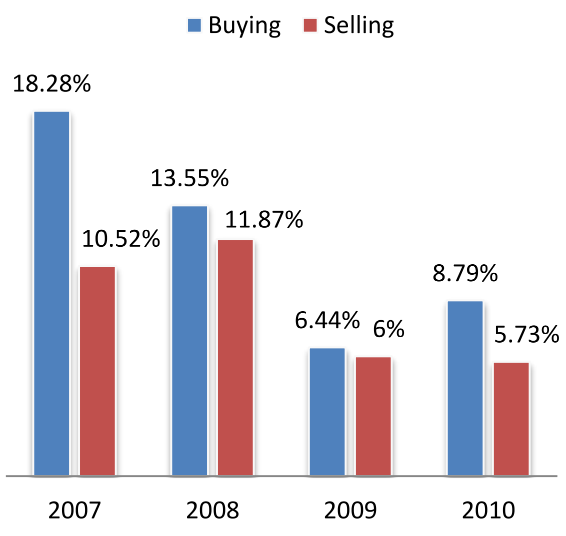
a/ Growing foreign presence

Since 2006, the commercial presence of foreign securities firms and investment funds has been evident due to the *bullish* movement of the market. Foreign participation is mostly in the form of joint venture fund management companies/securities firms and representative offices; offshore securities investment funds.

WTO commitments of Vietnam in securities sector allow for foreign invested joint venture and representative offices since 2007. As a result, a number of foreign securities companies as well as foreign management fund companies have been licensed to do business in Vietnam. Regarding the former, instances are Kim Eng Holdings Limited (Singapore) in KESV, Golden Bridge (Korea) in Click & Phone Securities company (now renamed as Golden Bridge Vietnam) or Woori Investment Securities (Korea) in Bien Viet Securities company (in short Woori CBV).

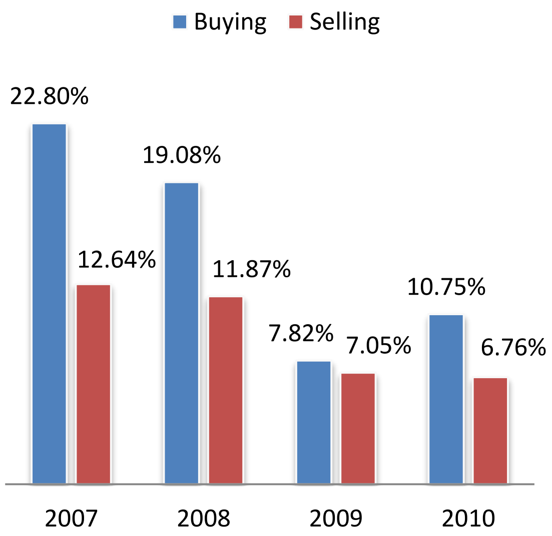
Total transaction volume and value of stock traded on HOSE of foreign investors have fluctuated between 10% and 20%, peak during the boom of securities market in 2007 and bottom out during the downturn of the market in 2009. Furthermore, another trend emerges as net foreign buying overshadowed net foreign selling most of the time.

Figure 9. Foreign share of volume of trading, 2007-2010



Source: SSC-HOSE trading data

Figure 10. Foreign share of value of trading, 2007-2010



Source: SSC-HOSE trading data

b/ State supervision

Overall, SSC has fulfilled its responsibilities in monitoring the securities market. Licensing procedures have been made in compliance with legislation and on an ongoing basis. Capital adequacy position of market intermediaries is monitored by the SSC semi-annually, based on audited financial statement submitted by securities firms. Up to date, the SSC has employed a compliance framework, the groundwork of which is hinged on the merit regulation approach and there is now debate around the risk-based measures.

2.3. Impacts of financial liberalization on financial development and volatility

2.3.1. Measuring financial liberalization

2.3.1.1. Mattoo Index

Using Mattoo Index introduced in Chapter I, accompanied by Vietnam commitments to WTO, we could compute Mattoo Index for banking sector.

Step 1*: Decide the level of restrictiveness for mode 1 and 2, banking sector in Vietnam*

Mode 1, Vietnam has made no commitment to provide free market access, both unbound for acceptance of deposits and lending. So a score of 0 is assigned for each. Mode 2, Vietnam has committed to impose no restrictions of market access on all activities. So a score of 1 is assigned for each.

Step 2*: Decide the most restrictive MA limitation for mode 3, banking sector in Vietnam*

Mode 3, Vietnam's entry is 'none', except for the legal form and cap on total foreign equity participation less than 50% in joint venture banks and less than 30% in a domestic bank. So a score of 0.5-partial liberalization is assigned for each.

Step 3*: Apply the corresponding modal weights to calculate the liberalization index of 2 activities of banking sector*

The result for Vietnam is indicated as follows. For both 2 vital parts of banking sector, the liberalization index represents level of partial financial liberalization (around 0.5).

Banking liberalization index in Vietnam	
Deposit	**0.455**
Lending	**0.425**

Compared to the regional and global liberalization indices for banking, Vietnam figures are relatively higher than that of Asia but lower than the international average. For Asia region, the openness of banking sector is indexed at 0.29 and 0.3 (1998) indicating a repressed Asian banking in 1998 compared to global level at 0.66 and 0.61 (Mattoo, 1999). The concluding remark is Vietnam has made a medium level of liberalization commitments under GAT framework.

2.3.1.2. Adjusted Mattoo Index

Step 1: Calculate number of limitations on national treatment and market access on the supply of each banking service through each mode

For deposits, mode 1, entry noted unbound results in a score of 0; mode 2, entry noted none results in a score of 1. Mode 3, deposits in the form of partial liberalization with 4 limitations on market access (only 3 since 2011) and 1 limitation on national treatment. To be specific, here is the detailed restriction classification for acceptance of deposits:

National treatment	**Market access**
Capital requirement	Legal form
	Number of transaction offices
	Equity participation
	Limit on acceptance of deposits (until 2011)

The same process is applied for the 10 remaining banking activities. Except for provision/ transfer of financial information and auxiliary services, the other are restricted, with 3 market limitations and 1 national treatment limitation.

Step 2: Calculate the corresponding liberalization indices for each activity in banking

For dealing with partial liberalization, “each member’s specific commitments entered according to an arithmetic formula referred to as a continuous function, C^n” (WTO (2005), pp.35). C is set at 0.5 and n is the number of limitations. The underlying rationale for formula is (i) each limitation should be considered as they lead to additional burden, (ii) the marginal effect is not proportionally accumulated but decreasing in a non-linear way.

$$>>> \boldsymbol{L_{(activity)}} = \boldsymbol{w_1} \times \frac{\mathbf{0.5^{n1}+0.5^{n2}}}{\mathbf{2}} + \boldsymbol{w_2} \times \frac{\mathbf{0.5^{n1}+0.5^{n2}}}{\mathbf{2}} + \boldsymbol{w_3} \times \frac{\mathbf{0.5^{n1}+0.5^{n2}}}{\mathbf{2}}$$

$$= \boldsymbol{w_1} \times \mathbf{0} + \boldsymbol{w_2} \times \mathbf{1} + \boldsymbol{w_3} \times \frac{\mathbf{0.5^{n1}+0.5^{n2}}}{\mathbf{2}}$$

w_i: respective weight for each mode of supply; $n_{1/2}$: number of MA or NT restrictions

Based on this liberalization index for banking, line of service-deposits:

2007-2011: $L_{(deposits)}=w_1\times 0 + w_2\times 1 + w_3 \times \frac{0.5^4 + 0.5^1}{2} = 0.269$

2011 onwards: $L_{(deposits)}=w_1\times 0 + w_2\times 1 + w_3 \times \frac{0.5^3 + 0.5^1}{2} = 0.296$

The weighted average indices for each activity through each mode for Vietnam are as below (the corresponding weight distribution is 0.2-0.05-0.75):

	Score		**Mode 3/ No of restrictions**		**WA Index**
	Mode 1	**Mode 2**	**MA**	**NT**	
Lending of all types	0	1	3	1	0.284375
Financial leasing	0	1	3	1	0.284375
Payment and transmission services	0	1	3	1	0.284375
guarantees and commitments	0	1	3	1	0.284375
Trading	0	1	3	1	0.284375
Money broking	0	1	3	1	0.284375
Settlement and clearing services	0	1	3	1	0.284375
Asset management	0	1	3	1	0.284375
Financial information services	1	1	3	1	0.484375
Auxiliary financial services	1	1	3	1	0.484375

Banking liberalization index = $\frac{\sum WA\ Index\ for\ each\ activtity}{11}$ ≈ **0.32** for both periods

Noticeably, after considering the national treatment limitation and the full number of market access restrictions rather than the most restrictive measure, banking liberalization index for Vietnam has significantly plummeted from around 0.4 to only 0.32. This means that domestic banking sector has not been liberalized enough. Bear in mind that the de jure indicator based on WTO commitments provides part of liberalization picture in Vietnam (de facto situation) since prudential requirements and regulatory measures play their role too.

2.3.2. Impacts of financial liberalization on financial development

2.3.2.1. Descriptive analysis

Firstly, descriptive analysis is used in the research in order to provide a comparative evaluation. To be specific, measures of the development indicators of Vietnam banking sector and securities market from 2007 to 2010 would be put in comparison with those prior years, from 2003 to 2006, to see how financial market has evolved due to financial liberalization (*Before-after analysis*).

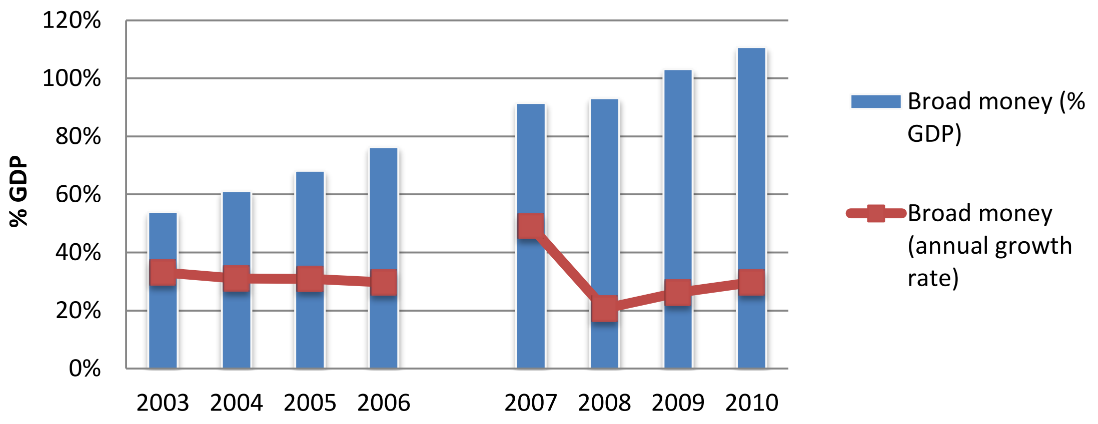
<u>a/ Banking sector development indicators</u>

We use in total 3 banking sector development indicators, of which major focus is on measuring the size and credit allocation of Vietnam banking system.

Broad money (% GDP)

It is clear from the chart that, there is a jumpstart growth in the percentage of broad money relative to GDP after commitments under GATS were brought into practice in 2007. It presents a visible trend towards more depth in financial system. However, the growth rate slows down from 2008, as a result of global financial crisis.

Figure 11. Growth of broad money, 2003-2010

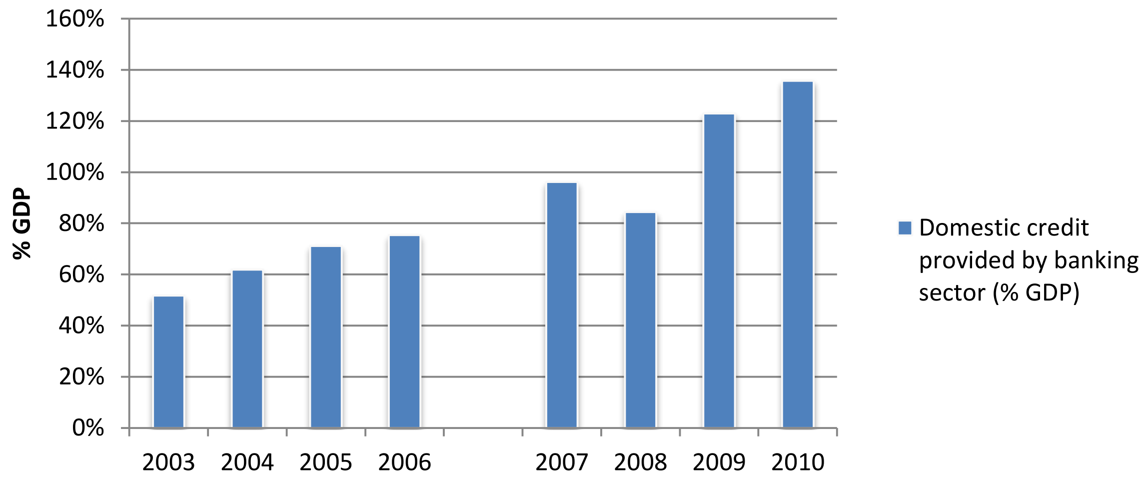


Source: World Bank financial indicators

Domestic credit provided by banking sector (% of GDP)

Similarly, credit allocation has been significantly improved during both period as domestic credit offered through the organized banking system relative the size of the economy is increasing. Especially, the growth in credit has been more robust (for 2007 and 2009) compared to pre liberalization period.

Figure 12. Domestic credit provided by banking sector (% GDP), 2003-2010



Source: World Bank Financial Indicators

Interest rate spread (lending rate minus deposit rate)

It seems like although the size and credit allocation have benefited tremendously from financial liberalization, bank efficiency takes time to improve. It is shown that interest rate spread hasn't narrowed gap after 2007. Foreign bank assets don't receive full national treatment in accepting deposits and their commercial presence in early stage focuses on serving foreign corporations and nonresidents.

b/ Securities market development indicators

WTO commitments in 2007 also imply the opening of securities market, however the liberalization in this sector is limited compared to banking sector. We use 3 indicators for the size and liquidity of the market.

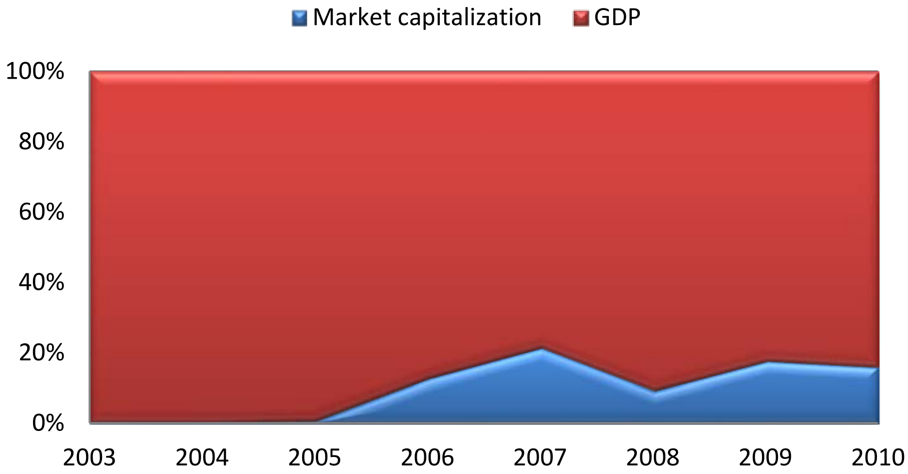
Stock market turnover ratio

Overall, observation shows that the stock market turnover fluctuated wildly during the period, which means efficiency hasn't improved yet. It could be explained that (i) external factor like financial crisis and (ii) inherently weak market and poor management susceptible to reversals of capital flows.

Market capitalization of listed companies (% of GDP)

From the figure, we could easily imply that after liberalization commitments, the size of the stock market grew most between 2006 and 2007 and shrank in 2008 as worries over inflation prevailed (which makes government to tighten monetary and credit policy). However, the most significant feature is that size of stock market is still accounting for modest part of GDP.

Figure 13. Size of stock market, 2003-2010



Source: World Bank Financial Indicators

Stock market total value traded (% GDP)

Stock market liquidity stood at nearly zero (few transactions) between 2004 and 2006. The liquidity situation has soared up as in 2007, as transaction volume was about US $13 billion and a jump in the number of securities companies. Though there is a sudden lump in the next year, liquidity improved (to 30% of GDP) before falling again. Overall, Vietnam stock market is not really liquid as total transaction volume accounts for only less than 30%, even after liberalization.

In conclusion, as Vietnam at current stage is more bank-based market, more commitments are now made in the banking system so the indicators show marked signs of improvement in credit allocation and financial depth (the same is not true for efficiency) while comparison of Vietnam stock market before and after fail to indicate positive impacts of financial liberalization on financial development. On the contrary, the demonstration of volatility is more evident as the stock market indicators do not yield consistent movement in the 4-year period study. Furthermore, some believe that reliance on descriptive before and after analysis is not enough.

2.3.2.2. Impacts of financial liberalization on financial development-Causation test

The general belief is financial liberalization could lead to higher level of financial development. In the research, Granger causal test is chosen to test whether openness and deregulation in domestic financial system of Vietnam could result in better financial performance. The causal link is examined on the 2 variables, for a period from 1993-2010, with one representing the level financial development and the other capturing how liberal the internal financial sector is:

(i) Financial development index (Broad money (%GDP), Private credit provided by banking sector (% GDP), market capitalization (%GDP))
(ii) Financial liberalization index

The method used to calculate aggregate index is principal component analysis.

a/ Financial development variable

Financial system acts in the conventional literature as an intermediary of funds between the surplus to the deficit. Hence, the development and efficiency of the whole financial system could be comfortably implied from the (a) size and depth (reflected partially through broad money), (b) the capability to provide funds to various economic sectors. The main ways of channeling funds are through organized banking system and the securities market.

Step 1: *Compute the natural log values of 3 variables*

Below is the summation table for 1993-2000 value and lnvalue of (a) and (b). The general underlying trend is quite evident that all 3 variables are rising fast in a short time. The 2 chronological economic benchmarks, *the signing of USBTA in 2000* and *the accession to WTO in 2007*, witness the corresponding high jump in the indicator in the post-event period, except for the one for second bridge of funds to private sector (the securities market- market capitalization of listed companies % of GDP).

Since securities market in Vietnam is in its incipient form, indicator is officially available from 2003 onwards. Overall, the figures have been quite modest and inconsistent, which means the funding ability of securities market in Vietnam has not evolved then and private sector hasn't used equity and bond instruments as an efficient way to raise fund for their business.

Table 6. Financial development variables, 1993-2010

	M2	LM2	CRE	LCRE	MAR	LMAR
1993	16.17%	-1.82	15.70%	-1.85	n/a	n/a
1994	15.77%	-1.85	22.50%	-1.49	n/a	n/a
1995	16.51%	-1.80	20.10%	-1.60	n/a	n/a
1996	20.20%	-1.60	20.10%	-1.60	n/a	n/a
1997	20.90%	-1.57	21.20%	-1.55	n/a	n/a
1998	21.90%	-1.52	22.00%	-1.51	n/a	n/a
1999	29.10%	-1.23	28.90%	-1.24	n/a	n/a
2000	38.80%	-0.95	35.10%	-1.05	n/a	n/a
2001	46.50%	-0.77	39.70%	-0.92	n/a	n/a
2002	49.90%	-0.70	44.80%	-0.80	n/a	n/a
2003	54.00%	-0.62	51.80%	-0.66	0.40%	-5.52
2004	61.10%	-0.49	61.90%	-0.48	0.50%	-5.30
2005	68.20%	-0.38	71.20%	-0.34	0.90%	-4.71
2006	76.40%	-0.27	75.40%	-0.28	14.90%	-1.90
2007	91.60%	-0.09	96.20%	-0.04	27.50%	-1.29
2008	93.20%	-0.07	84.50%	-0.17	10.50%	-2.25
2009	103.20%	0.03	123.00%	0.21	21.80%	-1.52
2010	110.80%	0.10	135.80%	0.31	19.20%	-1.65

Source: Author's calculation from World Bank & ADB

Step 2: PCA analysis to compute aggregate Financial Development Index

Next, since 3 variables are visibly highly correlated, so we use PCA to derive the weight for each variable. Below are the 3 components, ordered due to decreasing variation explained (eigenvalues λ) and the respective eigenvectors. Since the first component could explain more than 93%, we choose to weight the variables using the respective coefficient of eigenvector 1(0.577-0.563 – 0.589). The result will be shown in Table 9.

Included observations: 8 after adjusting endpoints

Correlation of LCRE LMAR LM2

	Comp 1	Comp 2	Comp 3
Eigenvalue	2.811611	0.167699	0.020690
Variance Prop.	0.937204	0.055900	0.006897
Cumulative Prop.	0.937204	0.993103	1.000000

Eigenvectors:

Variable	Vector 1	Vector 2	Vector 3
LCRE	0.577001	-0.583945	0.571033
LMAR	0.563886	0.790604	0.238702
LM2	0.590849	-0.184266	-0.785457

b/Financial liberalization variable

In the previous section, we use WTO commitments to compute Mattoo index from 2007 to 2010. All indicates that Vietnam is in the middle of financial liberalization (partial liberalization). In this section, domestic financial liberalization index will be measured by *phase wise method* and encompass components which affects most private credit through banking system, and market capitalization value.

Those 5 financial component covered are: interest rate liberalization, credit controls, removal of entry barriers, privatization of state owned banking sector, securities market reforms and the period covered is from 1993 to 2010.

Step 1: *Assign score for each component based on de jure policies*

Table 7 shows the compilation of liberalization policies. As the desirable focus of the research is to measure the liberalization impacts of GATS commitments (since early 2006), the phase wise method would give more weights to this period 2006-2010. Table 2.5 (b) shows the assigned score for each component.

Step 2: *PCA analysis to compute aggregate Financial Development Index*

Similarly, the 5 components show high correlation, so PCA is employed. Principal component is applied as 85% of the variation in the 5 components is explained. We weight the score of each component using the respective coefficient of eigenvector 1 (0.459-0.432 – 0.4396-0.442-0.4618).

The result is shown below, after Table 7, 8, and 9 show the aggregate indices using PCA.

Table 7. Liberalization policies for each component, 1993-2010

Components	Liberalization policies
Interest rate controls	• 1993-1995: Minimum deposit rate and maximum lending rate • 1996-1999: Imposed spread and cap lending rates, after 1997, spread abolished • 2000 onwards: introduction of basic interest rate and ceilings as a percentage of basic interest rate. Interest as agreed (since 2002) • 2010 onwards: no ceilings on lending rates
Credit controls	• 1995 onwards: compulsory directed credit abolished • 2001 onwards: reserve requirement <10% (2008) • 2007-2010: credit controls on specific, non production sectors
Entry barriers	• 1997: Law on CI ratified, discretionary license for foreign bank entry • 2006-2010: the entry of foreign banks, limitations on MA eased gradually to achieve national treatment, Law on CI 2010
Privatization	• 2004-2010: Vietcombank and Vietinbank privatized, in anticipation of WTO, 2009: public assets fell below 50%
Securities market reforms	• 1997-1999: foreign participation allowed, under imposed cap (20%) • 2000-2010: exchange market formed, 2007: foreign ownership up to 30-49% of shares, 2010: 49% for both listed and non listed

Table 8. Assigned score for each component, 1993-2010

	1993	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Interest rate	0.5	0.5	0.5	0.75	0.75	1	1	1.5	1.5
Credit controls	0.25	0.25	1	1	1	1	1	1	1.5
Entry barriers	0.25	0.25	0.25	0.25	0.5	0.5	0.5	0.5	0.5
Privatization	0	0	0	0	0	0	0	0	0
Securities market	0	0	0	0	0.25	0.25	0.5	1	1

	2002	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Interest rate	2	2	2	2	2	2	2	2	2.5
Credit controls	1.5	1.5	1.5	1.5	1.5	2.5	2	2.5	2.25
Entry barriers	0.5	0.5	0.5	0.5	2	2.25	2.5	2.75	3
Privatization	0	0	1	1	1	2	2	3	3
Securities market	1	1	1	1	1	1.5	1.5	1.5	1.75

Source: Author's compilation and calculation from various sources

The result of PCA of the correlation matrix of 5 liberalization policies is below:

Included observations: 18

Correlation of CC IR EB PRI SM

	Comp 1	Comp 2	Comp 3	Comp 4	Comp 5
Eigenvalue	4.280639	0.494939	0.121330	0.067914	0.035177
Variance Prop.	0.856128	0.098988	0.024266	0.013583	0.007035
Cumulative Prop.	0.856128	0.955116	0.979382	0.992965	1.000000

Eigenvectors:

Variable	Vector 1	Vector 2	Vector 3	Vector 4	Vector 5
CC	0.459263	0.080515	0.877383	0.042383	-0.104867
IR	0.431961	0.592820	-0.337452	-0.197142	-0.556089
EB	0.439562	-0.524813	-0.246521	0.622146	-0.288997
PRI	0.442683	-0.498895	-0.133610	-0.717975	0.147633
SM	0.461849	0.343157	-0.194165	0.238296	0.757927

Table 9. Aggregate FDEI and FLI (PCA method)

	1993	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
FDEI	-4.46	-4.48	-4.44	-4.43	-4.25	-4.21	-3.99	-3.80	-3.67
FLI	0.44	0.44	0.79	0.89	1.12	1.23	1.34	1.79	2.02
	2002	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
FDEI	-3.60	-3.86	-3.56	-3.08	-1.40	-0.80	-1.41	-0.72	-0.69
FLI	2.23	2.23	2.68	2.68	3.34	4.58	4.46	5.24	5.57

Source: Author's calculation

The ultimate result of the test is that we have the FDEI and FLI. It is visible that there is a strong relationship between the 2 variables and it must be positive. In fact, correlation coefficient is 0.965.

c/ Financial liberalization and financial development-Granger causality test

The Granger causality test is implemented using the following 3 steps. 2 variables are calculated above. The software employed is Eviews4.

Step 1: *Unit root test*

To employ unit root test for each time-series variable, or in other words, to examine whether the time-series is non-stationary or not, ADF test is used and we use p=1, lagged first difference, ΔY_{t-1} So we have:

$\Delta Y_t = \alpha + \beta T + \delta Y_{t-1} + \gamma \Delta Y_{t-1} + \epsilon_t$ ΔY_t: first difference (Y_t-Y_{t-1})

T: trend ϵ_t: error term

The results of FDEI and FLI are respectively below:

ADF Test Statistic	**-1.933050**	1% Critical Value*	-4.6712
		5% Critical Value	-3.7347
		10% Critical Value	-3.3086

*MacKinnon critical values for rejection of hypothesis of a unit root.

ADF Test Statistic	**-0.465674**	1% Critical Value*	-4.6712
		5% Critical Value	-3.7347
		10% Critical Value	-3.3086

*MacKinnon critical values for rejection of hypothesis of a unit root.

ADF test statistic (FDEI: -1.933 and FLI: -0.4656) > ADF critical value at 1%, 5%, 10% significance level, so do not reject null hypothesis. FLI and FDEI are non stationary.

Step 2: *Cointegration test*

So after, we have indentified 2 time series data as nonstationary, the next step is to explore the cointegration test between these 2 variables to make sure that there is actually a long run relation between FLI and FDEI (no spurious regression).

Sample(adjusted): 1995 2010

Included observations: 16 after adjusting endpoints

Trend assumption: Linear deterministic trend

Series: FDEI FLI

Lags interval (in first differences): 1 to 1

Unrestricted Cointegration Rank Test

Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	5 Percent Critical Value	1 Percent Critical Value
None **	0.714650	26.29743	15.41	20.04
At most 1 *	0.322640	6.232827	3.76	6.65

*(**) denotes rejection of the hypothesis at the 5%(1%) level

Trace test indicates 2 cointegrating equation(s) at the 5% level

Trace test indicates 1 cointegrating equation(s) at the 1% level

For the first null hypothesis, trace statistics (26.29743) > Critical value at 5%, 1% level, reject the null hypothesis, cointegration exists. For the second null hypothesis, trace statistics (6.23) < Critical value at 1% level, do not reject the null hypothesis, there is at most 1 cointegration equation.

Step 3: *Granger causality test*

The implication is that regression on FLI and FDEI works and Granger causality test is applicable. Given the methodology, using Eviews 4, the result is below:

Pairwise Granger Causality Tests

Sample: 1993 2010

Lags: 2

Null Hypothesis:	Obs	F-Statistic	Probability
FLI does not Granger Cause FDEI	16	11.7856	0.00184
FDEI does not Granger Cause FLI		24.5494	8.8E-05

-For the first null hypothesis, FLI doesn't *Granger cause* FDEI, F-statistic is 11.79 and low p-value at 0.00184 means that we rejectH_0. It indicates, in Vietnam, financial development results in more or less financial liberalization.

-For the second null hypothesis, FLI doesn't *Granger cause* FDEI, F-statistic is 24.5494 and a very low p-value means that we reject H_0 . Hence, domestic financial liberalization in Vietnam leads to higher level of financial development.

In conclusion, there is *a bidirectional relationship* between X and Y, which means financial liberalization policies lead to financial development and at a certain level of financial development, liberalization policies are encouraged. This makes sense, after integrating, especially in preparation for WTO since 2006, the economy has to adhere to GATS commitments and enjoy some financial achievements. Such financial development (depth of financial market, or provision of private credit) forces the nation to liberalize more. Since F-statistics are significant for both 2 hypothesis, it could be assumed that there is a quite strong bidirectional relationship between financial liberalization and financial development in Vietnam.

2.3.3. Impacts of financial liberalization on financial volatility

On the one hand, economic literature and empirical evidence have managed to prove the positive impacts of financial liberalization on financial growth; on the other hand, criticism of financial liberalization underscores the threat of volatility. Financial volatility focuses on external vulnerability (reserve and short term base) and financial soundness. In general, we rely on IMF approach to vulnerability and use before-after analysis, comparing 2 periods to detect the negative impacts on financial stability.

2.3.3.1. External vulnerability indicators

The 2 most central components are reserve adequacy and external debt sustainability. Based on these 2 components, reserve-related and debt-related vulnerability indicators are constructed to measure a country's vulnerability to its open position.

<u>a/ Reserve-related vulnerability indicators</u>

Reserves/ Imports

Overall, foreign exchange in Vietnam has been able to sustain, on average, 2 to 4 months of imports of goods and services. The period between 2005- 2007 experiences a rise to 4 months, indicating the country is less vulnerable to current account deficit. However, the figure fell since then to only 2 months, foreign exchange reserves haven't risen proportionally to level off imports, making the country more vulnerable in terms of current account liberalization.

Reserves/Broad money

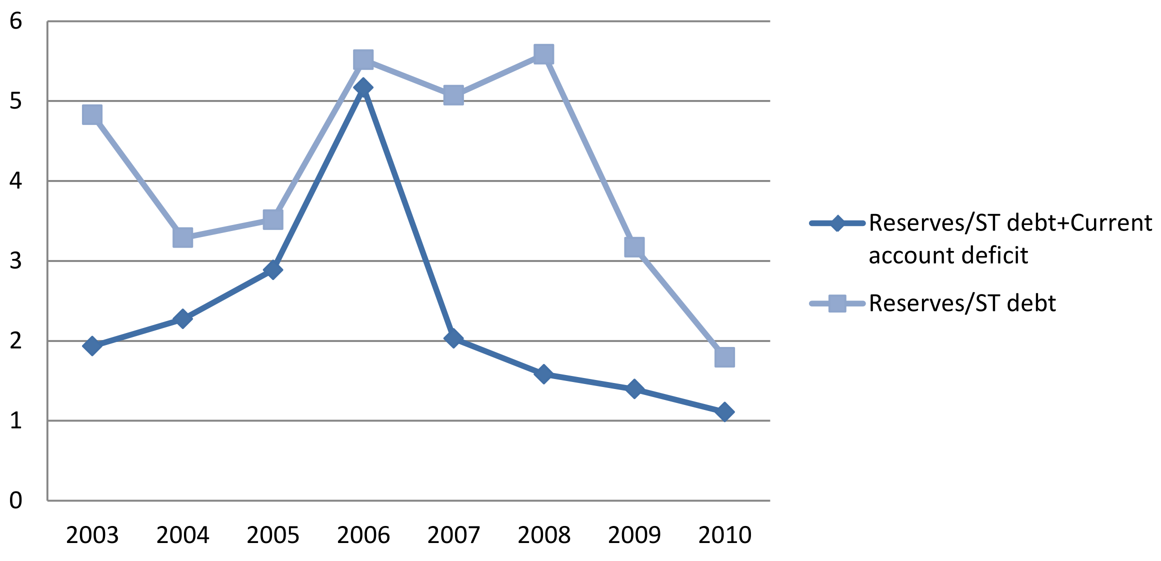
The same pattern is recorded here, Reserves/Broad money of Vietnam was best in 2007(30%) and since then declined to a lower than the pre-liberalization level. It implies that to a smaller extent of liquid domestic liabilities of the financial system (only 9%) are backed by foreign exchange reserves. Hence, from 2007, Vietnam financial market is more volatile to an unstable money demand and high likelihood of bank run.

Reserves/ Short term Debt

The indicator is pretty germane to Vietnam case as pointed out by IMF, such ratio works for country with significant yet uncertain access to capital markets. Again, 2010 experienced the trough in the indicator, after improvement in pre-crisis period, meaning Vietnam financial system is more and more volatile. Another pressure is added for the *financial stress test*, which is current account balance. The renewed ratio is: $\frac{\boldsymbol{Total\ reserves}}{\boldsymbol{Short\ term\ debt+current\ account\ deficit}}$ helps to see in case of current account deficit (Vietnam usually experiences this), the real volatility of the system to a negative withdrawal of capital flows.

The figure above gauges the original and renewed indicator with the same trend. However, it is clear to see that with long-time deficit in current account, the status of vulnerability to heavy external financing for Vietnam is more severe.

Figure 14. Reserves to short term debt, 2003-2010



Source: Author’s calculation from World Bank Financial Indicators

In conclusion, from 3 reserve-based ratios, we conclude that Vietnam doesn’t meet its reserve adequacy and for this reason, when opening its domestic market to foreign capital flows, the country financial situation will become more vulnerable.

b/ Debt-related vulnerability indicators

In total, there are 2 indicators and in each case total outstanding external debt at the end is scaled by the relevant flow over that period.

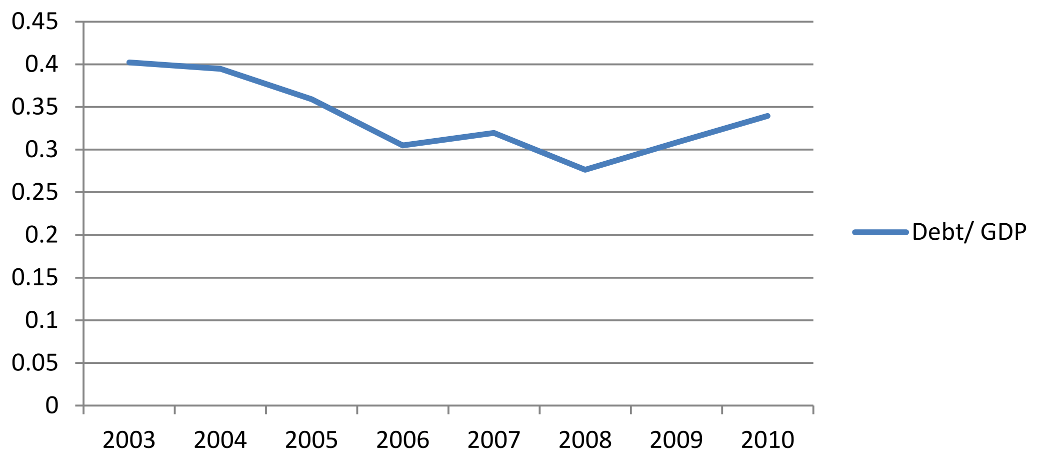
Debt service/Exports

Interestingly, the debt-based measure indicates greater resilience for Vietnam market as the proportion of exports to finance principal and interest repayment has been lowered. From 3.61% in 2003, the ratio has fallen to 2.28% in 2007, and further to 1. 66% in 2010. The reason may be growing foreign exchange income from exports, while the service of debt is maintaining. Besides, such ratio helps to scale down the risk of exchange rate.

External Debt Stock/ GDP

Total external debt stock is calculated against the level of GDP. Unlike the above ratio, it is more volatile and indeed, from 2008, when Vietnam dong depreciated in real terms, there is higher possibility of switching from production of domestic goods to production of exports to cover for external debt stock. However, considering the threshold of Debt/GDP to be 50% globally, Vietnam's volatility is medium.

Figure 15. External debt stock/ GDP, 2003-2010



Source: Author's calculation from World Bank Financial Indicators

In conclusion, unlike the substantial worsening downward trend in reserve-related indicators, debt-related indicators show inconsistent and unclear pattern of volatility after liberalization. The reason may be, "*Vietnam's external debt position has historically been robust, but has been negatively affected by the global crisis and domestic macroeconomic instability since last 2008. Most of Vietnam's external debt is concessional with long maturity, borrowing at low or negative interest rates, and a fairly diversified currency composition. Vietnam has access to large FDI inflows, providing significant non-debt creating financing*."(IMF Vietnam country report, 2010, pp.3-4)

2.3.3.2. Financial soundness indicators

By examining the financial soundness indicators of Vietnam financial markets before and post liberalization, we could identify the underlying vulnerability of the system, especially to market risk and banking crisis due to liberalization policies.

The research will focus on analyzing financial soundness indicators of Vietnamese banking system with 2 key attributes; capital adequacy and asset quality

Capital adequacy: regulatory capital to risk-weighted assets

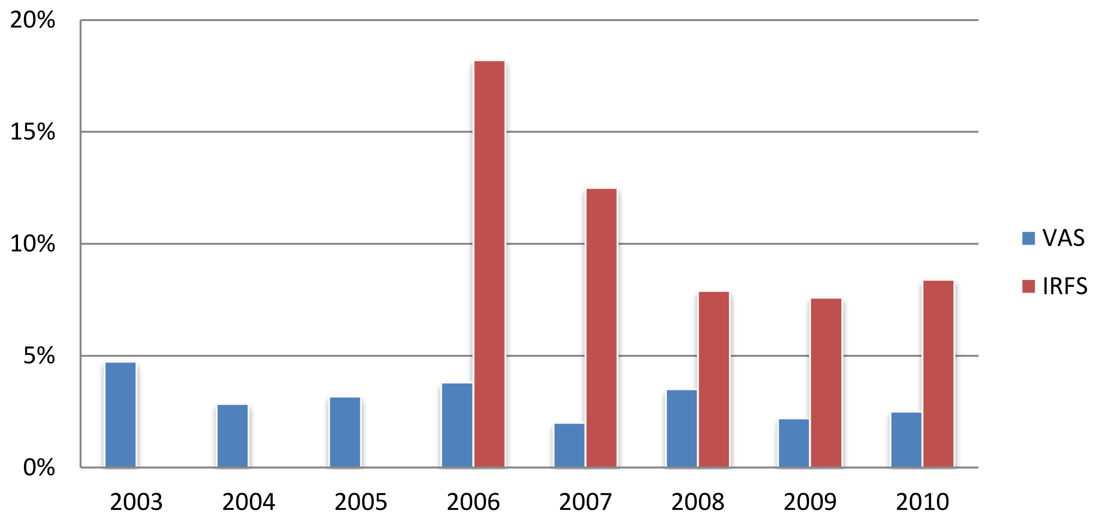
Currently, Vietnam banking sector is required to maintain minimum CAR of 9%, except for certain banks such as Agribank at 9%. Such level is higher for Basle II requirement of 8%. Most banks in Vietnam at the end of 2010 reached CAR of 9%, so we could conclude that there are enough cushions in Vietnam amount of bank capital to solvency or liquidity problems.

Asset quality: Non performing loans to total loans

In Vietnam, the concerns over bad debt have emerged, especially after the real estate and securities market boom following lifting of credit controls and robust development of stock market in 2006. High leveraged loans from banks to risky sector make the whole domestic network seriously vulnerable to credit risk and leads to a systemic banking crisis. Looking at the figure below, it is clear that according to VAS guidelines, CAR of Vietnam banks remain well below 5%-an acceptable level.

However, the prime worry is whether NPL ratio to total gross loans is presented true and fairly enough. Using IFRS approach, the accurate estimate of NPL was much higher compared to VAR approach, especially in 2006 and 2007, in coincidence with real estate and stock market bubbles. Besides, for VAS, the trend is downward while for IFRS measure, the trend is little upward.

Figure 16. NPL/gross loans, 2003-2010



Source: Fitch, Quach Thuy Linh (2011), pp.13

In conclusion, coupled with external vulnerability indicators, the aggregate picture for financial stability is, from late 2004 to 2007, financial health had been improving and practically peaked at 2007. However, the benefits of financial liberalization ceased as crisis in 2008 drove the most indicators down. *Volatility* of the system, thus, augments because: (i) Reserve insufficiency is eroded with loss of confidence in dong- denominated assets, (ii) Stable external debt profile is undermined by economic slowdown, falling exports and FDI, (iii) Publications on NPLs based on domestic standards drift far away from international standards.

2.4. Evaluation on impacts of financial liberalization on Vietnam

After Section 2.3 which studies the impacts of financial liberalization on the pace of financial development and financial volatility in Vietnam using before-after analysis and Granger Causality test, we identify there is a strong connection between financial deregulation and the welfare of financial market. Concerning the level of financial opening, due to Mattoo liberalization index, Vietnam has made commitment to aim at *partial liberalization*, both in banking and securities sector. The question here is should liberalization be encouraged in the future?

a/ Conclusion on impacts on financial development and financial volatility

Financial liberalization has its greatest effects on the growth of Vietnamese financial market. The freeing of trade of financial services under GATS commitments allows foreign participation as well as domestic reform of regulation and institutional factors to meet up with international accords. However, challenges come up since the opening. In short, financial liberalization proves to be a two-sided policy.

On the one hand, liberalization movements help to (i) increase *financial depth*, which manifests itself into further financial intermediation and more monetization of the whole economy, (ii) *improves credit allocation* through thriving financial intermediaries (i.e, banking system and stock market) especially credit to private sector (a feature hardly achieved in a closed, heavy government intervention).

On the other hand, liberalization emerges with trade-off effect, between development and volatility. In fact, development indicators of stock market yield volatility during 2006-2010 (post liberalization period), reserve vulnerability indicator shows that inadequate foreign exchange reserves and the current level of external debt of Vietnam have made the country fragile to adverse shocks. Institutional efficiency has not been enhanced yet, let alone exacerbated (asset quality with rising concerns over bad debts) and transparency/disclosure of information is not upheld properly.

b/ Other impacts of Financial Liberalization on the Vietnamese economy

Besides the evident impacts on the development of banking sector and securities market, financial liberalization also influences other economic aspects as well, such as foreign investment flows, imports and exports as well as inflation and government debt.

Firstly, GATS commitments of liberalizing capital movements in and out (in compliance with Article 8, IMF) oblige Vietnam to remove/lift restrictions on foreign exchange transactions. As a result, foreign investment flows to Vietnam, both direct and indirect increases substantially. In 2010, FDI in reached USD $8 billion, a consistent rise from USD $6 billion since 2007, while FDI out reached USD $0.9 billion. Net foreign portfolio investment as at 31/12/2010 stood at USD $2.37 billion, especially net foreign purchase in Vietnamese stock market was at USD $1.37 billion. All in all, capital account has been positive for the last 4 years, at USD $5.54 billion in 2010.

Net volume of imports-exports is still negative after financial liberalization; however current account balance is gradually shortened, only at 3.37% in 2010, compared to 8% in 2007, due to the freeing of repatriation of foreign exchange with repatriation in private sector up by 40% in 2010. However, the downside of financial liberalization is also reflected through escalating inflation due to influx of capital flows in Vietnam and the rapid monetization of economy (credit growth and broad money). Government debt constantly rises, creating more burden on debt service (up to USD $7.34 in 2010).

c/ Author’s final judgment

All balanced, financial liberalization in every respect brings about both benefits and drawbacks. From a developing economy’s perspective, financial liberalization offers Vietnam a chance to develop its financial market, channel funds to industrial sector, SOEs, SMEs to maintain the high growth rate. There is a large strand of literature that purports the idea of higher level financial development leading to more growth rate and Vietnam’s recent observations also speak the same. Besides, foreign participation in domestic market corrects inherently weak financial structure. Foreign investment flow such as FDI and FPI helps to build the whole economy too. Therefore, despite some adverse impacts on volatility, I recommend Vietnam should continue on financial liberalization, commit to more liberalization policies, however on a cautious approach.

CHAPTER 3. PROPOSALS TO IMPROVE FINANCIAL LIBERALIZATION OF VIETNAM

3.1. Learnt experience from other developing countries

3.1.1. Learnt experience from countries which succeed in financial liberalization

As mentioned in Chapter I, financial liberalization is a prevalent trend on a global scale. Many countries have liberalized their financial markets and achieved significant results such as expanding market size and depth, robust growth of financial intermediation and influx of foreign capital investments. The ultimate benefits are private sector provided with extra sources of financial funds and individuals with various options of investments, thereby promoting the monetization of the economy.

However, empirical observations and rising number of literature point out that financial liberalization goes with higher degree of financial vulnerability (especially capital account liberalization). Therefore, it is important to identify inherent domestic financial weakness, to improve prudential regulations so that misallocation of funds could be prevented. ADB approach is hinged on this risk-based premise to construct liberalization schedule: domestic liberalization starts first to solve innate flaws of financial system (bad debts, heavy government intervention…) >>> liberalization of FDI >>> liberalization of foreign portfolio investment >>> liberalization of external borrowings. In this approach, capital account liberalization follows domestic liberalization and is treated as the final destination. The approach is argued to be effective in limiting crisis risk. Many countries have adopted this strategy but how many manage to pull off?

3.1.1.1. The case of Hong Kong and Thailand

Among the financial development indices published by World Economic Forum on an annual basis, starting from 2008, Singapore and Hong Kong have stood out as Asian developing regions with high ranking in its index of financial development. Table 10 provides the snapshot of key economic indicators:

Table 10. Key economic indicators, Hong Kong & Singapore, 2010

	Hong Kong	Singapore
GDP (current billion $)	224.46	208.77
GDP growth (%)	7%	14.5%
Broad money (current billion LCU)	5780.68	403.078
Broad money (% GDP)	320.10%	127.5%
Securities market		
Market capitalization(current billion $)	890	308.32
Market capitalization (% GDP)	481	177.3
Banking sector		
Domestic credit provided by banking sector (% GDP)	199%	85.70%
Deposit money bank assets /GDP	1.336	1.102674

Source: World Bank financial indicators

Hong Kong and Singapore by and large have a developed market and robust growth rate. The monetization of Hong Kong and Singapore up to 2010 is reflected by high contribution of total value from market capitalization of listed companies as well as domestic credit channeled through organized system as a percentage of GDP. Compared to Vietnam's figures, these 2 economies clearly boast higher level of financial depth.

Later half of 1990s, Hong Kong and Singapore have made liberal opening of their banking sector as well as committed entry to WTO trade of services. However, unlike Thailand, Indonesia or Korea, the financial system of these 2 economies is still resilient and sufficiently sound against external shocks, reflected by their strong vulnerability indicators over years. Indeed, these 2 regions managed to successfully weather the Asian Crisis 1997-2998, which came right after their WTO participation.

The focus shifts to the numerical assessment of stability of financial performance under open capital and liberalized domestic market. Below are financial indicators of strength and liberalization indices of 2 economies:

Table 11. Hong Kong financial development indicators, 2008-2010

No	Indicators	Hong Kong		
		2010	2009	2008
1	Financial Development Index (1-7)	5.04	5.29	5.23
	Ranking	3	1	8
2	Financial sector liberalization	5.9	5.6	n/a
2.a	Capital account liberalization	2.5	2.5	2.6
	Ranking	1	1	1
2.b	Commitments to WTO agreement	35.3	35.3	n/a
	Ranking	33	33	n/a
2.c	Domestic financial sector liberalization	1	1	1
	Ranking	1	1	1
3	Financial stability	5.75	5.6	5.19
	Ranking	2	3	17
3.a	Reserves/ Imports	5	6	4
3.b	Financial strengths indicator	9	9	5.4

Table 12. Singapore financial development indicators, 2008-2010

No	Indicators	Singapore		
		2010	2009	2008
1	Financial Development Index (1-7)	5.03	4.68	5.15
	Ranking	4	11	10
2	Financial sector liberalization	6.7	6.7	n/a
2.a	Capital account liberalization	2.5	2.5	2.6
	Ranking	1	1	1

2.b	Commitments to WTO agreement	52.4	52.4	n/a
	Ranking	18	18	n/a
2.c	Domestic financial sector liberalization	1	1	1
	Ranking	1	1	1
3	Financial stability	5.6	5.6	6.22
	Ranking	4	5	1
3.a	Reserves/ Imports	5	5	6
3.b	Financial strengths indicator	9	9	5.3

Source: World Economic Forum Reports 2010, 2009, 2008

The ranks of 2 economies for each criterion are comparatively high and their performance has been consistent over time. Hong Kong and Singapore both ranked first on capital account liberalization, which mean capital flows to these 2 economies are subject to practically no or few restraints. Regarding domestic market liberalization, interest rate, credit controls, entry barriers are left market-oriented. Still their financial soundness indicators and financial stability indices are positive despite liberal openings.

3.1.1.2. Experience lesson

The common feature is that both Hong Kong and Singapore adopt ADB approach, to rectify their own flawed domestic market one step prior to allowing free capital flows. Several findings by Klein and Olivei (1999), Edwards (2001) all led to the conjecture that potential benefits of capital account liberalization depend on the level of financial development. So by reinforcing a strong domestic financial position, Hong Kong and Singapore have succeeded in financial liberalization without jeopardizing their financial health. Their liberalization schedule could be sketched out as a good learning steep curve for other countries:

(i) Restructure banking assets profiles, deal with non performing loans and prudential regulations
(ii) Update the legal framework, sufficient and transparency
(iii) Gradual domestic deregulation
(iv) Conduct banking reform to improve profitability and competitiveness
(v) Managed floating exchange rate regime
(vi) Government surveillance over short term foreign investment in securities market
(vii) Impose credit controls on sector, currency and maturity-related base

3.1.2. Learnt experience from other developing countries with mixed results

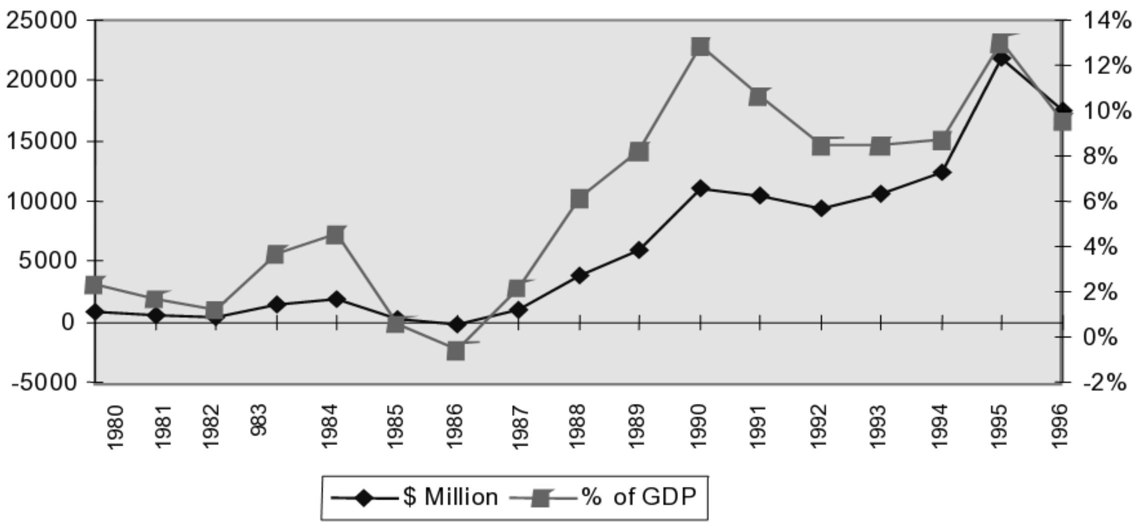
Certainly, the potential benefits of financial liberalization are not enjoyed evenly by countries in the world. Most of the time, the failure in other developing countries rests much with the pace of capital account liberalization and the old-questioned dilemma of when and how open the capital account should be, given certain achievements in domestic market liberalization (Asian Emerging markets).

3.1.2.1. The case of Thailand

Early achievements

The early 1980s saw a macroeconomic instability for Thailand, mainly attributable to Thai government undertaking a major adjustment effort to devalue the bath by 18.4% in 1984. Thailand gave priority to promoting capital inflows through tax and institutional reforms while concurrently developing its financial markets. The policy, accompanied by large positive interest differentials and a fixed exchange rate, promoted large net capital inflows. Such inflows contribute to a strong and fast economic growth during the 1987-1996. Social impacts were significantly amazing as well, the number of households below poverty line dropped from 32.6 % in 1988 to 16/3% in 1996. Cross-border trade contributed to 84% of GDP in 1996.

Figure 17. Net private capital flows to Thailand, 1980-1996

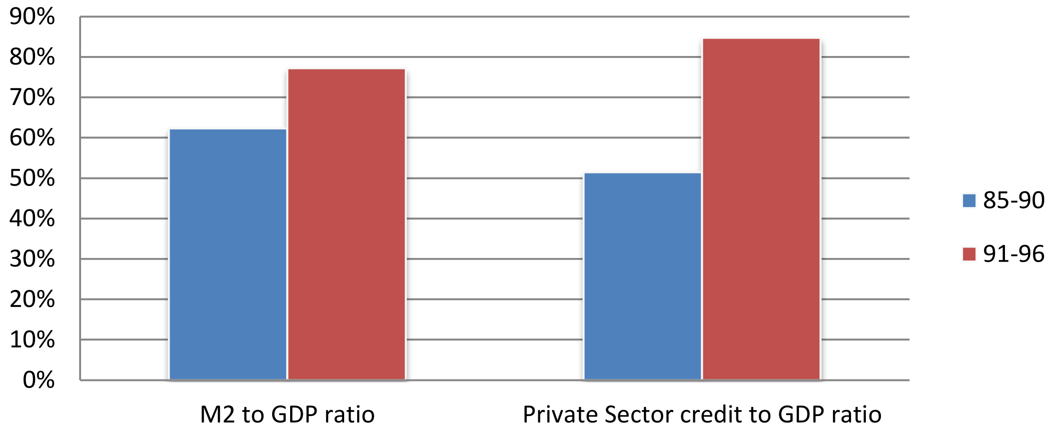


Source: Alba et al (2008), p. 18

With regard to financial integration, according to World Bank (1997), Thailand went from being a country only partially integrated in 1985-1987 to one of most integrated emerging economies in 1992-1994. During the period, Thailand was exposed to large inflows of foreign capital, which amounted up to 9.4 %, on average of GDP. The private capital flows experienced an abrupt dip in 1986 due to financial crisis which lasted 4 years, causing a slowdown in the economy. The short downturn could be put down to mismanagement on the part of several finance companies and banks.

Regarding Thailand domestic markets, banking sector, The Bangkok International Banking Facility (BIBF) was established in 1993 to facilitate the liberalization of banking business in Thailand. Due to more liberalized bank, reforms on interest rate, Thailand underwent a big jump in credit provided to private sector and financial deepening (higher ratio of M2/GDP).

Figure 18. Thailand financial deepening, 1985-1996



Source: IMF, World Economic outlook

Reversal in capital flows and crisis

In 1996, after a decade of robustness, growth and investment levels deteriorated in the face of an over appreciating real exchange rate, resulting in capital inflows and exports declined sharply. Foreign reserves dried up and because Thai government relied much on short term borrowings to finance long term assets so the economy suffered greatly from the liquidity problems. The large current account deficit, high interest rates, and increasing inflation left the country vulnerable to external shocks and a shift in market sentiment. Fixed exchange rate management, however doesn't allow the devaluation ò Bath and government use foreign currency reserve to maintain such fixed rate. This further compounds the currency crisis.

Moreover, serious weaknesses appeared in Thai financial system due to exposures to the property sector and inadequate loan provisioning. Exponential increase in credit strained banks and finance companies in their credit screening. High interest rates to counteract outflows exacerbated the situation. Thailand without a sound financial system could sustain in the case of capital flight.

3.1.2.2. Experience lesson from a developing, transition economy's perspective

The surge of liberalization in the decade from 1980-1990 signified the marked removal of government intervention in administering the movement of interest rate, allocation of credit. The financial market, after liberalizing, is led based on market signals and the system is open to international participation as well as domestic residents are allowed to tap into global investment. However, due to weak financial sector, improper macroeconomic policies that reduced that desirable impacts of liberalization and led to detrimental reversals.

The reasons for late 1990s failures could be summarized below and it is rather true of transition, emerging economies like Vietnam:

-High absorption of credit by public sector and government crowd out effects: despite certain termination of directed credit programs, bank credit still flock to the public sector, well-connected individuals, financial-industrial conglomerates and traditional state bank clients. In practice, government and central bank crowded out many borrowers. The rise in bank deposits over the 1990s tended to be inherited by government and central debt and by banks strengthening their offshore position

-Slow privatization and lingering restrictions on foreign entry which decrease competition

-Lack of attention to establish the framework for capital markets (treatment of minority shareholders, conduct rules for markets participants), compounding the problems that capital markets in developing countries face in terms of concerns about macroeconomic stability, high costs, and low liquidity

3.2. Vietnam financial liberalization outlook

3.2.1. Vietnamese further financial liberalization commitments

3.2.1.1. GATS commitments

As discussed in Section 2.4, the final judgment is that Vietnam should continue and progress to further financial liberalization. In fact, when we zoom in the commitment schedule and also in the computed liberalization index, the answer yields a partial level for Vietnamese case. During the unilateral and bilateral negotiation rounds in accession to WTO, there was a strong desire among the global community for Vietnam to liberalize more its financial sector. However, due to specifically handicapped domestic structure and threat of severe foreign competition, Vietnam has called for the current level of financial liberalization, as a way of incorporating financial liberalization efforts and the domestic sector reforms.

Therefore, the room for further financial liberalization in Vietnam, once the establishment of a more sophisticated domestic system, is plentiful. In fact, the accession to WTO has shortened the opening time frame for financial services pre specified under USVN BTA. For example, according to the timeline of BTA commitments, Vietnam shall lift restrictions on issuance of credit cards from 2009 for US banks; however the process is speeded up in 2007. Or until December 10, 2010, 100% foreign invested US banks are allowed; GATS commitments make it earlier in 2007.

Modes of supply

Among 4 modes of supply, only consumption abroad has entry noted "*none*", 2 entries are noted "*unbound*" for cross border supply and presence of natural person, commercial presence employs "*bound at more than current level*", making use of financial liberalization as an incentive to promote competition and domestic reforms. It is then implied that, In the future, Vietnam could liberalize the "*unbound*" entry for cross border supply of certain activities, not restricted within provision of financial information and auxiliary services.

Market access limitations

Vertical commitments in the market access column also give hints to more financial liberalization prospects. For example, Vietnam has reviewed and raised the equity participation rate for *individual* foreign banks in JSCBs from 15% to 20% (collective cap remains at 30% according to WTO commitments). Likewise, for the securities market, in 2010, foreign investors are allowed to purchase up to 49% of listed and non listed companies. From 2007-2012, only foreign securities branches of foreign securities suppliers are allowed to establish commercial presence in Vietnam but limited to certain services. Besides Vietnam still impose restrictions on the expansion of transaction points of foreign banks, except for ATM and the issuance of credit card.

Thus, it is observed that Vietnam has pursued a progressive financial liberalization policy and such market limitations could be revised and upgraded in the future when financial stability and domestic institutional health becomes more guaranteed.

3.2.1.2. ASEAN commitments

One of regional liberalization commitments is the ASEAN Framework Agreement on Services (AFAS), put together in practice in 1995, the objective of which is constantly reviewing market access limitations and maintaining MFN. The most notable feature of most ASEAN country commitments under AFAS is that they "*bound at below the actual level*" of market access, erring on the caution side. Such decision helps them to retain bargaining chips in the broader negotiations under AFAS and GATS. The capacity to withdraw licenses to operate on prudential grounds should provide sufficient protection for the system, so retaining the right to reverse access for foreign banks can be seen largely as a way to of raising the cost of entry by increasing uncertainty about the longer term treatment. Vietnam has made commitments under mode 3 in banking services giving ASEAN countries greater scope in the acceptance in the acceptance of dong deposits (demand and term but not savings) in the future.

Besides, capital account liberalization is also among 4 key points in ASEAN monetary blueprint in August 2003 to foster monetary and financial integration among ASEAN. In the future, in view of enhance the flows of funds between countries of ASEAN, capital account liberalization will be implemented under ASEAN Economic Community Blueprint. The 3 common are principles: (i) capital account liberalization should go with national financial conditions and willingness, (ii) allowance for reasonable protection in view of macro stability, (iii) on the basis of mutal benefits between countries. Therefore, it is expected that Vietnam in the future will perform more lifting of restrictions on capital flows, especially, capital flows between ASEAN countries.

3.2.2. Vietnamese financial market outlook

Whether Vietnam chooses to move on with further financial liberalization policies or backs down and reverses its commitments depends much on the current condition and development prospect of the financial market. A developed domestic sector could promise further liberal openings in the future while a less developed one could mean a country would sustain the existing level of openness for financial stability purpose and to spare time for self-improvement. So, by studying the outlook of Vietnamese financial market, including opportunities and challenges, we could gain fractional sight of the prospect of Vietnam financial liberalization in the coming years.

3.2.2.1. Current problems

The 5-year adherence to WTO commitments provides enormous benefits to the Vietnamese banking and securities sector. As indicated in Chapter II, these beneficial impacts could be reflected through rapid financial deepening, more intensive mobilization and allocation of resources within the banking system. Regarding institutional factors, although the same rosy result is not evident, the significant transformation of SOCBs group rooted from the wave of privatization and the robust emergence of JSCBs group couldn’t be denied. Despite some achievements, Vietnam still lags behind in terms of institutional and environment quality:

Insufficient charter capital

Recently although total assets of Vietnamese banking sector have risen exponentially, the scope of banking, measured by charter capital is still insignificant, only 25.6% of bank have charter capital of VND 5,000 billion. On average, charter capital in 2011 for the whole system was reported to be VND 12,574 billion, compared to the equivalent of VND 60,000-70,000 billion VND of Indian and Thailand banking sector. The prime concern is that, there is generally disequilibrium between the number of banks and the scope of each bank.

The same thing for Vietnam securities market as there are too many securities companies with relatively low market capitalization value, compared to Thailand and Malaysia.

Table 13. The scope of securities markets in selected Asian countries, 2010

Unit: USD billion

	No of firms	Market capitalization
China	107	3589
Indonesia	119	249
Vietnam	105	33
Philippines	55	92
Thailand	41	190
Malaysia	35	322
Singapore	24	492

Source: Mutrap (2010, p.55)

Prudential issues

Most banks in Vietnam records to achieve minimum CAR of 9%, however low compared to the average of APEC at 13.1% and Asian emerging countries at 12.3%. Except for Eximbank and Techcombank with CAR ≥12%, the others range from 8-11%. Bad debts also emerge in recent years, threatening the liquidity and credit position of the financial system.

Likewise, following Circular No.226/2010/TT-BTC, in 2011, 6 securities companies which could not meet the prudential ratio for securities firms (6% for domestic securities services suppliers and 4.8% for OECD foreign securities) were put under special supervision. Indeed, one of the results from small scope of securities firms is that, to make up for the negligible market share, some securities companies have decided to clinch to aggressive brokerage commission rates as well as illegal margin lending, which overall undermines the rationality of the whole system.

Low accessibility of financial services

Figure 19. Number of ATM per 100,000 adults, 2007-2010

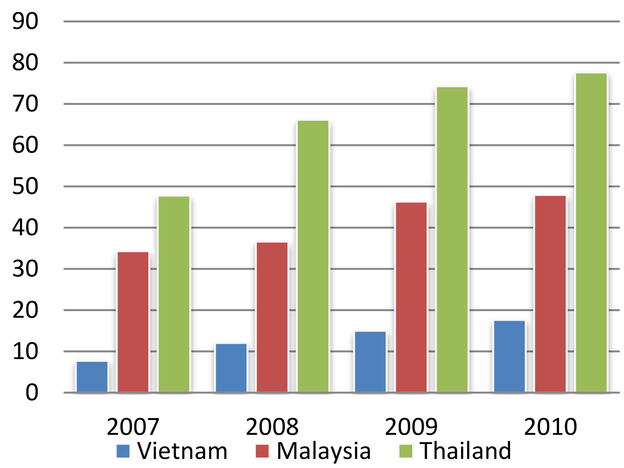
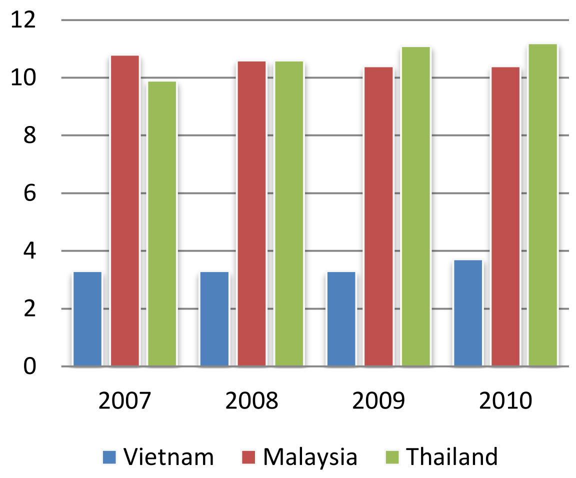


Figure 20. Number of bank branches per 100,000 adults, 2007-2010



Source: World Bank Financial Indicators

Accessibility of financial services, measured by the number of operation network (commercial bank branches and ATM per population), in Vietnam throughout the years has improved, however insignificant compared to other selected Asian emerging nations such as Thailand and Malaysia, only 4 bank branches and 20 ATM in 2010 available. This explains why Vietnam enjoys a very high ratio of loan/deposit, the demand for funds is overwhelming in the industry sector while banks mobilization of funds are still modest. The triggering problem is that Vietnam needs an investment rate of 30-40% of GDP to maintain a fast growth rate. Such low accessibility of financial services may lead to poor figure of resources mobilization and finally, lacking funds to invest.

3.2.2.2. Market opportunities

a/ Macro Economic prospect

In light of ongoing financial crisis and the concern over inflation, Vietnam has recently revised its economic growth targets for the next 5 years. The focus is to restructure the economy, with concentration on public sector and banking sector. Credit growth and economic growth rate would be remained at a moderate level (5.7-6.0%) while more attention would be directed to curb the spiral inflation rate.

Some achievements in recent economic movements are lowering inflation rate, building up of foreign reserves and controlled foreign exchange.

Below is the IMF estimated figures for selected Vietnamese macroeconomic indicators:

Table 14. Vietnamese economic development outlook, 2012-2015

	2012	**2013**	**2014**	**2015**
GDP per capita, USD $	1,498.11	1,617.10	1,744.77	1,872.36
GDP growth (%)	5.61	6.26	6.92	7.25
Inflation rate (%)	12.608	6.756	5.676	5.25
Current account balance (% GDP)	-1.579	-1.358	-1.247	-1.455

Source: IMF

Thus, the trend in the future, in general, is decelerating inflation and higher growth rate.

b/ Banking sector

Restructuring is the buzzword in the Vietnamese banking sector. Rigorous bank restructuring is to solve the problems of bad debts resulted from the unfettered and uncensored credit growth in the last few years accompanied by downturns in property and equities markets. The risk profile of banks and excessive association with unprofitable and overstretched SOEs, raises doubts over capital adequacy requirements.

The main points for banking sector opportunities are:

(i) Intensive regulatory and supervisory framework over bad debts and foreign currency loans. Foreign lending permitted to only selected import and export enterprises
(ii) Specific bank-based credit ration (classification of banks into 4 groups, with the best performance in financial soundness allowed to expand at 15-17%)
(iii) Disclosure of information to improve transparency issue
(iv) Rigorous bank recapitalization, M&A and bank privatization

Hopefully due to the restructuring schemes, the structural problems could be solved.

Table 15. Vietnamese banking sector outlook, 2012-2015

Unit: VND billion

	2012	**2013**	**2014**	**2015**
Total assets	4,166,766	5,000,119	6,000,143	7,200,171
Client loans	3,193,653	3,832,384	4,598,860	5,518,623
Client deposits	2,186,181	2,492,247	2,841,161	3,167,335

Source: BMI Commercial banking report Q4/2011

c/ Securities sector

From the late 2011 until early 2012, stock market records a higher level of transaction volume, especially inflows from foreign investors. During the first quarter of 2012, Vietnam has attracted USD $30 million from the foreign fund, and licensing for foreign transaction has been up by 0.13%. It is observed that foreign interest is back to Vietnamese stock market, because: (i) the average stock price is too low, (ii) long term positive signals such as fall in interest rate and cap rate on lending, allowing private sector, especially small and medium enterprises could access to financial resources.

Furthermore, proposed changes in simplifying the licensing requirement for foreign investors in early 2012 implies that foreign investment flows in Vietnamese stock market will increase in the future. Policy on management of foreign portfolio investment (i.e, proposed legalize transformation of closed funds to open funds). Therefore, the main points for opportunities in securities sector:

(i) Increased foreign investment flows to securities market
(ii) Disclosure of information
(iii) Restructuring of 2 stock exchange as well as securities firms
(iv) Improved payment and settlement system

3.2.2.3. Market challenges

Despite some upbeat, optimistic sentiments about Vietnamese macro economy and financial market, there are still some concerns over the overall financial stability and prospect. Some problems to deal with are uncertainties with inflation rate, foreign exchange rate, current account deficit, and ongoing economic downturn’s impacts on exports and imports. Performance of enterprise sector has not improved yet despite incentive packages.

Besides, lowering interest rate too quickly exposes the exchange rate to renewed pressure, undermining macroeconomic stabilization efforts and foreign reserves. Foreign reserves are still few, making Vietnam vulnerable to external shocks. Banks are still struggling with bad debts and capital mobilization due to lower deposit rate. Although recent moves in interest rate help to increase the accessibility of funds, however statistics show that funds are not actually channeled to enterprises, yet stuck at banks. Securities may enjoy large inflows of foreign investment, but the stability of the flows of foreign capital is questioned as well as liquidity.

Other concerns are fiscal deficits and government external debts to invest in unprofitable state own sector, which accumulates pressures on VND and financial health. Summary of challenges is as below:

(i) Volatile inflation rate and uncertain growth prospect
(ii) Banking bad debts and illiquidity
(iii) Poor foreign reserves
(iv) Securities market's risky margin lending and
(v) External vulnerability due to reliance on imports-exports

3.2.3. Basic action points for further financial liberalization of Vietnam

Admittedly, the key objective of further financial liberalization is to maintain the beneficial impacts on financial development such as financial deepening and credit allocation, while on the other hand minimize the volatility impacts rooted from vulnerable position in excessive external liabilities and lax institutional regulation. Besides, action points for financial liberalization should also account for current problems in the market and take consideration of financial market outlook. Basic action points for further enhancing financial liberalization of Vietnam, which could be classified into 3 major groups targeting:

(i) Financial Institutions and market
(ii) Regulatory bodies and government supervision
(iii) Integrated macroeconomic policy

3.2.3.1. Financial institutions and market

Banking sector

One of the most salient future prospects of the Vietnamese banking sector is restructuring and dealing with bad debts. The main object of restructuring is to build a more financially sound commercial bank system, thereby improving the competitiveness, resources mobilization and allocation of banks will improve.

Furthermore, set up long term plan for market expansion in terms of operation network and increase charter capital. Ensure the fair competition between domestic banks and foreign banks. Besides, the restructuring of state owned banking sector should be also speeded up.

Securities sector

Likewise, securities sector also face low profitability, liquidity problems and uncertainty about macroeconomic performance. Therefore, restructuring securities companies is necessary. Besides, to push for the rally of stock market and increase the scope of market capitalization (which is currently believed to be too insignificant compared to the number of securities firms), policies of streamlining foreign securities business registration; yet it is recommended to revise the existing investment room (30-49% of shares of listed and non listed companies) to encourage more foreign capital flows to stock market.

Improvement is also needed in the range of securities products, especially derivative products and debt securities, so that securities sector could mobilize funds from investors to channel them to private sector. Such improvement in market capitalization helps to relax burden on bank lending, which is originally the key source of credit to private sector.

3.2.3.2. Regulatory bodies and government supervision

Government bodies that bear prime responsibilities for regulatory and prudential function are State Bank of Vietnam and SSC. In order for further financial liberalization, overall, they should:

Upgrade legal background

The existing legal framework is not up to date and not sufficiently enough for all banking and financial services to be put in business practice.

Government risk supervision

Prudential compliance should be put under constant surveillance and measured by international standards approach such as Basel and IFRS to fairly present financial soundness and vulnerability position of financial institutions

Disclosure of Information

More independence as well as adequate authority

3.2.3.3. Macroeconomic policy

Monetary policy

The macroeconomic prospect of Vietnam shows that macro policy in the near future will focus on curbing inflation and promote long term stabilization. Since a positive, stabilized macro outlook creates a shield for the economy from external shocks and also as a way to sustain and keep the foreign capital outflows. Therefore, the very first basic action point is for government to implement a stabilization/inflation-oriented, independent monetary policy, keeping a close eye on current account balance and exchange rate regime.

In section 3.1, Hong Kong and Singapore emerge as a prominent example in managing the open economy trilemma: tradeoff between monetary policy independence, exchange rate stability and financial integration. Today the common policy is partial financial liberalization with restrictions on the flow of funds and exchange rate 'managed' floating regimes with central banks actively intervening in foreign currency markets.

Fiscal policy

The focus of fiscal policy should be on minimize state budget deficit and limit government financing relying on external debt, thereby reducing external vulnerability and supplement the monetary policy in attaining macro stabilization. So, in the future, fiscal policy should continue to be tightened.

Foreign exchange policy

The focus of foreign exchange policy is to make sure the stability of exchange rate, in order to prevent from bank run or balance sheet effects; build up foreign exchange reserves, mobilize foreign exchange from residents to bank system.

The macroeconomic outlook and financial market prospect suggest that there is a growing downward pressure on VND (perpetuating current account deficit, sudden lowering interest rate, volatility of foreign capital flows, etc), so it is important for the government to implement policies maintaining the investors' confidence in the exchange rate management.

3.3. Proposals to enhance financial liberalization of Vietnam

3.3.1. Proposals for financial institutions and markets

3.3.1.1. Banking sectors

As stated above, the basic action point for banking sector is to *build financially sound domestic commercial bank system* after years of robust growth. Restructuring banking system, dealing with bad debts help banks to become more effective, resistant to shocks and competitive enough for further liberalization.

Dealing with bad debts (M&A with foreign participation more than 30%)

The issue of *bad debts*, the weak lending of banks to risky sectors such as real estate assets is the root of the problem. To make the banking sector more financially sound, the very first core step is to improve the asset quality and find way to deal with bad debts. Government and financial institutions shall play a central role in solving the problems of bad debts.

Existing suggested solutions should be mergers and acquisitions of weak banks. Hopefully, the accumulation of capital possibly makes new merged entities more healthy and resistant against liquidity problems. Others are the creation of markets to purchase and sell bad debts among banks or between banks and government. However, due to US bad debt experience in 2008-2009, few banks in the US were willing to sell bad debts to the government so another solution emerges as government to buy shares of bank to increase the liquidity and confidence. However, in Vietnam, as privatization is on the rise and state budget deficit, the second solution may not be feasible, M&A is a better measure.

M&A should not be restricted to domestic M&A but should be allowed to foreign banks. If foreign banks could buy more than 30% of shares of JSCBs and use its strong risk management to deal with bad debts. Hence, in that case, government should relax restrictions on the cap rate of equity contribution in banks, in specific to permit the participation of foreign banks of more than 30% specified in WTO commitments.

Prudential measures in banking operation

Besides, settling the issues of bad debts, keep a close eye on prudential measures in the banking system. Domestic banks should therefore develop a risk management system to monitor bank operation in terms of government specified prudential ratios such as CAR, Non performing loans, or ROA, ROE. A part of building bank risk management, domestic banks also have to improve their internal auditing control in accordance with the government regulation.

Besides the frequent monitoring of prudential ratios, banks also develop solutions to deal with any troubled ratios. For CAR, it is recommended for the bank to increase charter capital and maintain the existing level of current assets (credit ration). For small banks with no prestigious brands, the solution of increase charter capital is somewhat difficult, especially in a sluggish stock market. Again the solution is to merge and acquisition with domestic or foreign partners.

Speed up privatization of SOCBs and reduce unfair competition

Government' major stake in SOCBs makes the competition in capital mobilization and credit expansion unfair. One the one hand, JSCBs have to deal with foreign penetration and its significant advantage in retail banking, one the other hand, SOCBs dominate the credit market with loans to their traditional state owned enterprises. JSCBs therefore focus on risky lending to small and medium enterprises (indirectly reduce the asset quality) and maintain a high level of ROE, ROA (use of leverage).

So in order to reduce such unfair competition, it is urgently needed to speed up privatization of SOCBs and allow foreign banks' participation in JSCBs to increase their competitiveness. Currently, SOCBs are intensively privatized (reflected by falling public assets); however more than 90% of shares still belong to government.

Universal banking services and increase funds accessibility to private sector

Foreign entry with diversified range of high quality banking and financial services is considered to be an incentive for domestic banks to improve and diversify their services. However, due to inadequate legal background, currently some services are not put in practice. Besides, despite of being provided, some services are poor in quality owing to lack of technical understanding and facilities.

Therefore universal bank model should be encouraged in Vietnam as it helps to increase ROA and ROE. Of course, the engagement in various activities, including trading on own account may expose banks to excess risks. Thus, only big, financially sound banks are allowed to become universal banks.

Still a large part of credit is now directed to state owned sector, while private sector are in thirst of financial resources. Recent government moves are to lower deposit rates and put a cap on lending rates to small and medium enterprises at 15%. However, the policy doesn't really materialize as because of high volume of bad debts, banks are still reluctant/ cautious to make a loan to the private sectors. Besides by lower interest rates, commercial banks find it harder to mobilize funds from deposits. Hence, government could establish a sort of guaranteed system to increase accessibility of financial funds to private sector.

3.3.1.2. Securities sectors

As stated above, low profitability, market capitalization and liquidity problems arise among domestic securities companies and the outlook for securities market is growing foreign presence, which leads to the need of restructuring securities market.

Partnership with foreign securities firms and intensive M&A

As a way to capitalize on foreign technological knowhow and professional expertise, securities firms could form partnership with foreign securities suppliers. Although in 2012, 100% foreign invested securities firms and branches could establish commercial presence in Vietnam; however, due to the fact that they are not familiar with the market as well as for fear of illiquidity, foreign investors want to contribute capital to existing domestic firms.

In light of securities' restructuring, domestic securities companies could choose from (i) maintain the current ownership structure, (ii) merge with a local firm, (iii) acquired by domestic or foreign firm, (iv) joint venture (foreign capital contribution less than 49%).

Concerning the 4^{th} option, equity investment by a foreign partner has immense profits to domestic companies such as large capital and foreign brand/recognition, technical know-how, etc. However, the joint venture/foreign partnership doesn't prove to work in long term as it often turns out foreign partners purchase domestic share for a conversion to 100% foreign owned company.

Besides, the current problem of low capital market capitalization vs the high number of securities companies could also be solved by mergers and acquisitions of low profitable companies. It is part of a larger, massive financial restructuring, implemented both in banking and securities sector

Improved financial and risk management

Concerning funding, domestic firms do not plan well and in advance for their funding needs, which can leave them in a position of unnecessary pressure to find capital in a short pace of time. Sufficient capital should therefore be made priority for securities firms. The realizable capital ratio of 180% and other prudential benchmarks provided in Circular No. 226/2010/TT-BTC should then be strictly accorded.

Risk management is also necessary concerning the major involvement of securities companies in proprietary trading and margin lending. As macroeconomic policy prospect focuses on long term stabilization and financial restructuring, it is vital for securities companies to be heedful of their risk position and compute measures to hedge. In recent years, over half of domestic securities reported losses due to adverse movements in stock market, low liquidity and engagement in highly risky margin lending. Therefore, it is urgent for securities companies to implement precautionary process to protect their portfolios from downward pressure of markets and from risky margin lending.

For example, collateral loans on securities should be rationed. Associated banks keep a close eye on their securities companies on such lending, making sure that loans provided to investors at only 30-40% of the value of securities pledged as collateral and those securities must be highly liquid and belong to companies with good business performance. The lending ratio for each collateralized securities should be revised constantly based on the quality/liquidity of these securities and also on the balance of margin lending on these securities.

Diversify the range of services

According to WTO schedules, there are in total 6 securities services that Vietnam made commitments to open the market. The traditional business for domestic securities firms is brokerage. In the future, when faced with the wave of competitive foreign securities firms, domestic counterparts should diversify their services to increase the profitability and competitiveness.

For example, full service model is now proposed for domestic firms enter more lucrative investment banking products. The benefits are more varied revenue structure, higher margin services, yet add up more to risky business. It is therefore important to incorporate the process of diversification of the range of services with proper risk management.

The provision of new products and policies for market development in liquidity

After long time of pushing, Circular No. 74/2011/TT-BTC was issued and made effects a strand of incentive policies for the development of stock market. The move is encouraged as Vietnamese securities sector still exhibits poor performance and lacks diversity and flexibility. For example, policies that should be allowed for investors are T+2 and derivatives. Although the former T+2 is still not legalized as expected, the T+3 for sale of securities are made applicable, which adds to the increased liquidity of the market. Some other incentive policies are multiple trading accounts, simultaneously purchasing and selling securities in the same day (on the condition of existing securities, so not daytrading) and margin trading. Derivatives are under consideration by regulatory bodies.

Provision of such new products and policies are essential to mobilize and sustain capital from investors, especially foreign ones. By doing this, could securities market be able to achieve the targeted market capitalization of 70% -100% of GDP in the coming years. Despite vibrant as it is, Vietnamese stock market is still small-scope and far away to act as a consistent source of medium and long term funds for enterprise sector if policies like these are not implemented.

Encourage foreign capital flows to stock market

Foreign participation in securities market helps to improve the liquidity, also acts an incentive for more transparency and efficiency. Therefore, policies to encourage foreign capital flows to securities market are intensively upheld; such as the recent streamlining of foreign business registration. However, due to the overarching macro stabilization target, the issue of raising investment room for foreign investors (more than 49%) has not been materialized yet. The encouragement of foreign portfolio flows to Vietnamese stock market should be go in tandem with strict capital controls.

3.3.2. Proposals for regulatory bodies and government supervision

3.3.2.1. Upgrade and constantly revise market conditions for adjustments in legal background

Financial liberalization under GATS obliges the regulatory bodies to renew the existing legal system in accordance with WTO commitments, yet further and more intensive financial liberalization in an open market forces the government to constantly update the new services/ problems and put them under legislation.

For WTO commitments

As stated in chapter II, Vietnam's implementation in legal respect of WTO commitments show that the legal framework doesn't fulfill so a lot of bound financial services are not implemented by banks and securities companies. Thus, when banking and securities sector are fully opened to foreign investors in 2012, government should rapidly upgrade the legal system.

For novel services/problems

Bad debts in securities companies have surfaced recently in margin lending - risky business threatening the liquidity position of the market. Therefore, definition and official legal regulation should be prepared. Margin loans by securities companies that are considered to be bad debts should have the net asset value smaller than margin rate and reserves the ability to recover. Government should issue specific regulations on the allowed ratio of margin loans and any measures to monitor margin loans. Besides, in light of financial restructuring, regulations on M&A should also be issued.

3.3.2.2. Government risk supervision

Prudential ratios

Government supervision of financial markets in an open economy would sooner or later transformed from a compliance based supervision to a more risk based approach. However, when financial risks such as liquidity risk or credit risk are used as a measure to supervise financial sector, there should be standardized base. For example, concerning the ratio of bad debts, although the released information of bad debts in the whole banking system is around the acceptable range, the computation base doesn't show consistency with each other and also with international standards. In section 2.3, the evidence is there is a wide gap between NPL reported on VAS and IFRS. So government risk-based supervision should adopt international standards and the conduct of supervision should be on regular basis.

Supervision on foreign capital flows

Government supervision on foreign capital flows could be implemented by both SBV and SSC. SBV supervises foreign capital flows on foreign currency account base (mostly with external liabilities) while foreign portfolio investment to stock markets will be put under supervision of SSC through monitoring of foreign investors group's transaction.

3.3.2.3. Disclosure of information

Weakness in financial market in Vietnam results much from lack of transparency, which severely disrupts deposits and investors' confidence in financial markets. Regarding the outlook of financial market, concentration is directed to the disclosure of financial soundness information in both banking sector and securities sector on a more regular basis. The key financial soundness information is among those to be disclosed:

(i) Capital adequacy ratio
(ii) Ratio of bad debts over total gross loans
(iii) Ratio of short term liabilities to finance long term assets
(iv) ROA, ROE of banking sector

Besides, for securities companies, apart from prudential ratios specified in Circular 226/2010/TT-BTC, disclosure of information related to margin loans should be heeded. For example, the outstanding balance of margin loans on each security, lending ratio (whether in compliance with government- proposed of ratio 30/70 specified in Circular No.74/2011/TT-BTC), interest rate on margin loans

3.3.2.4. More independence as well as adequate authority

In the future, regulatory bodies should be equipped with more independence as well as adequate authority to conduct onsite and offsite examination of financial institutions, also perform financial breaching of state regulation.

3.3.3. Proposals for macroeconomic policies and sequence of financial liberalization

As mentioned above, there should be an integrated macroeconomic policy, aiming at (i) long term domestic stabilization, (ii) exchange rate stability. The alignment of monetary, fiscal policy and exchange rate policy is really important. In terms of macro aspect, those points should be considered:

(i) Foreign exchange reserves: the higher the FPI and external liabilities, the higher foreign exchange reserves needed to sustain for foreign debt payment and prevent from currency risk
(ii) Domestic monetary policies to closely monitor aggregate money demands, to curb for inflation and limit credit growth
(iii) Improve the institutional quality (minimize balance sheet effects)
(iv) Monitor and maintain the balance between domestic and foreign currency
(v) Supervision on government budget and government debt

Besides, those macroeconomic policies should be implemented in close alignment with sequence of financial liberalization. The research suggests that Vietnam should follow ADB approach, to liberalize partially domestic market, before opening liberally its capital account position, especially the ongoing crisis and global instability. Therefore, a proposed plan for sequencing financial liberalization is as follows:

(i) From 2011-2015: continue the macroeconomic stabilization program, with tight monetary policies, fiscal policies and managed floating regimes. During the time, considering lifting few restrictions on FPI since 2011.
(ii) From 2015: When budget deficit reduces and macroeconomic stabilization target achieved, consider lifting restrictions on external borrowings. However, at this point, there should be a unified exchange rate system, not a multiple exchange rate regime as we have seen now in Vietnam. Foreign reserves should be made sure to be adequate.

(iii) From 2017: loosen regulations on the flows of foreign investments.

Sequencing capital account liberalization with financial reforms (Mai, Thu Hien, 2007)

Based on general principles, methodology for sequencing and coordinating capital account liberalization with other policies, current stand of capital account controls and degree of development of financial system, we suggest a scenario of steps of capital account liberalization that is suitable to Vietnam's circumstance as follows (Appendix E).

Stage 1: Laying the foundation for liberalization

The liberalization of FDI - the long-term capital flows - should be implemented firstly because the FDI is also a great source of foreign capital in Vietnam and the economy needs investment capital to develop the economy. In addition, the management of FDI is complex because there is an existence of new economic agent in the economy, foreign investors; thus, it will take a long time to prepare all necessary conditions to accept and treat them as equal as domestic economic agents. The relaxation of restriction on foreigners' purchase of equity shares also helps to attract more capital in Vietnam. It is important to discriminate the foreigners with long-term investment strategy with those having short-term investment strategy. Normally, the foreign investors having long-term investment strategy always take part in Board of Directors of the company.

The elimination of repatriation requirement for current account proceeds indicates the will of the host country in creating favourable conditions for investors to use their foreign exchange incomes, thereby attracting more capital in Vietnam.

To develop a deep and liquid interbank foreign exchange market, it is necessary to liberalize a part of banks' short-term borrowing and lending, subject to prudential safeguards, in order to create goods for foreign exchange market.

Derivatives transactions should be liberalized in order to enhance the ability of economic agents to hedge them against foreign exchange risks, provided these transactions are well managed.

In association with the liberalization of above-mentioned capital flows, banks' short-term borrowing and lending, and derivatives transactions is a development of interbank foreign exchange market, OMOs and the long-term public debt and equity market in order to create conditions for the foreign exchange transactions and intervention of the SBV when needed. A strong and sound prudential regulation and supervision and the improvement of banks' risk management are needed to manage and control the foreign exchange exposures in banks' short-term borrowing and lending and derivatives transactions.

Stage 2: Consolidating reforms

The second stage deepens the liberalization progress in the first stage. All longer term and nondebt-creating capital flows should be liberalized. Other restrictions on other money and capital market instruments (sales, purchases, issues of securities locally or abroad by residents and non-residents) should be eased depending on the ability of risk management of economic agents.

At this stage, prudential policies and risk management, financial markets and institutions are required to be in a considerable level of sophistication.

Stage 3: Completing and reassessing liberalization and reforms

At this final stage, all remaining capital controls, including controls on short-term capital flows should be lifted because financial sector conditions and level of risk management have developed to manage effectively risks. Only prudential regulations (such as open foreign exchange position limits) to manage risks should be maintained.

It is necessary to reassess the process of liberalization and identify remaining and emerging risks. The risk management must conform to international standards.

CONCLUSIONS

The research has so far focused on the study of financial liberalization under GATS, measuring the impacts of liberalization commitments and policies on financial development and financial volatility of Vietnamese economy. From this, the research has designed its proposed set of measures to enhance financial liberalization of Vietnam.

In Chapter 1, we learn that Financial Liberalization is an all-embraced economic trend in the world. However, financial liberalization is regarded to bring out dual effects on those which adopt it. Financial liberalization has primarily started in early 1980s and among many drivers of financial liberalization are multilateral trade agreements like GATS. Vietnam has officially joined WTO in 2007 and hence it has to open its domestic financial sector to foreign participation.

In Chapter 2, Vietnam's implementation of commitments under GATS framework is presented in legal and practical respect. For both banking and securities sector, the existing legal system is not adequate, impeding the implementation of financial liberalization in practice. Besides, based on the number of commitments, using de jure and de facto measures, Vietnam is judged to be in the middle of liberalization progress. Concerning impacts, financial liberalization in Vietnam leads to financial deepening in banking sector and securities market and better credit allocation. However, Vietnam financial system also struggles with financial volatility with worsening external vulnerability position and deteriorating soundness of financial system.

In Chapter 3, a number of measures are proposed to enhance the financial liberalization of Vietnam. From the experience learnt from success and failure case, couple with outlining the financial liberalization outlook, proposals are presented related to 3 main subjects including financial institutions and markets, regulatory bodies and macroeconomic policies. Sequence of financial liberalization will incorporated with proper conduct of appropriate policies.

LIST OF BIOGRAPHY

Abiad, A., Detragiache, E. and Tressel, T. (2008) A new database of financial reforms. *IMF Working Paper* WP/08/266.

Abiad, A. and Mody, A. (2005) Financial Liberalization: What Shakes It? What Shapes It?. *American Economic Review*, Vol. 95, pp.66–88.

Abiad, A. and Mody, A. (2003) Financial reform: What shakes it? What shapes it?. *IMF Working Paper* WP/03/70.

Alba, P., Hernandez, L. and Klingebiel, D. (2008) Financial Liberalization and the Capital account: Thailand 1988-1997. *World Bank Policy Research Working Paper* No. 2188.

Arestis, P. and Caner, A. (2004) Financial liberalization and poverty: channels of influence. *The Levy Economics Institute Working Paper* No. 411.

Balassa B. (1989) Financial liberalization in developing countries, *Background paper for the1989 World Development Report* WPS 55.

Bandiera, O., Caprio G., Honohan P. and Schiantarelli F. (2000) Does Financial Reform Raise or Reduce Saving?. *Review of Economics and Statistics*, Vol.82, No. 2, pp.239-263.

Bekaert, G., Harvey, C. R., and Lundblad, C. (2004) Growth volatility and financial liberalization. *NBER Working Paper* 10560.

Demirgüç-Kunt, A. and Detragiache, E. (1998) Financial liberalization and financial fragility, *World Bank Policy Research Working Paper* No.1917.

Henry, P. (2000) Stock market liberalization, economic reform, and emerging market equity prices. *Journal of Finance*, Vol. 55 (April), pp. 529-63.

IMF (2010) Vietnam country report No. 10/281.

Ishii, S. and Habermeier, K. F. (2002) Capital account liberalization and financial sector stability", *IMF Occasional Paper* No. 211.

Johnston, R. B., Darbar, S. M., and Echeverria C. (1997) Sequencing Capital Account Liberalization: Lessons from the Experiences in Chile, Indonesia, Korea, and Thailand. *IMF Working Paper* WP/97/157

Kaminsky, G, L., and Reinhart C. M. (1999) The twin crises: the causes of banking and balance-of-payments problems. *American Economic Review*, 89(3): 473-500.

Kaminsky, G. L. and Schmukler, S. L. (2003) Short-run pain, long-run gain: the effects of financial liberalization. *IMF Working Paper* WP/03/34.

Kammoun A., Trabelsi A. and Mamoghli C. (2011) Financial liberalization and financial market development: the case of Tunisia. *Review of Economics & Finance* 2011, 5, pp.57-70.

Klein, M. and Olivei, G. (2006) Capital account liberalization, financial depth, and economic growth, *NBER Working Paper* 7384.

Mai, Thu Hien (2007), Solutions for exchange rate policy of transition economy of Vietnam. *Doctoral thesis*, Available at http://sundoc.bibliothek.uni-halle.de/diss-online/07/07H128/prom.pdf.

Mattoo, A. (1999) Financial services and the World Trade Organization, liberalisation commitments of the developing and transition economies. *World Bank Policy Research Working Paper* No. 2184.

Mattoo, A., Rathindran, R. and Subramanian, A. (2001) Measuring services trade liberalisation and its impact on economic growth: an illustration. *World Bank Policy Research Working Paper* No. 2655.

McKinnon, R. I. (1973) Money and capital in economic development. The Brookings Institution, Washington, DC.

Mutrap (2010) Securities market liberalization in Vietnam - Key issues for the securities regulator and the domestic securities companies. *Mutrap report*.

Prica, I. and Vujačić, J. P. (2010) Financial services liberalization in transition countries and the role of the WTO. *Panoeconomicus*, 2010, 4, pp.487-501.

Quach, Thuy Linh (2011) Vietnam banking sector report, *Vietcombank Securities*.

Quinn, D. P. (1997) The correlates of changes in international financial regulation. *American Political Science Review*, 91, pp.531-551.

Quinn, D. P. and Inclan, C. (1997) The origins of financial openness: a study of current and capital account liberalization. *American Journal of Political Science,* 41, pp.814-845.

SBV (2007) Annual report 2007.

SBV (2008) Annual report 2008.

SBV (2009) Annual report 2009.

SBV (2010) Annual report 2010.

Shaw, E. S. (1973) Financial deepening in economic development. Oxford University Press, New York.

Shehzad, C. T. and de Haan, J. (2009) Financial Reform and Banking Crises. *CESifo Working Paper Series* No. 2870.

Shrestha, M. B. and Chowdhury, K. (2006) Financial liberalization index for Nepal. *International Journal of Applied Econometrics and Quantitative Studies*, Vol3-1, pp.41-54

Singh, A. (1997) Stock markets, financial liberalization, and economic development, *Economic Journal*, 107, pp.771-782.

Stulz, R. M. (1999) International portfolio flows and security markets (March 1999). Working Paper No. 99-3. Available at SSRN: http://ssrn.com/abstract=155188 or http://dx.doi.org/10.2139/ssrn.155188

Ucer, E. M. (2008) Notes on Financial Liberalization. Faculty of Economics, Chulalongkorn University.

Waliullah (2010), "Financial Liberalization and Stock Market Behavior in an Emerging Market– A Case Study of Pakistan", *International Journal of Business and Social Science*, 3: 75-86.

Williamson, J. and Mahar, M. (1998) A Survey of financial liberalization. *Princeton Essays in International Finance*, No. 211.

World Bank (2005) Financial Liberalization: What went right, what went wrong? in Economic growth in the 1990s, Learning from a decade of reform, *World Bank publications*, pp. 207-239

LIST OF APPENDICES

APPENDIX A

IMF FINANCIAL REFORM INDEX

Abiad (2008) developed an aggregate index measuring the level of financial liberalization based on the construction of 7 different components of financial sector policy:

(i) Credit controls and reserve requirements
(ii) Interest rate regulation
(iii) Entry barriers
(iv) State ownership
(v) Policies on securities market
(vi) Prudential regulations and supervision of banking sector
(vii) Capital account restrictions

With regard to (i), under statutory administration, certain amount of bank loans have to be allocated to priority projects whereas loans to given economic sectors are subject to restrictions at a particular period of time. For instance, *directed credit schemes* to agriculture or under developed utilities industry in Vietnam are often associated with subsidized rates or back in 2011, the freezing real estate market could be attributed to non-manufacturing credit rationing. Besides, to achieve macroeconomic objectives, high reserve requirements are obligatory. The absence of unreasonable reserve requirements and directed credit schemes plays an important part to promote financial liberalization.

Interest rate controls refer to the vital part of domestic financial deregulation, letting interest rate to be determined by the market, supply-demand forces. The third dimension is *entry barriers*, which prevents competition and foreign participation in domestic market. Financial system considered to be liberalized should see entry barriers brought down. (iv) implies the *privatization of state owned sector* to free the credit allocation as well as for the market to be transparent and competitive. The next component is a little reversal as more government interference into *prudential measures and bank supervision* is a positive opening. The 2 last components deal with policies to develop *securities market* and loosen *capital account restrictions* on international financial flows.

Such measures is different from Mattoo's which is adopted above as the latter is based mainly on Vietnam's commitments while the former on the actual Vietnamese government policies and moves to open the financial sector.

1. Methodology

Each component will be evaluated to be to which extent of financial liberalization and be assigned respective score, ranging from 0, denoted as fully repressed, to 1 denoted as fully liberalized. As we have 7 components, the total score will be summed between 0 and 21. At the next stage, equally weighted average method could be used to normalize the score to a standard range of (0, 1) or principal component analysis could be employed.

Below is the coding rule for IMF financial reform index:

No	Components	Score
1	**Credit controls and reserve requirements**	
a	How high is reserve requirement	
	Reserve requirement is more than 20%	0
	Reserve requirement is 10-20%	1
	Reserve requirement is less than 10%	2
b	*Are there minimum amounts of credit to certain sectors*	
	Credit allocations controlled by central bank	0
	Mandatory credit allocation to certain sectors eliminated	1
c	*Are there any credits supplied to certain sectors at subsidized rates*	
	Bank supply of credit to certain sectors at subsidized rates	0
	No subsidized rates specified	1
d	*Are there restrictions on credit expansion by banks*	
	Credit ceilings exist, specific sectors including	0
	No restrictions exist	1
2	**Interest rate liberalization (*)**	
	Government-set or subject to a binding ceiling	0
	Within a band	1
	Freely floating	2
3	**Banking sector entry**	
a	*Are there restrictions on the participation of foreign banks*	
	No entry of foreign banks allowed	0
	Foreign bank allowed, foreign participation < 50% equity share	1
	MFN and >50% ownership allowed for foreign equity participation	2
b	*Allow for the entry of domestic banks and other financial institutions*	
	Entry restricted strictly or not allowed	0
	Entry allowed for domestic banks and other financial institutions	1
c	*Are there restrictions on branching*	
	Restrictions on branching	0
	No restrictions on branching	1
d	*Are there restrictions on bank and other financial institutions' activities*	
	Banks restricted only to banking activities	0
	Banks allowed to become universal banks	1
4	**Capital account transactions**	
a	*Exchange rate system unified*	
	Special Exchange rate regime exists	0
	Exchange rate system unified, no rate discrimination	1
b	*Are there restrictions on capital inflows*	
	Restrictions on capital flows exist, tax or quota	0
	No restrictions on capital flows: FDI, FFI, bank borrowing	1
c	*Are there restrictions on capital outflows*	
	Restrictions on capital flows exist, tax or quota	0
	No restrictions on capital flows or with minimal approval	1
5	**Privatization**	
	Major banks are state-owned, public bank asset 50-100%	0
	Major banks state-owned, public bank asset 25-50%	1

	Most banks privately owned, public bank asset 10-25%	2
	Public bank asset less than 10%	3
6	**Securities market reforms**	
a	*Development incentives to promote securities market*	
	Securities market doesn't exist	0
	Securities market in early stage with Security commission	1
	Further measures taken	2
	Derivative markets allowed and encourage institutional investor	3
b	*Openness to foreign investors*	
	No foreign equity ownership allowed	0
	Foreign ownership allowed, less than 50%	1
	Foreign ownership allowed, more than 50%	2
7	**Prudential regulations and supervision of banking sector**	
a	*Is there adoption of capital adequacy ratio based on Basle standard*	
	Not implemented risk-weighted capital adequacy ratio	0
	Implemented Basle CAR	1
b	*Independence from executive's influence*	
	Inadequate legal framework, delays due to political inference	0
	Agency clearly defined yet inadequate legal framework	1
	Legal framework for problems and legally independent	2
c	*Effective on-site and off-site examinations*	
	No conduct	0
	Ineffective conduct or insufficient manner	1
	Effective conduct and sophisticated examinations	2
d	*Cover all financial institutions*	
	Certain banks or offshore intermediaries of banks exclusively exempted	0
	All banks subject to supervision	1

(*) calculate for deposit and lending rates

(**) conversion: 4,5,= fully liberalized (3), 3=partially liberalized (2), 1,2=partially repressed, 0=fully repressed (0)

2. Application in Vietnam

Step 1: Examine liberalization policies for each component from 2007 to 2011

Credit controls and reserve requirements

- How high is reserve requirement?

2007: Decision 1141/2007/QĐ-NHNN, effected from 1/6/2007, reserve requirement to be set from 4% to 10% for various types of deposits, in VND and foreign currency. The twofold increase from 5% to 10% was attributed to robust credit growth.

2008: Decision 187/2008/QĐ-NHNN, effected from 2/1/2008, reserve requirement reached 11% for demand deposit in both currencies. In November, Decision 2560/QĐ-NHNN effected 5/11/2008 specified reserve requirement at 10% maximum. The reserve requirement continues to be brought down to less than 10% in December. 2009: Decision 379/2009/QĐ-

NHNN, effected from 1/3/2009, the level was further lowered down to 3% for VND deposits and 7% for foreign currency deposits.

2010: Decision 74/QĐ-NHNN, effected from 1/2/2010, while the domestic currency reserve held still, the benchmark for foreign currency was brought down (both less than 10%) 2011: Decision 1209/2011/QĐ-NHNN, effected from 1/6/2011, reserve requirement was raised to 7% for foreign currency deposits. The last quarter witnessed another rise to 8%.

- Directed credit schemes?

Although credit to agriculture and reincarnate regions in the aftermath of natural disasters is encouraged among financial systems (about 20% of total credit is favored to be allocated to this preferential sector due to SBV governor), the directed credit scheme is not compulsory.

-Subsidized interest rates?

From 2009, subsidized interest rates (government endorsement of 4%) are granted to short term credit to individuals and enterprises for manufacturing following Circular 02/2009/TT-NHNN. Few months later, Decision 443/QĐ-TTg extended the government interest rate subsidy package to long and medium term loan. Such package has been maintained till 2011.

-Restrictions on credit expansion by banks?

The year 2007 and 2008 both saw credit restrictions to securities market. In 2009, total credit limit was set at 30%. In 2010, Circular 13/2010/TT-NHNN was issued and affirmed the rationing of credit to securities market. In 2011, with the increase in bad debts, SBV required commercial banks to maintain non-manufacturing deposits at 22% to June 2011, and at 16% to December 2011. The total credit limit for the whole banking sector was 20%. Besides, about 30% maximum of short term deposits (major sources of funds) is allowed to be directed to medium and long term loans (major uses of funds).

>>> The assigned score is below:

Sub-components	**2007**	**2008**	**2009**	**2010**	**2011**
Reserve requirement	2	1	2	2	2
Directed credit	0	0	0	0	0
Subsidized rates	0	0	1	1	1
Credit restrictions	0	0	0	0	0
Total	2	1	3	3	3
Converted score	**1**	**1**	**2**	**2**	**2**

Interest rate controls

-Deposit rates: SBV specified cap rate on deposit activities. From 2007 to 2011, cap rates on deposits have constantly increased from 11% to 14%.

-Lending rates: no specific ceiling on the rates. However, the lending interest rate could not exceed 150% of basic interest rate (Civil Code 2005). For example, if basic interest rate is

8%, the cap rate on loans should be less than 12%. However, the stipulation expired. In 2010, Circular 07/2010/TT-NHNN dated 26/2/2010 liberalized interest rate loans on medium and long term loans and Circular 12/2010/TT-NHNN liberalized interest rate on short term loans.

>>> The assigned score is below:

Sub-components	2007	2008	2009	2010	2011
Deposit rates	0	0	0	0	0
Lending rates	0	0	0	1	1
Total	0	0	0	1	1
Converted score	0	0	0	1	1

Banking sector entry

-Restrictions on the participation of foreign banks?

According to Vietnam’s schedule of commitments, since 2007, foreign banks are allowed to establish commercial presence with ceiling on foreign equity participation less than 50% of equity share

-Entry for domestic banks and other financial institutions?

Domestic banks and other financial institutions that meet capital requirements could be established and provide financial services to customers. There are no discretionary conditions on the entry of other domestic banks and financial intermediaries.

-Are there restrictions on branching?

There are national treatment limitations on the establishment of foreign branches in Vietnam. Besides the capital requirement of 20 billion USD for the parent bank, other prudential regulations are adopted as well.

-Restrictions on banking activities?

Banks are allowed to become universal banks according to Law on Credit Institutions 2010, including acceptance of deposits, providing credit, payment and transmission services, money broking, trading etc. However banks are not allowed for direct investment in real estate. Besides, market access limitation on foreign branches to mobilize VND capital in forms of deposits is implemented from 2007 to 2011.

>>> The assigned score is below:

Sub-components	2007	2008	2009	2010	2011
Participation of foreign banks	1	1	1	1	1
Entry for domestic banks and other financial institutions	1	1	1	1	1
Restrictions on Branching	0	0	0	0	0

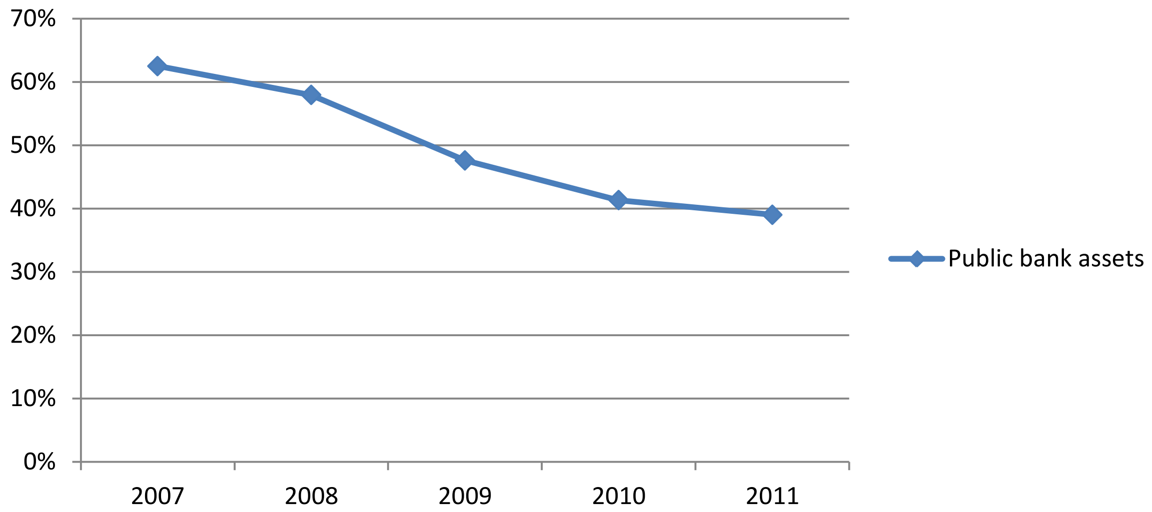
Restrictions on activities	0	0	0	0	1
Total	2	2	2	2	3
Converted score	1	1	1	1	2

Privatization

Since the accession to WTO, Vietnam has accelerated the privatization of state owned banking sector. From 2007 to 2011, the number of joint stock commercial banks has picked up fast and the share of this group has also grown larger.

Figure 21. Percentage of public bank assets

(Total assets of 4 SOCBs)



Source: Author's compilation from various banking sector reports

>>>The assigned score is below:

	2007	2008	2009	2010	2011
Converted score	0	0	1	1	1

Capital account restrictions

-Exchange rate system unified?

Based on de jure evaluation, system of multiple exchange rates for various transactions was abolished in 1989 and a unified, single official exchange rate system for all transactions has been put in practice. However, due to IMF de facto classification, Vietnam has been categorized to maintain multiple-exchange-rate regime. From 1999, SBV based their exchange rate from the average inter-bank foreign exchange market and commercial market allowed to move within a predetermined band.

Regarding official markets, there are 2: inter-bank foreign exchange market with heavy government interference to manage stable nominal exchange rates referred to as primary market and retail secondary market between commercial banks and their customers, of which movements confined within a band and such distortion removes the impact of market forces. The black market or parallel market has different exchange rates compared to official exchange rates and the premium could be of significant difference.

The difference mentioned above could not satisfy the current account demand and capital account demand. For instance, only imports/exports of certain, preferential goods could access foreign funds in inter-bank market while imports/exports of others and capital account could turn to black market, “providing a means to shift private portfolios between domestic and foreign assets, especially under capital controls” (Bui Thi Minh Tam, Who gains and who loses from the exchange rate system in Vietnam, Decopen working paper series No.2012/4). Nonetheless, in 2011, empirical observation indicates Vietnam government’s attempt to unify the exchange market by depreciating interbank market rate as well as gradually close the black market.

-*Restrictions on capital inflows and outflows?*

Ordinance on Foreign Exchange 2005 specified a liberalized policy on capital inflows and outflows. FDI and foreign portfolio investment, bank borrowings are subject to few restrictions, resulting in a large capital inflow to Vietnam.

>>> The assigned score is below:

Sub-components	**2007**	**2008**	**2009**	**2010**	**2011**
Unified exchange system	0	0	0	0	1
Restrictions on capital inflows	1	1	1	1	1
Restrictions on capital outflows	1	1	1	1	1
Total	**2**	**2**	**2**	**2**	**3**

Securities market reforms

-*Development incentives to promote securities market*

In 2007, Law on Securities Market was issued with specific statutory requirements to help develop corporate bonds and equity markets. Furthermore, Decision 2276/2006/QĐ-BTC regulated the auctioning of government bills on exchange traded floor.

In 2008, the authorities planned the primary dealer system for government bonds. In early 2009, government announced first bailout package, and expand leverage in the sector. Tax on securities investors were brought in practice (0.1% on value of each transaction, or 20% on the total year end value). 2010 and 2011, although leveraged credit to securities markets is limited for prudential purposes, several measures are put forward to attract foreign investment portfolios.

-*Openness to foreign investors?*

Foreign entry is allowed since the accession to WTO, however, there is market access limitations on the share of equity contribution in joint venture company to be less than 49%.

Regarding the cap of foreign participation in domestic joint stock companies, Decision 55/2009/QĐ-TTg, the level was raised from 30% to 40%. The year 2009 started to witness a surging wave in equitization of state-owned sector.

>>>The assigned score is below:

Sub-components	2007	2008	2009	2010	2011
Development incentives	1	1	2	2	2
Openness to foreign investors	1	1	1	2	2
Total	2	2	3	4	4
Converted score	**1**	**1**	**2**	**3**	**3**

Prudential regulations and supervision of banking sector

-*Adoption of CAR based on international standard*

Capital adequacy ratio is upheld in the whole banking sector. From 2007 to 2010, the CAR was kept at 8% while in 2010; it was raised to 9%.

-*Independence*

The banking regulatory commission belongs to SBV and since 2007, a number of legal documents have been ratified to endorse the operation of the commission. In 2008, Direction 03/2008/CT-NHNN dated 22/4/2008 emphasized an intense supervising system for banking sector. In 2009, Decision 1647/QĐ-NHNN stipulated the responsibilities and rights of the banking regulatory commission, which was established due to Decision 83/2009/QĐ-TTg dated 27/5/2009. In 2010, Circular 08/2010/TT-NHNN was for special supervision of financial institutions. In 2011, Direction 02/CT-NHNN targeted banks' adherence to cap deposit rate and Circular 44/2011/TT-NHNN aimed to improve internal control and the audit of financial institutions.

-*Efficiency in onsite and offsite examinations*

The model to evaluate financial capability of banking sector adopted by the Commission is CAMELS. From 2007 to 2011, although the supervision of banking sector has been conducted, however the result is limited. A number of domestic banks violated cap deposit rate, prudential ratios, especially on loans to risky sectors have not been accorded appropriately. In 2011, however, the supervision of banking sector has been greatly improved, in particular the bank's adherence to cap deposit rate.

-*Completeness-Cover all financial institutions?*

All financial institutions, both state-owned or publicly owned banks/other financial institutions are subject to state supervision. There are no exceptions.

>>>The score is assigned below:

Sub-components	2007	2008	2009	2010	2011
Adoption of CAR	1	1	1	1	1

Independence	0	0	1	1	1
Efficiency	1	1	1	1	2
Completeness	1	1	1	1	1
Total	3	3	4	4	5
Converted score	**1**	**1**	**2**	**2**	**2**

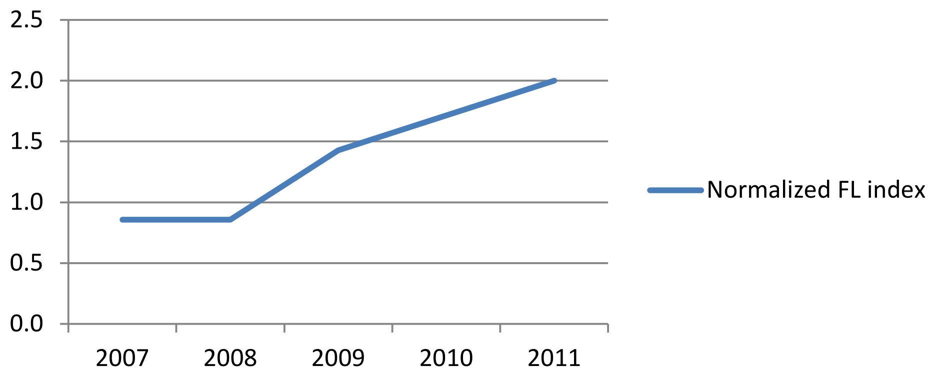
Step 2: *Construct an aggregate index using weighted average method*

The assigned score for each component over a time period from 2007 to 2011 and the sum of 7 components:

	2007	**2008**	**2009**	**2010**	**2011**
Credit controls and reserve requirements	1	1	2	2	2
Interest rate controls	0	0	0	1	1
Entry barriers	1	1	1	1	2
Privatization	0	0	1	1	1
Capital account restrictions	2	2	2	2	3
Securities market reforms	1	1	2	3	3
Prudential regulations and bank supervision	1	1	2	2	2
Total	6	6	10	12	14
Normalized index	**0.86**	**0.86**	**1.43**	**1.71**	**2.00**

By using equally weighted average method, it means that the contribution of each component to aggregate index is the same. Thus the final indices are computed by deriving the average of all 7 components and we have results as above.

Figure 22. Normalized IMF financial reform index for Vietnam



By and large, Vietnam's indices could be categorized as partially liberal financial liberalization, although still maintaining stringent restrictiveness policies. The policies were tightened in early years due to inflation concerns and drastic state regulation, while from 2009, liberalization progress resumed and accelerated, due to more privatization and the enactment of bank supervision.

>>>**Conclusion**: The method of IMF may provide a quite de facto assessment of liberalization; however, it relies much on subjective assessment so the result may potentially be biased and inaccurate to some extent.

APPENDIX B

VIETNAM BANKING SECTOR COMMITMENTS TO WTO

	Vietnam's commitment to WTO	
Mode of supply	**Limitations on Market Access**	**Limitations on National Treatment**
1-Cross-Border supply	Unbound	Unbound
	except for Provision and transfer of financial information, and financial data processing and related software by suppliers of other financial services	except for Provision and transfer of financial information, and financial data processing and related software by suppliers of other financial services
	except for Advisory, intermediation and other auxiliary financial services on all banking activities, including credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strategy	except for Advisory, intermediation and other auxiliary financial services on all banking activities, including credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strategy
2-Consumption abroad	None	None
3-Commercial Presence	None, except only permitted in the following firms	None, except
a/ Foreign Commercial Banks	Representative office (not for profit) (since 11/1/2007)	For a commercial bank branch: the parent bank with total asset > 20 billion USD
	Branch (limitation in accepting deposits) (2007-2011) (*)	
	Commercial Joint Venture (foreign capital contribution <50% (since 11/1/2007)	For a joint venture or a 100% foreign-owned bank: the parent with total asset> 10 billion USD
	100% foreign owned banks (since 1/4/2007)	
	Joint venture financial leasing company (since 11/1/2007)	For a 100% foreign invested finance company or a joint venture finance company, a 100% foreign invested financial leasing company or a joint venture financial leasing company: the parent with total asset> 10 billion USD
	100% foreign invested financial leasing company (since 11/1/2007)	
	Joint venture finance company (since 11/1/2007)	
	100% foreign invested finance company (since 11/1/2007)	
b/Foreign finance and financial leasing company	Representative office (not for profit) (since 11/1/2007)	

	Branch (unbound)	
	Joint venture finance company (since 11/1/2007) 100% foreign invested finance company (since 11/1/2007) Joint venture financial leasing company (since 11/1/2007) 100% foreign invested financial leasing company (since 11/1/2007)	For a 100% foreign invested finance company or a joint venture finance company, a 100% foreign invested financial leasing company or a joint venture financial leasing company: the parent with total asset> 10 billion USD
4-Natural person	Unbound	Unbound

Source: Author's adaptation from Accession of Vietnam to WTO (2006)

APPENDIX C

VIETNAM SECURITIES SECTOR COMMITMENTS TO WTO

Vietnam's commitment to WTO		
Mode of supply	**Limitations on Market Access**	**Limitations on National Treatment**
1-Cross-Border supply	Unbound	Unbound
	except for Provision and transfer of financial information, and financial data processing and related software by suppliers of other financial services	except for Provision and transfer of financial information, and financial data processing and related software by suppliers of other financial services
	except for Advisory, intermediation and other auxiliary financial services on all banking activities, including credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strategy	except for Advisory, intermediation and other auxiliary financial services on all banking activities, including credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strategy
2-Consumption abroad	None	None
3-Commercial Presence	None, except in the following form:	None
	Representative office (since 11/1/2007)	
Foreign securities services suppliers	Joint venture with foreign capital <49%	
	(since 11/1/2007)	
	100% foreign invested capital (since 11/1/2012)	
	Branches (since 11/1/2012)	
4-Natural person	Unbound	Unbound

Source: Author's adaptation from Accession of Vietnam to WTO (2006)

APPENDIX D

KEY LEGAL FRAMEWORK RELATED TO EACH SUBSECTOR OF ACTIVITIES UNDER COMMITMENTS

Banking activities	**Relevant laws and regulations**	**Specific content**
Acceptance of deposits and other repayable funds from the public	Law on Credit Institutions 2010	Article 98, 108, 112 allow for commercial banks, finance companies and financial leasing companies to provide all types of deposits and repayable funds from the public
	Decision 210/2005/QD-NHNN	EU Foreign branches are allowed to accept deposits in VND from natural persons and legal entities up to 350% and 400% of paid in capital
	Document No 1210/NHNN-CNH 2007	Step-by-step easing limitations on foreign bank's branches in accepting VND deposits over a 5-year phase ending in 2011 when national treatment to foreign competitors are granted
	>>> Since 2011, according to WTO commitment schedule, there will be no difference of treatment in the mobilization of VND deposits between domestic commercial banks and foreign bank branches.	
Lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transaction	Law on Credit Institutions 2010 Decision No 1627/2001/QĐ-NHNN dated December 2001	Article 98, 108, 112 allow for commercial banks, finance companies and financial leasing companies to provide all types of credit
	Decision 1096/2004/QĐ-NHNN (amended and supplemented by Decision No 30/2008/QĐ-NHNN)	Credit institutions eligible for factoring services include domestic commercial banks, joint venture banks, 100% foreign owned banks, finance companies, financial leasing companies and foreign branches
	>>> By and large, there is no discrimination between domestic and foreign credit institutions in this subsector.	
(3) Financial leasing	Law on Credit Institutions 2010	Article 108, 112 specifies that finance and financial leasing companies could offer financial leasing services Article 103 specifies the requirement for commercial banks to establish joint venture companies or subsidiaries to provide financial leasing services. Article 123 specifies that foreign branches not allowed to conduct financial leasing
(4) All payment and money transmission services , including credit, charge and debit cards, travelers' cheques and bankers drafts	Law on Credit Institutions 2010 Decision 226/2002/QĐ-NHNN	Various legal documents issued related the subsector of services, although the organization of these documents are overall scattered and doesn't cover all payment instruments

	Document No.32326/NHNN-TTGSNH	The document specifies regulations on opening and operating ATM, which emphasizes the MFN and NT treatment. In short, there is no limitation on the number of ATM that foreign commercial banks could open.
(5) Guarantees and commitments	Decision No.26/2006/QĐ-NHNN	Article 3 notes that all credit institutions eligible to provide guarantees and commitments Article 7 notes the national treatment in a sense that the balance of guarantees should be kept less than 15% of charter capital for both foreign and domestic suppliers
(6) Trading for own account or for account of customers.	Decision No.07/2008/QH-NHNN	Money market instruments: there is no discrimination regarding the issuance of promissory notes (full national treatment)
	Decision No.1452/2004/QĐ-NHNN	Foreign exchange and derivative products: open FX dealings regulation for all types of credit institutions
	Decision No. 62/2006/QĐ-NHNN	Exchange rate and interest rate instruments: Foreign branches, joint venture and 100% foreign owned banks allowed to provide interest rate swap agreements
(7) Money broking	Law on Credit Institutions 2010 Decision No. 351/2004/QĐ-NHNN	Article 107 restricts money broking services to commercial banks and foreign branches in Vietnam only
(8) Asset management	Law on Credit Institutions 2010	Article 107, 111 allow commercial banks and finance companies to provide asset management services.
	Circular No.04/2012/TT-NHNN	All credit institutions in Vietnam and Foreign Branches eligible for trust services and act as loan agents for bank operation
(9) Settlement and clearing services for financial assets	Decision No.87/2007/QĐ-BTC	Settlement and clearance for securities: joint venture and 100% owned banks, foreign branches
	Law No.49/2005/QH11 on Negotiable Instruments	Settlement and clearance for negotiable instruments: in compliance with commitments
(10) provision and transfer of financial information, and financial data processing	Decree No. 10/2010	The provision and transfer of financial of financial information legalized between banks.
(11) advisory, intermediation and other auxiliary financial services on all activities	Law on Credit Institutions 2010	Article 107, 111, 116 implies all credit institutions are open to provided advisory services.

Source: Author’s compilation and updates based on Mutrap Report (2006)

APPENDIX E

VIETNAM: SEQUENCING CAPITAL LIBERALIZATION WITH FINANCIAL REFORMS

Capital account liberalization	Financial sector reforms
1. Stage 1: Laying the foundation for liberalization	
Capital inflows - Liberalization of FDI. - Relax restrictions on non-residents' purchase of equity shares. *Capital outflows* - Eliminate repatriation requirement for current account proceeds. *Banks' short-term borrowing* - Limited liberalization of banks' short-term borrowing and lending to develop a deep and liquid interbank foreign exchange market, subject to prudential safeguards. *Derivatives* - Early liberalize derivatives transactions.	*Markets and systems* - Develop a deep interbank foreign exchange market - Introduce more active open market operations. - Develop the long-term public debt and equity market. *Prudential policies and risk management* - Strengthen prudential regulation and supervision, especially of banks' derivatives operations; introduce reporting on banks' foreign exchange dealings and oversight of banks' foreign exchange lending to non-banks. - Improve banks' risk management, particularly with respect to derivatives activities and corporate clients' foreign exchange exposures. - Preparations for new legal frame work for supervision, with an emphasis on supervisory independence. *Financial sector restructuring* - Foster orderly consolidation and privatization in the banking sector. - Provide supervisors with additional powers to foster bank mergers and restructuring. *Financial safety nets* - Cease lender-of-last-resort support to clearly insolvent institutions. All lender-of last-resort supports should be on a short-term and collateralized basis.
2. Stage 2: Consolidating reforms	
Capital inflows and outflows - Complete liberalization of inward and outward FDI, except for conditional investment sector. - Lifting restrictions on portfolio investment. - Ease restrictions on other money and capital market instruments.	*Prudential policies and risk management* - Continue to improve risk management. - Fully implement consolidated supervision of financial groups. - Increase the frequency and depth of on-site banking and insurance supervision. Hire and train needed personnel. - Fully implement arrangements for supervisory cooperation (both among different domestic supervisory agencies and with foreign supervisors). - Place stricter limits on insider trading. - Adopt new legislation strengthening the independence of all supervisory agencies. - Review and address other remaining deficiencies with respect to international supervisory standards. *Financial sector restructuring* - Continue consolidation and privatization in the banking sector, with all systemic problems to be solved during this stage. *Transparency* - Further strengthen the transparency of monetary and financial policies to reduce uncertainty of market participants, particularly non-resident investors.
3. Completing and reassessing liberalization and reforms	
Complete liberalization - Eliminating all remaining capital controls, including	*Market and systems development* - Review possibilities for further development and seek to identify emerging risks.

controls on short-term capital flows. - Maintaining prudential regulations (such as open foreign exchange position limits) to manage risks.	- Continue to develop multiple, redundant, and robust channels for transforming savings into productive investment, thus reducing reliance on bank intermediation. *Prudential policies and risk management* - With prudential policies now conforming in all important respects to international standards, seek to identify areas in which practices can be improved further. - Continue efforts by supervisors to encourage improved risk management by financial institutions. *Financial sector restructuring* - This process should be complete by the end of this stage, with no systemic threats remaining with respect to profitability, capital adequacy, liquidity, or asset quality.