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Financial market in developing countries: the raie of financial integration and globalization - The case of Vietnam

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Financial market in developing countries: the role of financial integration and globalization – The case of Vietnam

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List of abbreviations

ADB	Asian Development Bank
AFTA	Asian FTA
ASEAN	Association of Southeast Asian Nations
BIDV	Bank for Investment and Development of Vietnam
BOD	Board of Director
BOM	Board of Management
EU	European Union
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
GDP	Gross Domestic Product
HI	High Income
HNX	Hanoi Stock Exchange
HOSE	Hochiminh Stock Exchange
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
LI	Low Income
LMI	Low and Middle Income
NPL	Non Performing Loans
ROA	Return on Assets
SBV	State Bank of Vietnam
SME	Small and Medium Enterprises
SOCB	State owned commercial bank
SOE	State owned Enterprises
SSC	State Securities Commission
VAMC	Vietnam Asset Management Company
VAS	Vietnam Accounting Standard
VBMA	Vietnam Bond Market Association
VCB	Bank for Foreign Trade of Vietnam
VND	Vietnam Dongs
VSD	Vietnam Securities Depository
VSE	Vietnam Stock Exchange
WB	World Bank
WTO	World Trade Organization

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I. Introduction

Over the last years, the question of how well the financial sector contributes to the economic growth remains open for discussion. Whether the financial system contributes to the economic development or on the contrary, worse it is highly debatable. On the one hand, international financial flows are expected to enhance economic growth through augmentation of domestic savings, reduction in the cost of capital, transfer of technology from advanced to developing countries, and development of domestic financial sectors. Besides, better risk management, and improvements in both macroeconomic policies and institutions induced by the competitive pressures or the discipline effect of globalization could increase production specialization, thus boosting development. Furthermore, financial integration, in principle, should decrease volatility by to providing access to capital, reducing equity risk, smoothing consumption, and by creating a risk sharing mechanism between domestic and foreign parties. On the other hand, rising financial integration could also lead to a more vulnerable financial system through contagion effects, higher imperfections and could make the developing countries more dependent on external capital source. Financial integration is indeed blamed for increasing a country's vulnerability to international financial crises, which tend to occur during periods of sudden reversals in international capital flows.

These questions raise important issues both from a theoretical and a policy perspective. It is therefore hardly surprising that the number of contributions to the debate is high and growing. Despite a rich body of contributions, the empirical literature remained inconclusive with regard to the financial integration-growth, financial integration-volatility nexus. Empirical work has not confirmed a robust long-term impact of financial openness on growth. A long literature indicates that financial development has the potential to boost economic growth, raise financial and economic inclusion and increase a country's resilience to shocks. Gine and Townsen, 2004; Jeong and Townsend, 2007, 2008; Amaral and Quintin,2010; Buera et al., 2011; Greenwood et all., 2013 have found sizeable impacts of improved financial intermediation on aggregate productivity and income. King and Levine, 1993; Levin, 2005; support by empirical evidence the view that financial deepening spurs economic growth. Yet some studies concluded that "capital controls are essentially uncorrelated with long-term economic performance" (Rodrik (1998). Also, researchers have analyzed whether the growth impact of financial integration was conditional on third factors such as a sound institutional framework or income levels, but the results remained mixed as well (Edwards, 2001; Edison et al., 2002; Alfaro et. al., 2003; Klein, 2005). A balanced summary of empirical research on the issue has been given in a study by the research International Monetary Fund (IMF), one of the main proponents of capital account liberalization in the 1990s. It is so crucial to find the answer or at least to analyze the cause of each channel, the benefit and the limit of the financial integration in order to know how to and in what direction to develop the financial system.

This small personal project has an aim to investigate the financial market in Vietnam and determine whether the financial integration contributes to the development of the financial system in particular and to the economic development as the whole. The structure of this paper is as follows. In the first section, I briefly review the literature, present the benefits and limits, then some statistics about the financial integration and globalization and eventually some empirical evidences illustrating the link between financial integration-growth and financial integration-volatility. In the following parts (section 3), I relate and link these findings to the situation of financial market of Vietnam. In order to do this, first part shows data about main Vietnamese macroeconomic indicators and tries to link its trend to financial integration waves. Subsequently, the project provides deeper insights on the financial integration of Vietnamese financial system into the world capital market. The role of banking integration and financial market integration on economic growth and volatility are respectively examined in section 3.2. The last part concludes.

II. Financial integration and globalization

2.1 Definition and measurement

In the globalization era as we are living today, no single country could stay isolated in the strict term. The globalizing process, triggered by international trade and transactions came with capital and investment movements, migration and movement of people, and the dissemination of knowledge between nations. Financial integration became inevitable in this nested world.

Financial globalization, the integration of countries with the global financial system, has increased substantially since the 1970s and particularly with more force since the 1990s. In fact, the gold standard period of 1880-1914 saw a major wave of financial globalization, as cross-border capital flows surged, incorporating countries in the center into a worldwide network of finance and investment. With the advent of World War I, global growth halted and international financial integration was disrupted as barriers were erected, with minimal capital movements between 1914 and 1945. Although domestic financial markets remained heavily regulated and control were typically imposed on capital flows, a slow reconstruction of the world financial system took place during the Bretton Woods era of 1945-71. It was not until the late 1970s, however, that the world witnessed the beginning of a new wave of international financial integration, reflecting the dismantling of capital controls, the deregulation of domestic financial systems, and a technological revolution, not just in information and telecommunications, but also in financial product engineering. Newly emerging markets joined this wave of financial globalization, starting in the latter part of the 1980s and mostly in the 1990s.

According to Sergio L. Schumukler (2004) and Eswar Prasad et al (2003), financial globalization is an aggregate concept which is defined as global linkages through cross-border financial flows. Meanwhile, financial integration is a process through which a country opens its financial market to foreign parties, or integrate it with the international financial market. It leads to a situation in which capital or funds can move easily from this country to other countries, or vice versa. It implies the elimination of barriers for international financial intermediaries to operate in the country or to offer cross-border financial services to the country.

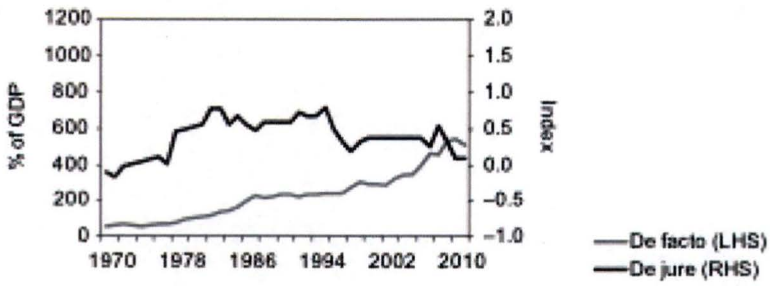
In general, these two concepts, financial integration and financial globalization, are relatively similar to each other so that in this paper, they are used interchangeably. It is measured *de jure* by the capital account liberalization, based on the official restrictions on capital flow as reported to the International Monetary Fund (IMF). A wide variety of such restrictions are currently in use, including price- and quantity-based controls on the international movement of capital, as well as restrictions on equity holdings by nonresidents. Indeed, the IMF reports more than 60 different types of such controls in its Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER). The inherent weakness of this approach is that counting capital controls gives us no information regarding the degree to which such restrictions are effective in limiting the extent of international capital flows.

The financial integration is then assessed by an actual measure (*de facto*) of financial openess based on the estimated gross stock of foreign assets and liabilities as a share of GDP. In many ways, such an approach constitutes an improvement over the legal approach, in that, what matters is not how open capital markets appear on paper, but how integrated they are in practice. However, such a measure raises the question as to whether gross or net financial flows constitute the more suitable measure, particularly since both tend to be volatile and often subject to procedural issues in their measurement.

2.2 Some facts about global financial globalization

We can see in the previous part how financial integration is measured. There are a number of paper trying to assess in reality and compare the degree of financial integration worldwide.

Figure 1: De Jure and De Facto Financial Integration in Emerging Asia



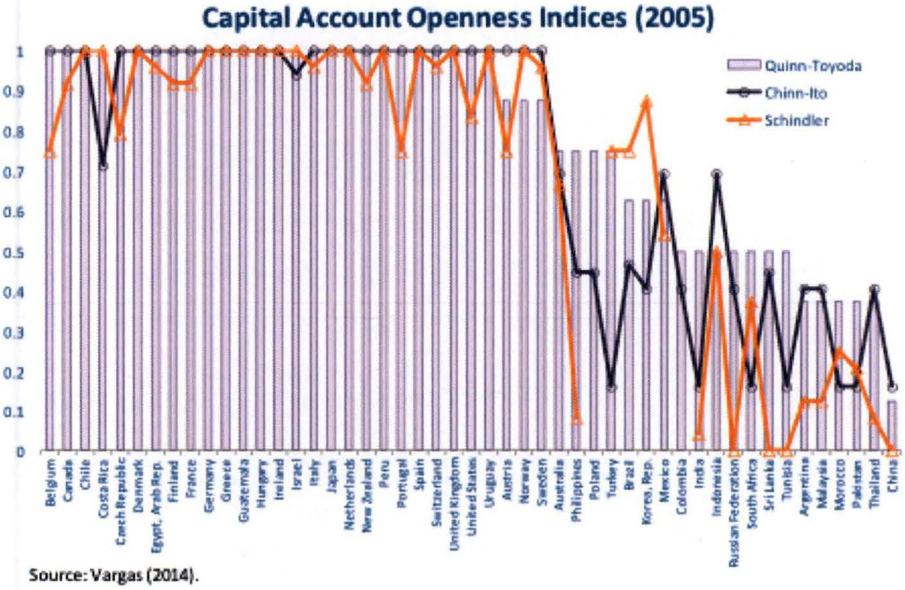
Source: ADB

The *de facto* (LHS = left hand scale) measure refers to the sum of foreign assets and liabilities expressed as a percentage of GDP. The *de jure* (RHS = right hand scale) measure refers to the estimated Chinn-Ito Index, which is based on the IMF's AREAER

As depicted in Figure 1, emerging Asia's *legal financial integration index* rose sharply during the late 1970s and early 1980s, reflecting the wave of financial deregulation that occurred across the region during this period. Although there were some adjustments to legal restrictions, the legal financial integration index remained high up until the late-1990s, the period just prior to the Asian financial crisis. The fall in the legal financial integration index around the time of the Asian financial crisis reflects increased foreign exchange interventions by Asian economies in the run-up to the crisis of 1997, as well as the introduction of capital control measures following the outbreak of the crisis. The emerging Asian countries sustained their post-Asian financial crisis controls overall, and even introduced additional controls during the global financial crisis of 2008.

Interestingly, the *actual* financial integration index for all emerging Asia shows a steady uptrend despite the declines that occurred in the legal financial integration index. This highlights the substantial *gap* between de facto and de jure measures of financial openness and integration. In short, the fact that numerous developing countries impose significant legal controls on the international movement of capital does not mean that such controls are particularly effective in curbing international capital flows. Actual financial integration—as measured by capital flows and cross-border financial asset holdings—may significantly exceed the level implied by corresponding legal controls.

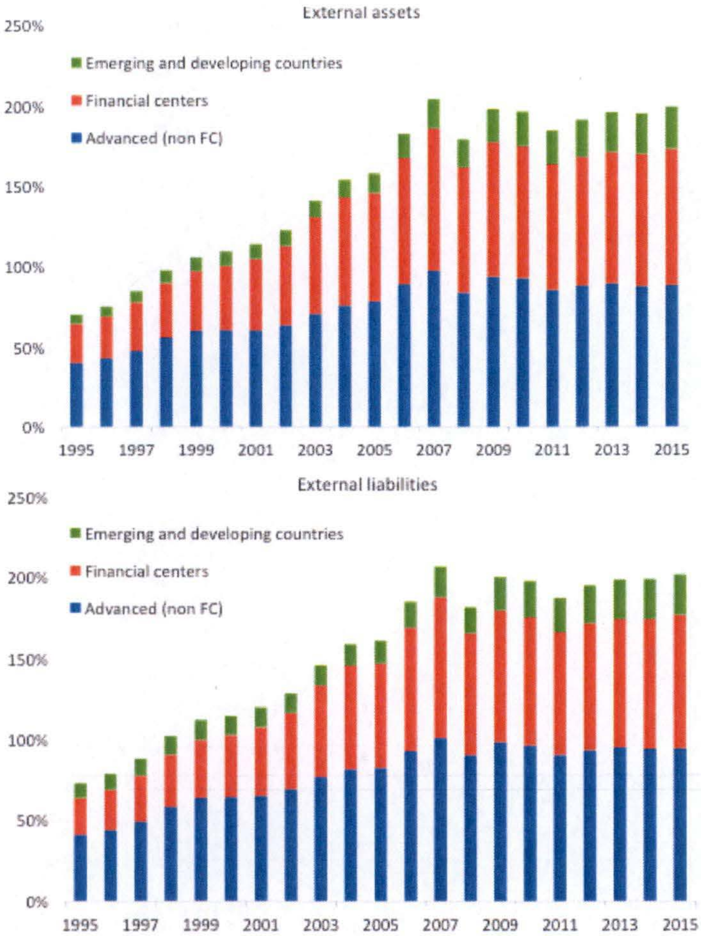
Figure 2: Capital Account Openness Indices



Source: Vargas (2014).

Regarding the degree of financial openess, the Figure 2 above shows the three de jure indices for 2005, the latest year for which all the three indices are available. All are scaled to a common zero-to-one range, where a larger number represents a higher level of capital control openness. The chart ranks the countries by their score on the Quinn-Toyoda index. The three indices show a substantial correlation and all put the ASEAN countries among the emerging market economies with less open capital accounts.

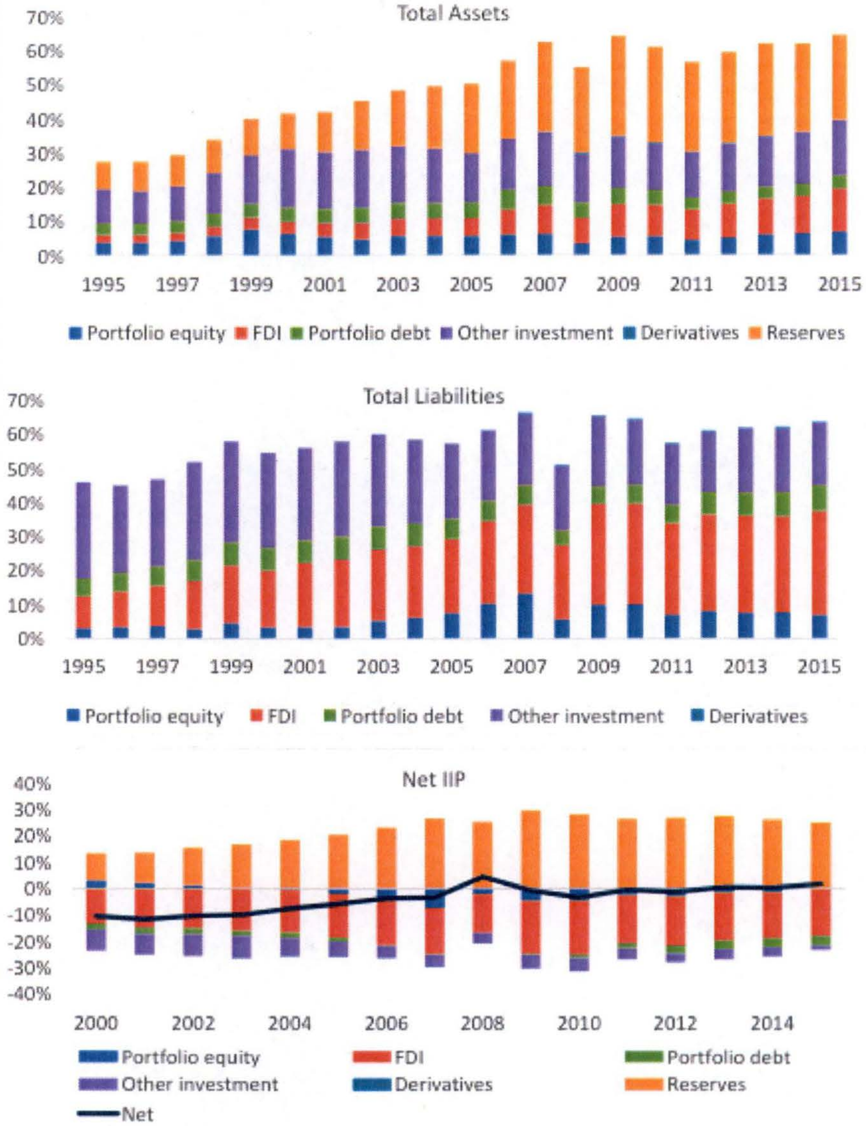
Figure 3: Global External Assets and Liabilities



Source: IMF (May 2017)
Financial centers: Belgium; Hong Kong S.A.R.; Ireland; Luxembourg; Netherlands; Singapore; Switzerland; and the United Kingdom, Mauritius and Panama, Bermuda and the Cayman Islands);
Other advanced economies: Australia, Austria, Canada, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Iceland, Israel, Italy, Japan, Korea, Latvia, Lithuania, New Zealand, Norway, Portugal, Slovak republic, Slovenia, Spain, Sweden, Taiwan province of China, United States
Emerging and developing economies: referring to Appendix 1, IMF Working paper 17/115

The figure 3 shows clearly a remarkable expansion in cross-border positions up to a peak in 2007, and then these have actually declined slightly in relation to world GDP. The figure shows the important role played by financial centers in the global expansion of cross-border positions. Emerging markets and developing economies account for a small, albeit growing share of cross-border holdings.

Figure 4: Gross and net external positions, emerging and developing countries, ratio of group GDP



Source: IMF Working paper 17/115

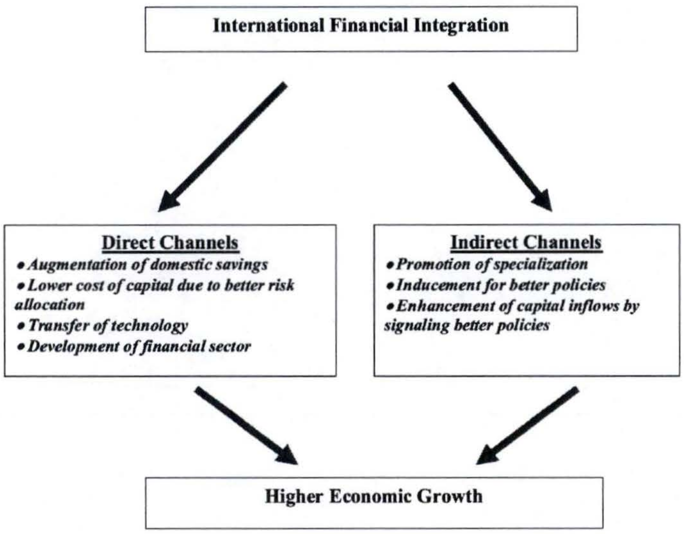
Figure 4 illustrates changes in external positions between 2000 and 2015 by type of instrument. We can see a low stock of external assets and liabilities when compared to the size of these economies (around 60 percent of GDP). Foreign exchange reserves are an important component of their external assets, and on the liabilities front the relative importance of debt instruments relative to equity instruments has been declining. Also, FDI accounts for the majority part of the liabilities of these emerging countries and its proportion increased overtime. The net position shows a trend improvement over time, notwithstanding a peak in the net position in 2008–09 driven by valuation effects, as these countries' currencies depreciated and stock market valuations declined sharply.

Briefly, we can see that emerging countries took part in this process of financial globalization. Although developing economies account for a small share of cross-border holdings, this share is growing overtime.

2.3 Potential benefits of financial globalization

In the previous section, we have referred to the concept of financial integration and how it is actually measured. The paper continues to discuss how financial integration could enhance economic performance. In theory, there are a number of direct and indirect channels through which financial globalization can help enhance growth in developing countries. These channels are inter-related in some ways.

Figure 5: Financial integration and economic growth



Source: IMF, Rogoff et al, 'Effects of Financial Globalization on Developing Countries: Some Empirical Evidence'

A. Direct Channels

2.3.1 Augmentation of domestic savings

The capital flows from a developed country to the less developed one allow for increased investment in capital-poor countries while they provide a higher return on capital than is available in capital-rich countries.

2.3.2 Reduction in the cost of capital through better global allocation of risk

Stock market liberalization improves the allocation of risk according to the International asset pricing models (Henry (2000a), and Stulz (1999a,b)). First, increased risk sharing opportunities between foreign and domestic investors might help to diversify risks. This ability to diversify in turn encourages firms to take on more total investment, thereby enhancing growth. Third, as capital flows increase, the domestic stock market becomes more liquid, which could further reduce the equity risk premium, thereby lowering the cost of raising capital for investment.

2.3.3 Transfer of technological and managerial know-how

Financially integrated economies seem to attract more FDI inflows, which have the potential to generate technology spillovers and to push on better management practices. These spillovers can raise aggregate productivity and, in turn, boost economic growth (Borensztein, De Gregorio, and Lee (1998), and G.D.A. MacDougall (1960) and Grossman and Helpman (1991).

2.3.4 Stimulation of domestic financial sector development

Increased foreign ownership of domestic banks can also generate a variety of other benefits (Levine (1996); Caprio and Honohan (1999)). First, foreign bank participation can facilitate access to international financial markets. Second, it can help improve the regulatory and supervisory framework of the domestic banking industry. Third, foreign banks often introduce a variety of new financial instruments and techniques and also foster technological improvements in domestic markets. The entry of foreign banks tends to increase competition which, in turn, can improve the quality of domestic financial services as well as allocative efficiency.

B. Indirect Channels

2.3.5. Promotion of specialization

In principle, financial globalization could play a useful role by helping countries to engage in international risk sharing and thereby reduce consumption volatility, and subsequently, the reduction in volatility may encourage countries from taking up growth-enhancing specialization activities (Brainard and Cooper (1968), Kemp and Liviatan (1973), Ruffin (1974), and Imbs and Wacziarg (2002).

2.3.6. Commitment to better economic policies

Financial opening can be self-sustaining and constrains the government from engaging in predatory policies in the future since the negative consequences of such actions are far more severe under financial integration (Gourinchas and Jeanne (2002).

2.3.7 Signaling

A country's willingness to undertake financial integration could be interpreted as a signal that it is going to practice more friendly policies towards foreign investment in the future.

2.4 Challenges of financial integration

Beside the potential benefits that financial globalization could generate to the economy, it can also entails important risks. As countries become more intertwined with the international financial system, developing countries are more dependent on foreign capital; plus, adverse shocks in foreign countries can be threats to domestic stability through contagion effects, potentially making countries prone to crises. Furthermore, financial globalization can pose challenges for management of external assets and liabilities, leads to the higher imperfection in the international markets and can make banks taking excessive credit. This all might lead to suggest that globalization generates financial volatility and crises. The higher frequency and higher amplitude of financial crises raised the importance of identification and control of these risks.

2.4.1 More dependent on foreign capital

The financial liberalization makes the country more dependent on foreign capitals. The shift of foreign capitals flows affects dramatically the economy and can create financing difficulties and economic downturns. These shifts do not necessarily depend on country fundamentals but also derives from macroeconomic conditions from developed countries, as mentioned by Eswar Prasad et al (2003). When developed countries face with economic downturns, they normally minimize their investments on developing countries. Calvo, Leiderman, and Reinhart (1996) argue that external factors are important determinants of capital flows to developing countries. Economic cyclical movements in developed countries, a global drive towards diversification of investments in major financial centers, and regional effects tend to be other important global factors.

Furthermore, a growing literature suggests that the procyclical nature of capital flows appears to have had an adverse impact on consumption volatility in developing economies. One manifestation of this procyclicality is the phenomenon of "sudden stops" of capital inflows (Calvo and Reinhart (1999)). More generally, access to international capital markets has a procyclical element, which tends to generate higher output volatility as well as excess consumption volatility (relative to that of income). Reinhart (2002), for instance, finds that sovereign bond ratings are procyclical. Since the spreads on bonds of developing economies are strongly influenced by these ratings, this implies that costs of borrowing on international markets are procyclical as well. Kaminsky and Reinhart (2002) present more direct evidence on the procyclical behavior of capital inflows.

2.4.2 Contagion effect

When a country integrated to the world economy, it is more exposed to international risks and shocks. It is also called the contagion effect through which the shocks are transmitted across countries. Sergio L. Schumukler (2004) tried to identify 3 channels of contagion: real links, financial links, and herding behavior or "unexplained high correlations".

a) Real links is associated with trade links. When two countries trade among themselves or if they compete in the same external markets, a devaluation of the exchange rate in one country deteriorates the other country's competitive advantage. As a consequence, both countries will likely end up devaluing their currencies to re-balance their external sectors.
b) Financial links exist when two economies are connected through the international financial system. One example of financial links is when leveraged institutions face margin calls. When the value of their collateral falls, due to a negative shock in one country, leveraged companies need to increase their reserves. Therefore, they sell part

of their valuable holdings on the countries that are still unaffected by the initial shock. This mechanism propagates the shock to other economies.

c) Finally, financial markets might transmit shocks across countries due to herding behavior or panics. A financial crisis as a branch of contagion is formed when "a co-movement occurs, even when there are no global shocks and interdependence and fundamentals are not factors. A typical herding behavior is asymmetric information. Information is costly, investors try to infer future price changes based on how other markets are reacting. This type of reaction leads to herding behavior, panics, and "irrational exuberance."

2.4.3 Higher imperfection in international financial markets

Globalization can also lead to crises if there are imperfections in international financial markets. The imperfections in financial markets can generate bubbles, herding behavior, speculative attacks, and crashes among other things. Imperfections in international capital markets can lead to crises even in countries with sound fundamentals. Imperfections can also deteriorate fundamentals. For example, moral hazard can lead to over-borrowing syndromes when economies are liberalized and there are implicit government guarantees, increasing the likelihood of crises, as argued in McKinnon and Pill (1997).

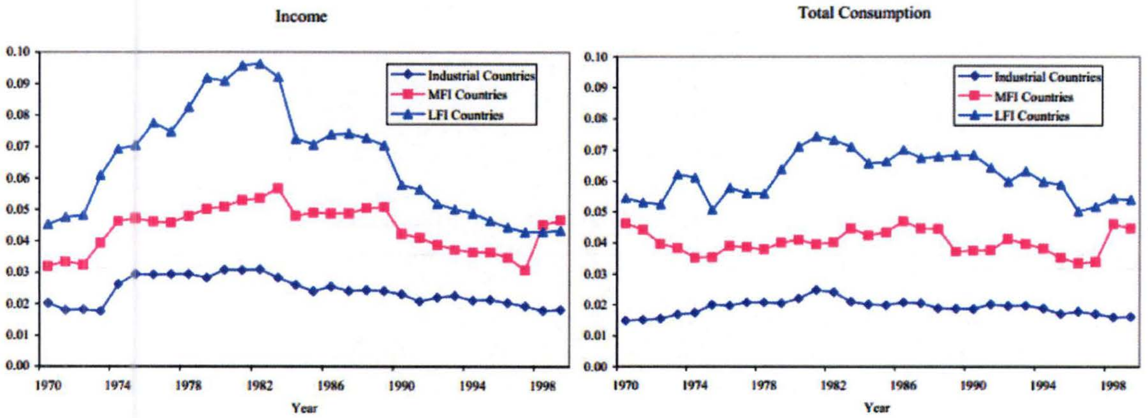
2.4.4 Excessive credit growth

Another risk of financial globalization is excessive credit growth, meaning that the globalization can lead to credit risks when developing countries can borrow excessively from the international capital market and expand lending to overly risky economic activities, according to Sergio L. Schumukler (2004). Philip R. Lane (2012) shares the same idea that financial globalization contributes to rapid domestic credit growth on both supply and demand sides. Because domestic banks can raise funds from the international market and foreign investors can also access the domestic market both through portfolio equity and FDI, the credit supply will increase. Regarding to the demand side, the increased capital inflows can lower domestic interest rate and improve the net worth of domestic borrowers by pushing up domestic asset prices so that the credit demand will increase. Therefore, although financial globalization can result in welfare-increasing factors through the availability of funds, the increase in investment, smoother consumption, etc… but it also leads to welfare-decreasing factors due to excessive growth in credit markets, over-borrowing distortions, or asset bubbles which are considered as a contributor of financial crises.

2.4.5 Higher volatility

Some empirical studies examined the impact of financial integration on volatility and proposed the threshold effect, meaning that financial integration at initial stage is often associated with greater volatility, the volatility is only reduced when the country attains a certain level of financial development. On one hand, financial integration helps to increase the access to capital, to reduce equity risk, to smooth consumption, and to create a risk sharing mechanism between domestic and foreign parties, so that financial globalization should theoretically reduce volatility. On the other hand, financial globalization can derive to an increasing specialization of production due to comparative advantages that can make the economy become more vulnerable to the shocks specific to industries (Razin and Rose, 1994). Besides, as mentioned above, financial globalization makes the domestic economy become more exposed to international crises, dependent on foreign capital, and can lead to excessive credit growth. Therefore, it can make the developing countries more volatile after financial liberalization, especially when these countries have under-developed financial systems in order to be able to regulate well their markets. O'Donnell (2001), Bekaert, Harvey, and Lundblad (2002), Kose, Prasad, and Terrones (2003a), Eswar Prasad et al (2003)..., all show that in industrial countries with developed financial systems, volatility is reduced through financial integration, but in developing countries, financial integration is often associated with higher volatility.

Figure 6: Volatility of Income and Consumption Growth



Source: Effects of Financial Globalization on Developing Countries: Some Empirical Evidence, 2003, by Eswar Prasad, Kenneth Rogoff, Shang-Jin Wei and M. Ayhan Kose.

From what mentioned above, we can see that financial integration could enhance economic performance but is probably subject to various risk. There is a growing literature trying to investigate the positive and negative features and want to conclude the net effect of this process.

2.5 Empirical evidences

The question whether financial globalization is a source of economic growth raise important issues from both a theoretical and a policy perspective. It is therefore not surprising that the number of contributions to the debate is high and growing. However, the empirical literature has not yet established a robust link between openness to the international capital market and economic growth. There are some empirical evidences showing the confusing effect on growth and volatility.

Table 1: Summary of Recent Research on Financial Integration and Economic Growth

Study	Number of Countries	Years Covered	Effect on Growth
Alesina, Grilli, and Milesi-Ferretti (1994)	20	1950-89	No effect
Grilli and Milesi-Ferretti (1995)	61	1966-89	No effect
Quinn (1997)	58	1975-89	Positive
Kraay (1998)	117	1985-97	No effect / mixed
Rodrik (1998)	95	1975-89	No effect
Klein and Olivei (2000)	Up to 92	1986-95	Positive
Chanda (2001)	116	1976-95	Mixed
Arteta, Eichengreen, and Wyplosz (2001)	51-59	1973-92	Mixed
Bekaert, Harvey, and Lundblad (2001)	30	1981-97	Positive
Edwards (2001)	62	1980s	No effect for poor countries
O'Donnell (2001)	94	1971-94	No effect, or at best mixed
Reisen and Soto (2001)	44	1986-97	Mixed
Edison, Klein, Ricci, and Sløk (2002)	Up to 89	1973-95	Mixed
Edison, Levine, Ricci, and Sløk (2002)	57	1980-2000	No effect

Source: IMF, Rogoff et al, 'Effects of Financial Globalization on Developing Countries: Some Empirical Evidence'

Table 2: Summary of recent research on Financial Integration and Volatility

Authors	Number of countries	Years covered	Effect on Volatility
Razin and Rose (1994)	138	1950-1988	No effect
Islam, and Stiglitz (2001)	74	1960-1997	Positive
Buch, Dopke, and Pierdzioch (2002)	25 OECD countries		No effect
Gavin and Hausmann 1996	Developping countries	1970-1992	Positive
O'Donnell 2001	93	1971-1994	Negative
Bekaert, Harvey, and Lundblad 2002		1980-2000	Negative in developped countries. Positive in emerging market countries

Source: IMF, Rogoff et al, 'Effects of Financial Globalization on Developing Countries: Some Empirical Evidence'. Positive: means High level of integration leads to an increase of volatility

We can see that the effect of financial integration on both economic growth and volatility is not conclusive. As opposed to the theoritical benefit of reduction of volatility, financial intergration is rather more accompanied by increased vulnerability to crises, and has potential of amplifying the effect of real and financial shocks.

This confusing effect opens the question why we observe such different results. Do the divergence remains on the inherent differences between countries ? Do domestic factors are of major importance? Or among the other things, the innefficient regulatory and supervisory system in emerging markets leads to a more volatile financial system? The effects of financial globalization are likely to vary across countries. Furethermore, this variation arises not only from the depth of globalization achieved by a country but also from the speed of integration and the timing at which it happens. From this perspective, I'm trying to provide an comprehensive report on the experiences of an individual country, Vietnam, with their process of financial integration.

III. Financial integration in Vietnam

3.1 Macroeconomic background

3.1.1 Vietnamese economic integration into the world

From the previous sections, we can have an overview of financial integration, how countries differ in financial openness degree, and through which channels it could affect the growth and volatility. It make me think to the financial situation of my country, Vietnam and inspire me to further my research on the link between financial integration and economic growth. Do financial globalization enhance Vietnamese economic growth or worse it? Does financial integration accelerates the volatility or helps stabilize the Vietnamese system? Do the negative or positive effect of financial integration prevail?

In 1986, Vietnam conducted a comprehensive and radical reform in all areas, economy, politics, and society. From this year, the country moved from centrally planned economy to market oriented economy, and Vietnamese economy started to grow. However, at that time, the financial market in Vietnam was still immature, with a mono-bank system; the state-owned banks functioned as both commercial banks and central bank. Financial operations were extremely simple; banks mobilized deposits from residents and domestic companies, then provided credit only to state-owned companies.

During the 1990s, Vietnam became integrated into the global economy. Vietnam has gradually joined international organizations and economic institutions as well as cooperated with other countries for mutual development. Vietnam re-joined the World Bank (WB), International Monetary Fund (IMF) and Asian Development Bank (ADB) in 1992 and 1993. The year 1995 saw many significant external economic events. Vietnam joined the ASEAN and committed to implement the ASEAN Free Trade Area (AFTA), signed a Cooperative Agreement with the European Union (EU) and normalized relations with the US and applied for WTO membership. In 1998 Vietnam officially became a member of the Asia Pacific Economic Cooperation (APEC)". Most significantly from the international integration, after eleven years of negotiation, in 2007 Vietnam became the official member of the world trade organization (WTO)-the world's biggest trade organization. Since then, Vietnam has fully joined in the globalization process.

Table 3: Foreign Trade Agreement (FTA) of Vietnam

Year	FTAs
	Signed
1995	ASEAN (AFTA)
2001	Viet Nam – US Bilateral Trade Agreements
2004	ASEAN – People Republic of China FTA (ASEAN – PRC FTA)
2006	ASEAN – Korea FTA (ASEAN – KOR FTA)
2007	*Viet Nam Joining the WTO*
2008	ASEAN – Japan
2008	Viet Nam – Japan
2009	ASEAN – Australia/New Zealand (AANZFTA)
2009	ASEAN – India (AIFTA)
2012	Viet Nam – Chile FTA (VCFTA)
2014	Viet Nam – Customs Union of Russia – Belarus - Kazakhstan
2015	Viet Nam – Korea FTA (VKFTA)
2015	Viet Nam – Eurasian Economic Union (EAEU) FTA
	In negotiation
	+ ASEAN – EU
	+ Trans Pacific Partnership (TPP)
	+ Viet Nam – European Free Trade Agreement (EFTA)
	+ Regional Comprehensive Economic Partnership Agreement (RCEP) (ASEAN+6)

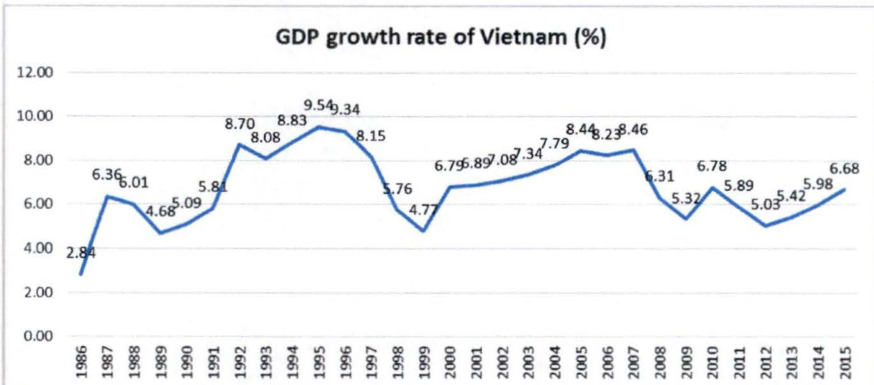
Source: Country report: 15 years achieving the Vietnam Millennium Development Goal

3.1.2 Macroeconomic indicators and the role of financial integration on the economy

3.1.2.1 GDP growth rate

Vietnam development record over the past 30 years is remarkable with strong economic growth. Since 1990, Vietnam's GDP per capita growth has been among the fastest in the world, averaging 6.4 percent a year in the 2000s.

Figure 7: GDP growth rate of Vietnam



Source: World Bank

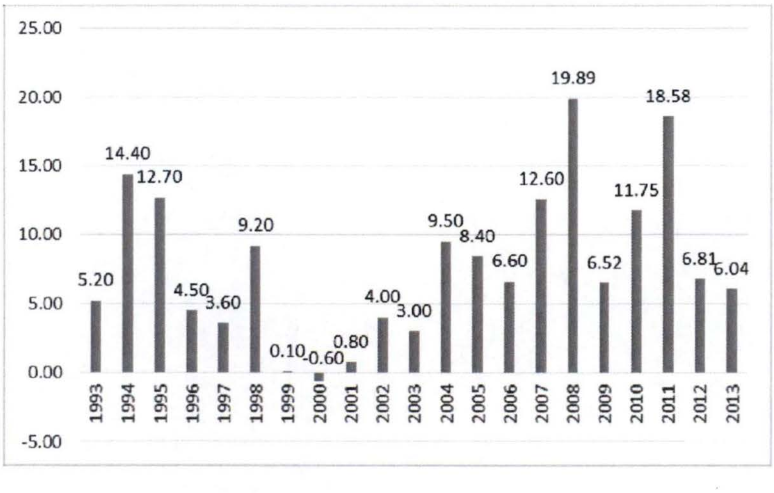
However, it is unclear that the strong economic growth is derived from financial integration, or from the general economic integration, or it is due to various reforms that the country conducted during the same period or due to the combination of these reasons. This paper cannot measure exactly how much the financial integration and globalization contributed to the development of Vietnamese economy, the idea is to try to show how the economy evolved since the country integrated in the international financial market.

As can be seen in the figure 7, before 1986, GDP growth rate stood at around 2%. Due to the economic reform launched in 1986, GDP growth rate then increased sharply and gradually to more than 6% in the late of 1980s. The economy was in its heyday since the country integrated in the global economy from the early of 1990s with GDP peaking at 9.54% in 1995. From 1990 to 2015, the average GDP growth rate of Vietnam was round 7%, among the fastest in the world. We can see that trade and finance liberalization moments coincide with the booming of the economy. Financial integration, more or less, contribute to the economic growth.

Also from the figure 7, GDP growth rate experienced 3 period of slowing down, in 1898, 1997 and 2008. These collapse of the economy once again confirms the negative effect when country opens its economy to the world. When a country integrates in the international financial market, it becomes exposed to international shocks and crises. It is through the contagion effect that the shocks can be transmitted from foreign countries to the domestic economy. Due to the collapse of the Soviet Union, important trade partner of Vietnam, in 1989, Vietnamese manufacturing was badly affected, and the growth rate of GDP slowed down, at 4.7%. Significant slowdowns were seen in 1998. Most observers have argued that the 1997 regional crisis was directly responsible for the slowdowns in GDP growth in 1998-1999. From 1997, the economy was strongly affected by the regional financial and monetary crisis that hit most of the economies of Southeast Asia that year. As a result, economic growth from 1998 to 1999 decreased to half what it was from 1995 to 1996. The economy has deflated, markets have stagnated, and products cannot be sold. Similarly, Vietnam is not exempted from the global crisis of 2008. The external shock from the global crisis 2008 has exposed serious structural weaknesses in Vietnam's economy. Directly, Vietnam has been affected by the global financial crisis due to its exposure to international financial markets. Furthermore, Vietnam is affected indirectly through trade, FDI and financial capital movement, which consequently affect the overall economic growth.

3.1.2.2 Inflation

Figure 8: Inflation of Vietnam, 1993-2013



Source: General Statistic Office of Vietnam.

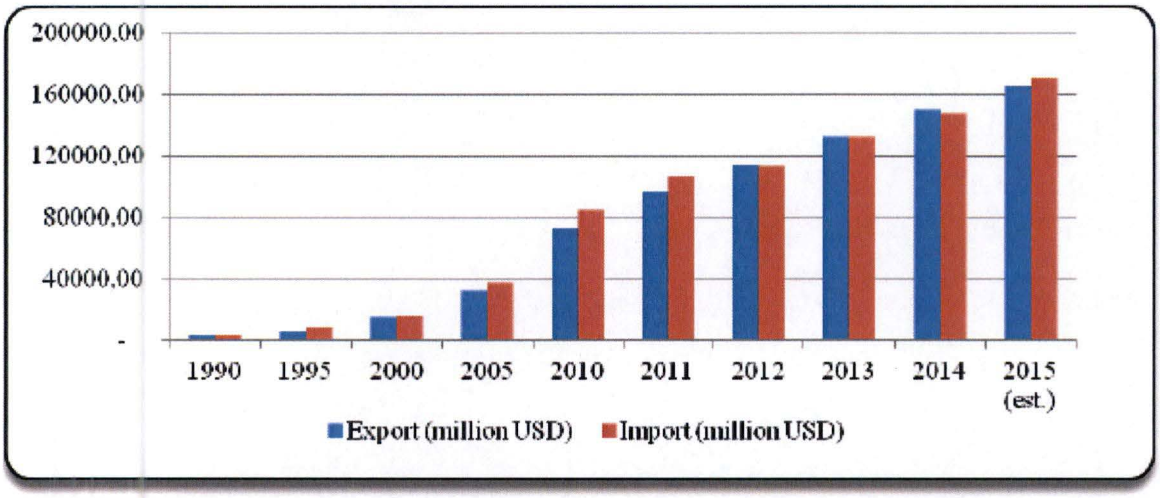
Figure 8 shows that inflation fluctuated widely in Vietnam from 1996 to 2016. In 1998, due to the impact of Asian financial crisis, inflation rate nearly doubled, from 3.2% in 1997 to 7.2% in 1998. Similarly, during the global financial crisis in 2007, inflation rate in Vietnam also increased significantly from 8.3% in 2007 to its peak, 23.1% in 2008. Joining the WTO in 2007 led to a period of ever deepening integration, increasing trade exchange and international investment, and making a strong rise in capital influx (both direct and indirect investment). Demand for VND stability required State Bank of Vietnam to sterilize a large amount of foreign currency, thus contributing to high inflation in 2008. Overall, macro-control in this period proved embarrassing. These factors, together with the tremendous impact of the world economic crisis made the economy suffer a period of low economic growth and high inflation from 2008-2009.

3.1.2.3 Trade volume

From the perspective of trade, typically, a country's degree of financial integration tends to increase with its degree of trade integration. Overall, FTAs have brought about positive impacts on Vietnam's economic development, including a surge in the amount of trade (both import and export) and inflows of FDI. By advocating economic integration, trade reforms have gradually removed import tariff barriers, progressive deregulation of trade regimes and relaxation of restrictions on entry to trading activities. The average weighted tariff rate dropped from 20% in early 1990s to around 15% in the early 2000s prior to accession to the WTO. In turn, with WTO accession, Vietnam has had to reduce its tariffs on industrial products by 13% on average, on agricultural products by 21% over 3 to 5 years.

Figure 9 represents Vietnam's export and import value in millions of USD over the period 1990 – 2015. Exports have grown 62 times while imports 53 times. However, trade deficits occurred during most of this time, except for some years where marginal trade surpluses were recorded. Notably, trade deficits have been quite high since 2005 and have enlarged due to growing demands of foreign investment and domestic demand for production inputs (i.e. are driven by capital account surpluses). Although the country's trade balance remains in deficit, imports and exports show positive trends in relation to the ratio of non-oil exports to total exports. This ratio has steadily increased.

Figure 9: Vietnam's import-export data in the period 1990 - 2015

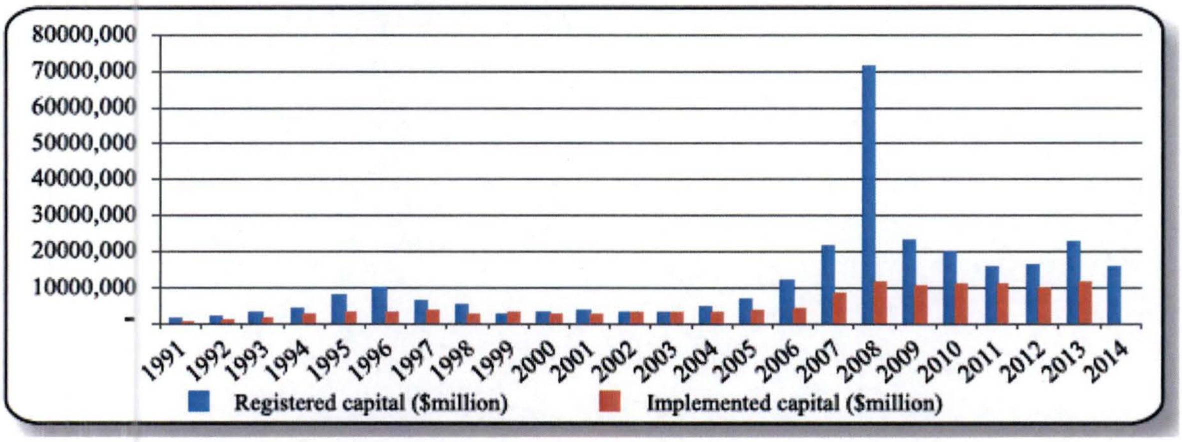


Source: Country report: 15 years achieving the Vietnam Millennium Development Goal

3.1.2.4 Foreign direct investment

Among the different channels of financial globalization, FDI is considered as providing more types of benefits than other capital flows. Because it embodies technology and know-how as well as foreign capital, FDI can benefit host countries through knowledge spillovers as well as linkages between domestic and foreign firms. Potential positive effects include productivity gains, technology transfer, exposure of domestic firms to new processes, managerial skills and know-how, enhancements to employee training, development of international production networks, and broader access to markets. When new products or processes are introduced to the domestic market by foreign firms, domestic firms may benefit from accelerated diffusion of new technology. In some cases, this might occur simply by domestic firms observing foreign firms, or in other cases through labor turnover as employees hired by foreign firms move to domestic firms. These benefits together with direct capital financing suggest an important role for FDI in modernizing national economies and promoting economic development. Moreover, though net FDI flows to Vietnam do exhibit fluctuations, they have consistently been positive during the past three decades.

Figure 10: FDI capital registered and implemented during 1991-2014 (million USD)



Source: Country report: 15 years achieving the Vietnam Millennium Development Goal

The period from 1991 to 2017 witnessed different phases of FDI inflows to Vietnam (Figure 10). From 1991 to 1996, FDI to Vietnam went up continuously and rapidly, with newly registered capital reaching a peak of nearly USD 10 billion in 1996. This increase in FDI during this period resulted partly from the expectations held by foreign investor of a newly-opened economy with a large consumer market as well as from attempts of foreign enterprises to penetrate Vietnam's market in the presence of massive import controls. Also, implemented capital went up in absolute terms, but accounted for a decreasing share of registered capital. As a key reason, while this period marked the start of FDI inflows to Vietnam, foreign investor just wanted to register their capital to invest rather than actual flow capital to Vietnam.

The years from 1997 to 1999 saw a sharp fall in FDI inflows to Vietnam, mainly as a result of the East Asian financial crisis and the less attractive investment environment of Vietnam relative to other regional ones. Newly-registered capital decreased on average by 34 percent per annum. Implemented capital went down more slowly, by 3.5 percent per annum on average due to the increase in implemented capital since 1997.

In subsequent years from 2000 to 2003, FDI inflows to Vietnam were quite stagnant. Total registered capital fluctuated in the range of USD2.8 billion – USD 3.2 billion. During this same period, implemented capital of FDI projects in Vietnam increased slightly from over USD 2.4 billion to over USD 2.6 billion. Since 2004, FDI inflows into Vietnam began to increase. The large surge in FDI inflows can be attributed to the improved investment environment after passage of the revised Foreign Investment Law, and the granting of permission by the Government to foreign entrepreneurs to invest in some previously State-monopolized industries, e.g. electric supply, insurance, banking, telecommunications.

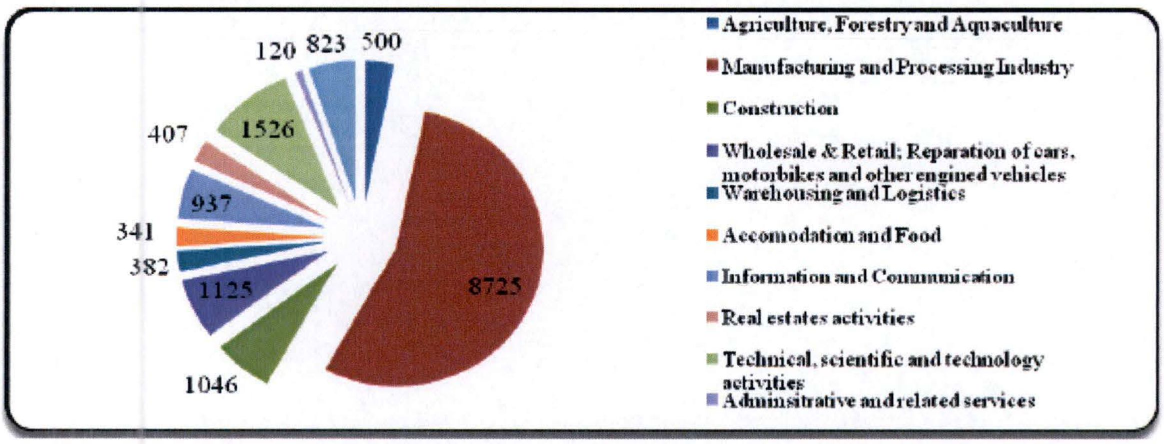
In particular, the WTO accession in 2007 enhanced the growth prospect of Vietnam, leading to a faster surge in FDI inflows to the country. First, due to the removal of some preferential treatment statutes on foreign investment in the revised Foreign Investment Law in 1996, the number rose dramatically. Total registered capital went up even more quickly, from over

USD 4.5 billion in 2004 to above USD 12 billion in 2006, before peaking at USD 71.7 billion in 2008. Similarly, implemented capital increased more rapidly than in previous years, to US$4.1 billion in 2006, and USD 11.5 billion in 2008, as compared to about USD 2.8 billion in 2004. More importantly, unlike previous years, FDI attraction in 2008 was characterized by presence of many large projects, each of which has billions of USD in registered capital.

Due to the negative impact of the global financial crisis and Vietnam's domestic economic downturn since late 2008, the pace of new FDI registration and the implementation of several FDI projects, particularly large ones, slowed significantly. The number of projects fell dramatically. Total registered capital went down even more sharply, reaching only over USD 23.1 billion in 2009 and USD 15.6 billion in 2011. Implemented capital decreased more slowly, to USD 10 billion in 2009 and around USD 11.0 billion in 2010-2011. Thus, the share of FDI as part of total investment in Vietnam went down to only 25.7 percent in 2009, despite a minor recovery to 25.9 percent in 2011.

We can clearly see that financial integration, degree of openness of the countries affect dramatically the capital inflows into the country in form of FDI. The fluctuations of FDI is procyclical in Vietnam. For more details on FDI, figure 11 shows key sectors attracting investment are manufacturing and processing industries, construction and technical activities, and scientific and technology activities.

Figure 11: Total value of FDI accumulation by 2013, disaggregated by key sectors



Source: Country report: 15 years achieving the Vietnam Millennium Development Goal,

In summary, the financial globalization contributed greatly to the enhancement of economic performance, higher GDP, trade volume, low inflation and higher FDI inflows in time of expansion but affected severely the economy in time of recession. However, it is unfair to say that the globalization process did not have a positive impact on economic growth. Since Vietnam integrated to the world, trough trade and financial linkages, the economic performance did obviously increased.

3.2 The financial integration and their role on the growth and volatility

After investigating the macroeconomic indicators, we can see that liberalization goes on par with the economic growth but at the same time, accompanied with the vulnerability of the economic system. The paper now goes deeper into the financial structure of Vietnam, how and at what degree banks and financial market integrated in the world capital market and how this integration affects the whole system.

3.2.1 Overview of Vietnamese financial system

3.2.1.1 Evolution of financial market

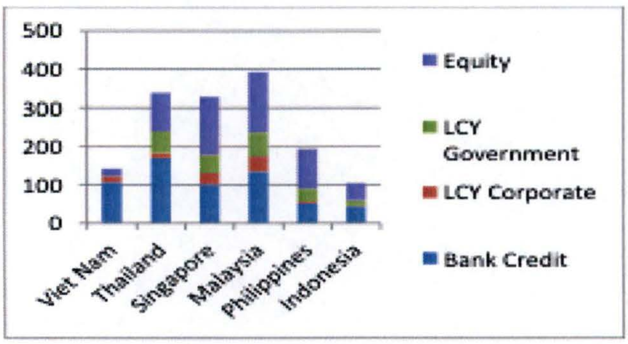
In May 1990, the government issued a new banking law which consisted of two decrees: one regulated State Bank of Vietnam (SBV), which is the central bank of Vietnam, and the other regulated commercial banks. Beside four state-owned commercial banks, joint stock commercial banks were established in Vietnam from 1992. Since then, the country liberalized its financial market to the international financial market, Vietnamese financial market started to develop properly. The banking system extended credit to all economic sectors. In addition, new legislation for non-bank financial institutions such as insurance companies, financial companies, leasing companies, etc... was issued in the second half of the 1990s.

In July 2000, the stock market was established in Vietnam. This was a milestone in the development of financial market in Vietnam. Capital flows moved more easily both within the country and across borders. Financial integration became deeper and wider, and the financial market as well as the whole economy achieved impressive accomplishments. The evolution included the establishment of a State Securities Commission (SSC) in 1996, opening of Ho Chi Minh Stock Exchange (HOSE) in 2000 and Hanoi Stock Exchange (HNX) in 2005, launch of Vietnamese Securities Depository (VSD) in 2006 and Vietnam Bond Market Forum (current Vietnam Bond Market Association, VBMA) in 2006, enactment of Law on Securities in 2007, and introduction of transaction system of government bonds at the HNX in 2009. The derivative market was recently opened, in August 2017.

3.2.1.2 Overview of financial structure and financial deepening of Vietnam

Vietnamese financial system is large for a middle-income country but still small compared to some peer ASEAN countries. The Vietnam's financial system remains bank-centric and dominated by state-owned banks, while non-bank financial institutions are relatively small.

Figure 12: Financial sector assets to GDP, in 2013

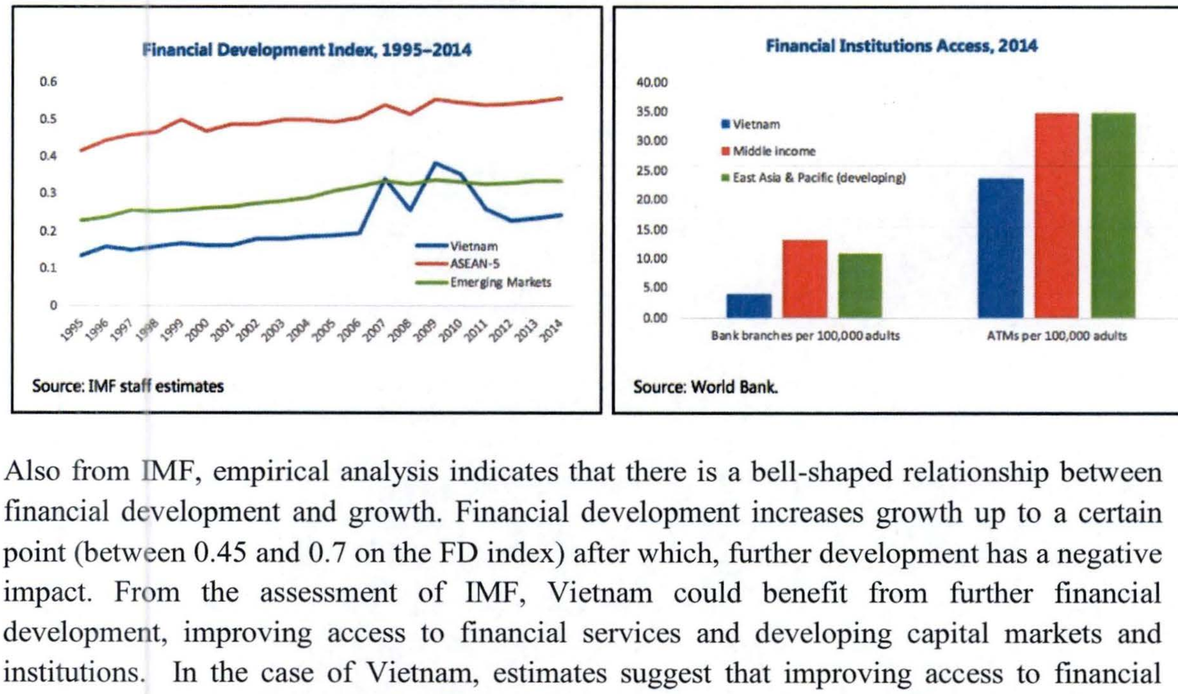


Source: ADB

Figure 12 shows clearly that compared to other peer Asean countries, the bank credit was the main source of funding in Vietnam, while equity market accounted for the majority of the financing source in Singapore, Malaysia and Phillipines. According to the Vietnamese National Financial Supervisory Commission report in 2016, banking sector accounted for more than 96% of the financial sector assets; insurance companies: 2,8%; and securities and fund management companies: 1%. The banking sector is large, but non-banking financial institutions remains small. Non-banking financial institutions (including cooperatives) account for only 8% of financial institution assets.

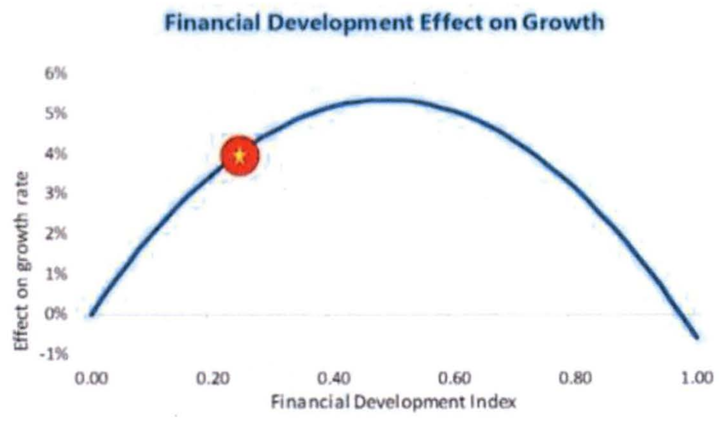
According to the IMF country report in 2017, Vietnam's financial sector development has improved during the last two decades but remains below emerging markets. The Financial Development Index (developed by the IMF) illustrates that **Vietnam's financial depth and efficiency are at its peers' level for both institutions and markets** (Figure 13). However, access to financial institutions is low, due to the relatively small amount of bank branches and ATMs per capita (respectively 4 and 24 per 100,000 adults).

Figure 13: Financial development index



Also from IMF, empirical analysis indicates that there is a bell-shaped relationship between financial development and growth. Financial development increases growth up to a certain point (between 0.45 and 0.7 on the FD index) after which, further development has a negative impact. From the assessment of IMF, Vietnam could benefit from further financial development, improving access to financial services and developing capital markets and institutions. In the case of Vietnam, estimates suggest that improving access to financial services to individuals and SMEs could help boost growth by an additional percentage point each year (Figure 14).

Figure 14: Financial development effect on growth



Source: IMF staff estimates.

3.2.2 The role of banking integration on the economic growth and volatility

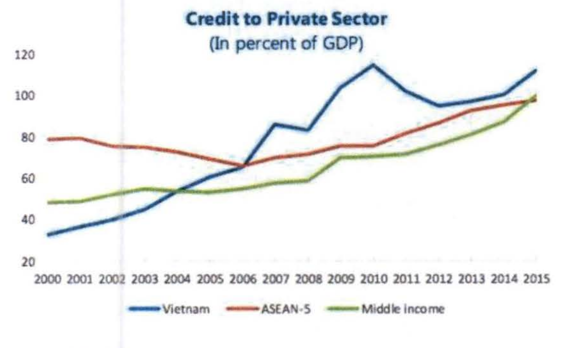
After investigating the financial structure and financial deepening of Vietnamese system, the paper proceeds to examine the role of financial integration on the growth. As banking system remains at the heart of financial structure, the role of banking system integration is crucial for the growth of the whole financial system as well as of the economic growth. In short, integration helps develop a strong and diversified financial intermediation system, opens markets opportunities abroad, favorizes the transfer of technology and management techniques, promotes innovation and enhance governance, and leads to better regulatory practices.

3.2.2.1. Positive effect

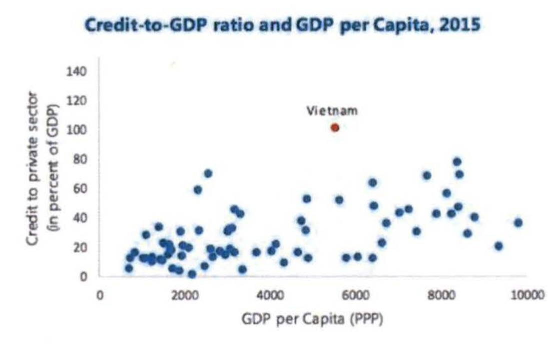
a) Strong and diversified system

Vietnam's rapid economic development during the last decade reflects rapid growth in bank credit, including to the private sector. Credit growth has averaged 24%in the last ten years. On average, the credit-to-GDP ratio expended by 4.8 percentage point per annum between 2000 and 2015 and reached 124% of GDP at end-2016, exceeding the ASEAN-5, other middle income countries, and significantly exceeding countries at similar levels of development. It shows the capacity of the financial system to provide financial resources to meet the need of firms, households and individuals. This reflects the rapid evolution of financial market in Vietnam over the period which stemmed from the liberalization of the financial market from 1990s.

Figure 15: Credit to private sector and credit to GDP ratio and GDP per capita



Source: World Bank.



Sources: World Bank; and IMF staff estimates.

In addition, the opening up and integration in the banking sector allow domestic and foreign commercial banks to run business, compete and grow. By the end of 2015, the commercial banking system of Vietnam has had a strong and diversified development, with the form of state commercial banks, joint stock commercial banks, joint venture banks and foreign bank branches. Many foreign banks (the majority come from Asia) have opened 100% foreign-owned banks in Vietnam, including ANZ, Hong Leong, HSBC, Shinhan, Standard Chartered, CIMB, Public Bank Berhad, and Woori Bank.

Table 4: Banking system by type of banks

Banks	2012	2013	2014	2015	2016
State commercial banks	2	1	1	1	4
Joint-stock commercial bank	38	38	38	37	31
Commercial joint venture bank	5	4	4	4	3
Commercial banks with 100% foreign capital	5	5	5	5	5

Source: State Bank of Vietnam

However, the foreign investor's ownership permitted by Vietnam's banking sector still remains low compared with other top-ranked countries in the region (20% for Vietnam, 25% for Thailand, 30% for Malaysia, 40% for Indonesia, 100% for the Philippines and Singapore). Increase in foreign investor's ownership would create more opportunities for foreign investors to be involved in the Vietnamese market, as they could invest in a domestic bank with a certain level of control rather than having to establish a wholly foreign owned bank. This measure will help to increase the capital of Vietnamese commercial banks, establishing a firm basis for enlarging their business in domestic and foreign markets. Moreover, a higher capital adequacy ratio increase the bank's ability to respond to negative shock.

b) Market opportunities

International economic integration opens up a market opportunity for Vietnamese commercial banks to operate abroad. Vietnamese commercial banks have the opportunity to access capital, technology, experiences and management level of the commercial banks in the world. In the period 2011 - 2015, commercial banks (such as BIDV, VCB, Vietin bank) have pioneered the export of banking, securities and insurance services to foreign markets. Next is the representative office, branch. Up to now, there are more than 20 branches and representative offices of Vietnamese commercial banks in foreign countries. By the end of 2015, commercial banks in Vietnam have 11 investment projects to establish branches / joint venture banks abroad (Table 5).

Table 5: Projects abroad of Vietnamese commercial banks

Date range	Bank	Receiving country invest	Total estimated capital (USD)	Total Vietnamese Capital (USD)	Profit before tax in 2015 (million dollars)
08/02/2012	BIDV	Laos	70.000.000	45.500.000	15.2
14/08/2009		Campuchia	70.000.000	70.000.000	-
10/03/2010	Agribank	Campuchia	39.000.000	39.000.000	-
07/12/2010	MB	Laos	12.000.000	12.000.000	1.3
07/12/2011		Campuchia	39.000.000	39.000.000	-
18/08/2011	Sacombank	Campuchia	38.000.000	38.000.000	1.7
20/12/2012		Laos	38.000.000	38.000.000	4.1
19/10/2011		Campuchia	39.000.000	39.000.000	2
14/05/2012	SHB	Laos	13.000.000	13.000.000	-
19/10/2011	Vietinbank	Laos	22.000.000	22.000.000	-
28/06/2012		Germany	65.500.000	65.500.000	-

Source: Ministry of Planning and Investment, Annual report of banks in 2015

At the same time, it opens up opportunities for commercial banks to seek foreign strategic shareholders in order to overcome the limitations on financial capacity, governance and competitiveness to improve service quality, business performance. In the last 10 years, many Vietnamese banks have selected large foreign financial institutions as their strategic shareholders (Table 6).

Table 6: Strategic foreign shareholders in Vietnamese commercial banks

Bank	Foreign strategic shareholder	Initial investment time	Share ownership ratio
ABBank	Maybank	03/2008	20%
ACBank	Standard Chartered	06/2005	15%
Techcombank	HSBC	12/2005	20%
Eximbank	SMBC	11/2007	15%
Sacombank	Macquarie Capital	11/2011	14%
Vietcombank	Mizuho	09/2011	15%
Southern Bank	UOB	05/2007	15%

Source: State Bank of Vietnam

c) Transfert of technology and management techniques

Financial integration gives banks access to technology transfer and modern banking management techniques. At most joint-stock commercial banks with foreign ownership of over 5%, foreign experts are in charge of such important positions as Techcombank, VIB. The opportunity to work with experts, senior managers in the bank will help transfer technology, skills and good management skills to Vietnamese bank managers. In addition, many domestic commercial banks have hired foreign consultants to provide consultancy packages focusing on: Strategic Planning, Business Planning, Risk Management, Human Resource Management, Evaluation service quality.

In addition, many commercial banks have applied modern software systems to manage the banking system such as core-banking system, customer management system CRM to constantly improve service quality. Compared to the time before equalization, state-owned commercial banks, including VCB, BIDV and Vietin bank, had a clear change in both quality and quantity.

d) Promote innovation and enhance governance

Furthermore, integration created motivation to promote innovation and enhance transparency, publicity, governance and self-responsibility of the system of Vietnamese commercial banks in accordance with international standards, thereby improving the operating efficiency in the field of currency and banking. As the rate of foreign ownership in commercial banks increases, it means that State owned commercial banks (SOCB) must standardize governance, accounting and finance in line with international practice, standards of transparency and publicity.

Most commercial banks, when listed on the stock market, had to convert their accounting systems into international standards (IFRS), in addition to the Vietnamese Accounting Standards (VAS). This is indispensable when commercial banks have a need to list on the international market. Accordingly, a number of large commercial banks have also hired valuation organizations, international ratings to credit rating. Public ratings by international organizations will open up opportunities to penetrate international markets in the context of integration of Vietnamese commercial banks.

e) Better regulatory pratices

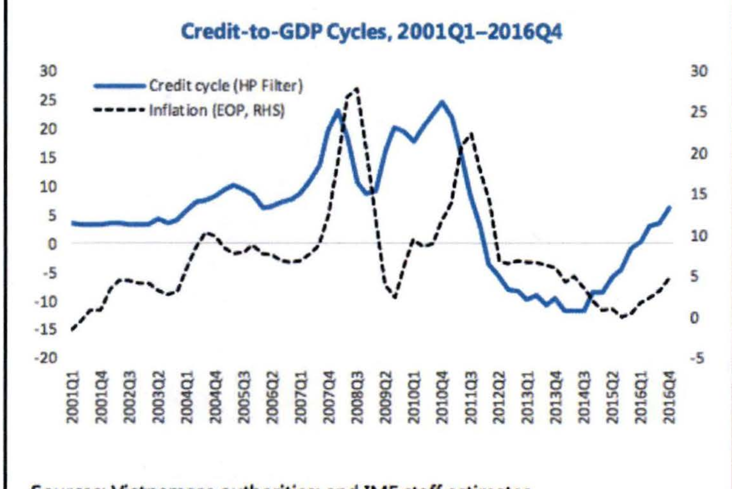
Fifthly, integration requires a better regulatory environment to implement international commitments, leading to a more attractive investment climate. Financial integration requires Vietnamese banks to operate under the international standards on risk management and corporate governance. The banks should increase the transparency and accountability of the bank with customers and of the board of directors (BOD) and managers (BOM) with shareholders. In return, it forces the BOD and BOM to act in the interest of shareholders, customers, increasing the trust from customers and partner to keep their market share from highly competitive foreign banks. Corporate governance in the Vietnamese banking system seems rather poor as cross-ownership issue has not been thoroughly treated but it need to be improved to face the more competitive global market, in the context of increasing integration.

In banking sector, Vietnam is also moving towards international standards of risk management. SBV adapts its regulation relating to risk management in light with Basel requirements. Furthermore, from 2005 to 2010, SBV regulated the minimum capital requirement (or Capital Adequacy Ratio – CAR) for banks by 8% under Basel recommendation, then due to the international financial crisis in 2008 and the increasing risks in the domestic financial market, SBV even increased the minimum CAR to 9% by Circular 13/2010/TT-NHNN in 2010. Moreover, although SBV replaced Circular 13/2010/TT-NHNN by the new one, Circular 41/2016/TT-NHNN in 2016 to apply Basel II for the whole banking system, some domestic banks started to study and apply Basel III, the newest standards issued in 2011 with the transition period up to 2019, within their banks. It can demonstrate that Vietnam's banking sector has taken significant steps to comply with Basel II requirements.

3.2.2.2 Unfavorable impact on growth and volatility

Unfortunately, the performance of the banking sector has deteriorated in recent years and this definitely had an adverse effect on the growth and contributed to a higher volatility. Past credit cycles led to a deteriorating quality of bank balance sheets and a higher inflation. The most recent ones, in 2008 and 2011, were characterized by large shares of credit directed to SOEs and to the real estate sector. They were followed by surges of inflation—over 20 percent—and engendered a sharp rise of NPLs and significant weaknesses in the banking sector, which are still weighing on the real economy.

Figure 16: Credit to GDP Cycles



Sources: Vietnamese authorities; and IMF staff estimates.

In the following sub-section, I first identify some performance weaknesses due to the inefficiencies in the allocation of capital, the problem of NPL, the cross-ownership structure. The analysis of the fragility of banking system comes after to show that this fragility definitely leads to a very vulnerable economy.

a) Inefficiencies in the allocation of capital

With rapid credit growth, the productivity of credit and rates of return to investment have deteriorated. Credit targets—by bank and by sector of activity—remain in effect, creating inefficiencies in the allocation of capital across enterprises, between and within industries. The problem of transparence in the selection of credit makes some poor performing SOEs highly leveraged.

Small and medium enterprises (SMEs) face barriers to credit, adding to the credit misallocation problem. In 2015, according to a survey on Vietnamese enterprises, access to finance was the main business environment constraint for the SMEs. Only 29% of the small enterprises (1–20 employees) have an active line of credit versus 57% of large firms (+100 employees). Domestic SMEs compete for credit with SOEs and large domestic enterprises with preferential access to resources. Consequently, their investment is subdued and is largely internally financed.

Figure 17: Credit and bad debt growth in Vietnam from 2006-2013

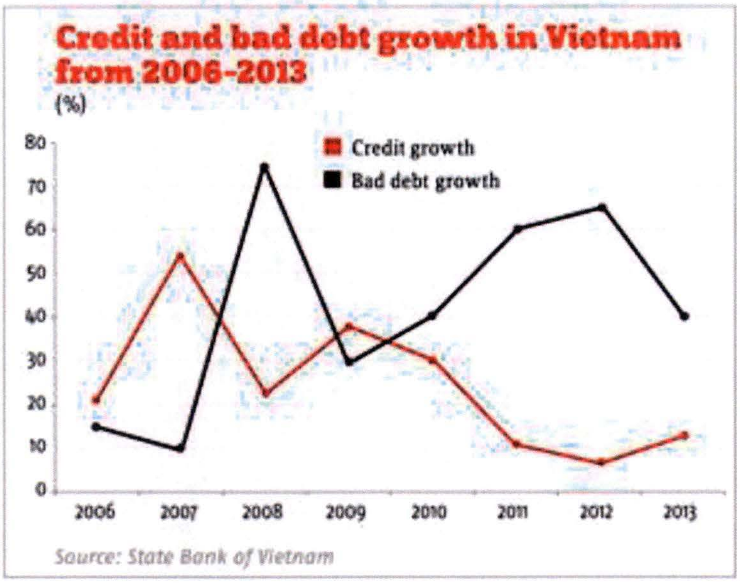


Figure 17 illustrates the growth of bad debt and credit in Vietnam from 2006 to 2013. The bad debt growth was much quicker than the credit growth. The figure also indicates that Vietnam was affected significantly by the international financial crisis in 2007. Credit growth declined dramatically in 2008 while bad debt growth soared up to more than 70%.

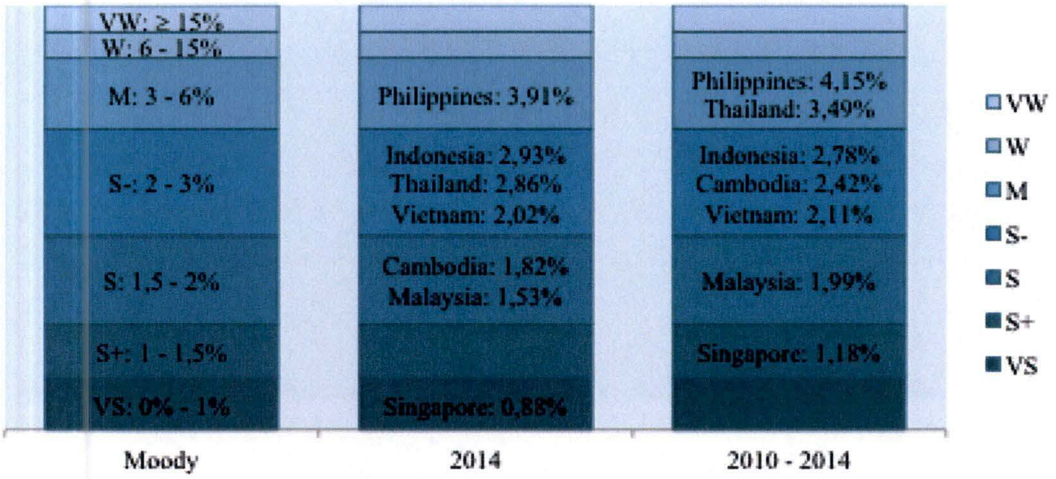
The problem of credit misallocation and SME financing constraints contributes to a low share of investment in GDP (down by 10 percentage points since 2005) and are keeping Vietnam from reaching a higher growth path. The private sector has not benefited from cutbacks in SOE investment and non-state sector investment has stagnated around 12% of GDP. Public investment efficiency is hampered by tight fiscal space and lack of coordination in a fragmented general government. Local governments—which now account for about 80% of total state budget investment—and SOE tend to select and undertake their own infrastructure projects without employing a strategic approach linked to national priorities.

b) Non performing loans (NPL)

The problem of NPL hampers the growth of the real economy and increases volatility in different ways. Due to the high financial leverage, a small decline in asset value could cause significant impact on the solvency of the bank. In addition, a growing share of NPL is going to real estate, financial and personal sectors including mortgages. Real estate investment expanded by 29%per year on average in real terms over the last decade while average annual output growth in the sector was a 5.2% over the same period. This potentially creates real estate bubble, distorting price and leads to financial and macroeconomic turbulences, even crisis.

Compared to other ASEAN countries, in 2014, the NPL ratio of Vietnamese banking system was 2.02%, ranked the fourth highest in ASEAN region. Compared to the period from 2010 to 2014, the 2014 NPL ratio of Vietnam's banking system was mitigated by the sale of NPL to Vietnam Asset Management Company (VAMC) and the use of risk provisions. VAMC is a special purpose company set up by Vietnamese government to deal with NPL in Vietnamese banking system. There are special rules regarding how VAMC can purchase bank loans (which will then become VAMC NPL) and sell VAMC NPL.

Figure 18: NPL ratios in ASEAN's banking systems and Moody's measuring scale



Source: "Vietnamese banking system in the context of ASEAN financial integration", 2017

Furthermore, the resilience against credit risk of Vietnam's banking system remains low. The problem of credit risk is that highest part of NPL still remained in VAMC's balance sheet (at the end of 2015, credit institutions sold around 210 thousand of billions VND to VAMC and the recovery ratio was only around 20 thousand of billion VND) and there have not been any effective solution to deal with such loans. After 5 years, if commercial banks and VAMC cannot resolve such impaired loans, they will be returned to the commercial banks and it will be their responsibility to resolve such loans.

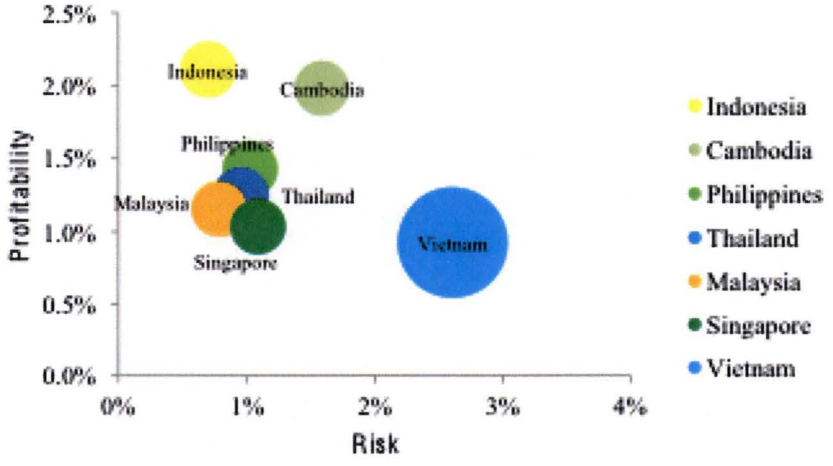
c) Cross-ownership structure

The Vietnamese banking system is also characterized by a high degree of cross-ownership between banks and between banks and enterprises. This includes ownership of joint stock banks by other banks (both State owned commercial banks and other joint stock banks) and by economic groups (including SOEs) whose structures are not well-understood. The complex shareholding structure raises serious concerns about conflicts of interest and related/connected party lending to finance questionable projects. These structures have also led to an overstatement of capital through multiple gearing and facilitated the circumvention of prudential regulations, such as credit concentration limits.

d) Fragility of the banking system

To analyze the efficiency and the stability of the banking system, I use the Z-score and the share of short-term lending. Z-score consists of three assessment components: profitability (return on assets), financial leverage (equity to total assets ratio) and earnings volatility (variance of return on assets). This is an integrated indicator which reflects profitability and the state of excessive risk-taking. Of the 7 ASEAN countries, Vietnam's banking system has the highest level of risk (as measured by inverse of Z-score), yet lowest level of profitability (measured by ROA).

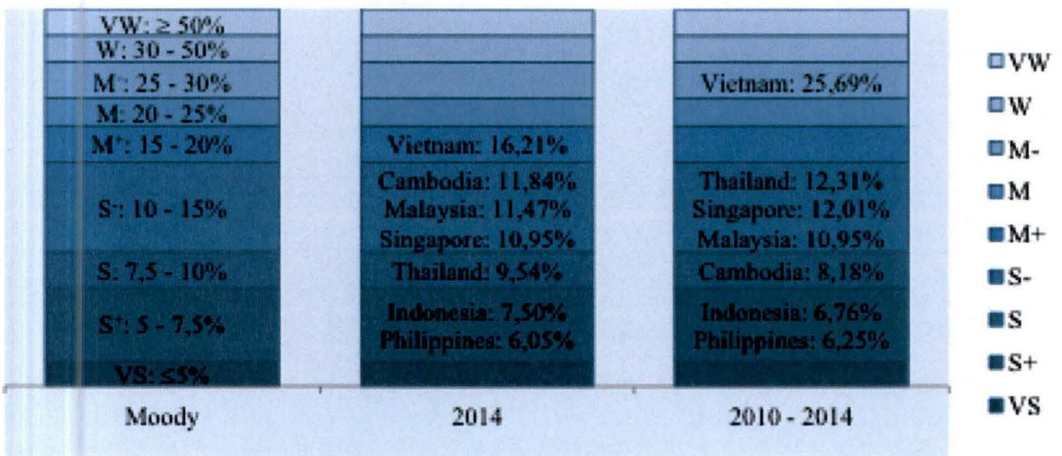
Figure 19: The relationship between profitability and risk of ASEAN's banking systems



Source: "Vietnamese banking system in the context of ASEAN financial integration", 2017

To assess the bank's liquidity situation, the share of short-term funding and prone to be withdrawn by highly sensitive-to-risk depositors is used. According to Moody's, organization's deposit and residents' are deemed far more stable than the wholesale funding from financial institutions (interbank market funds, short-term valuable papers, bonds, etc.)

Figure 20: Share of short-term funding and prone to be withdrawn of ASEAN's banking systems and Moody's rating



Source: "Vietnamese banking system in the context of ASEAN financial integration", 2017

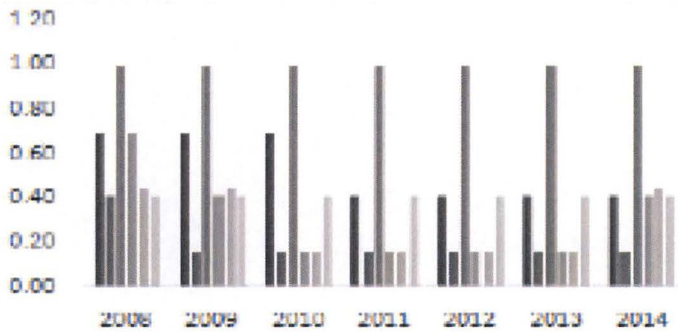
Despite the dramatic downward trend, the share of easy-withdrawing-fund of Vietnam's banking system still ranks first among ASEAN countries. Among these funds, credit institution's deposit and short-term borrowings register the highest proportion although deposits from credit institutions has fallen sharply due to the more stringent regulations on interbank market management.

In conclusion, the integration of the banking system did enhance the economic growth but it also make banks more vulnerable to outside risk. The fact that the drawbacks of Vietnamese banking system have not yet resolved are likely to pose risks to the bank's operation in the future. This may make the banks from other countries in the region more cautious when approaching Vietnam markets due to high risk aversion. Thus, the intrinsic weaknesses of Vietnam's banking system need to be resolved in order to enhance the financial strength of banks, reduce the systemic risk, and accelerate integration process in banking with other countries.

3.2.3 The role of financial market integration on the economic growth and volatility

Before going to see if financial liberalization allows economy to grow, it is necessary to see how much the financial system of Vietnam is integrated to the world market. Financial openness is indicators that reflect the degree of cross-border capital transaction. The Kaopen index, developed by Chin and Ito in 2008, is used in the measurement of financial openness.

Figure 21: Kaopen index



Source: "Potential impact of Integration of financial services on economic growth Asean5+Vietnam", 2017

Based on Chin-Ito Index Calculation (Kaopen Index), there is only one country that has free financial markets i.e. Singapore (with value equal to 1). The level of financial openness of Vietnam is relatively low. This indicates that this country is still far from full integration.

3.2.3.1 Positive effect

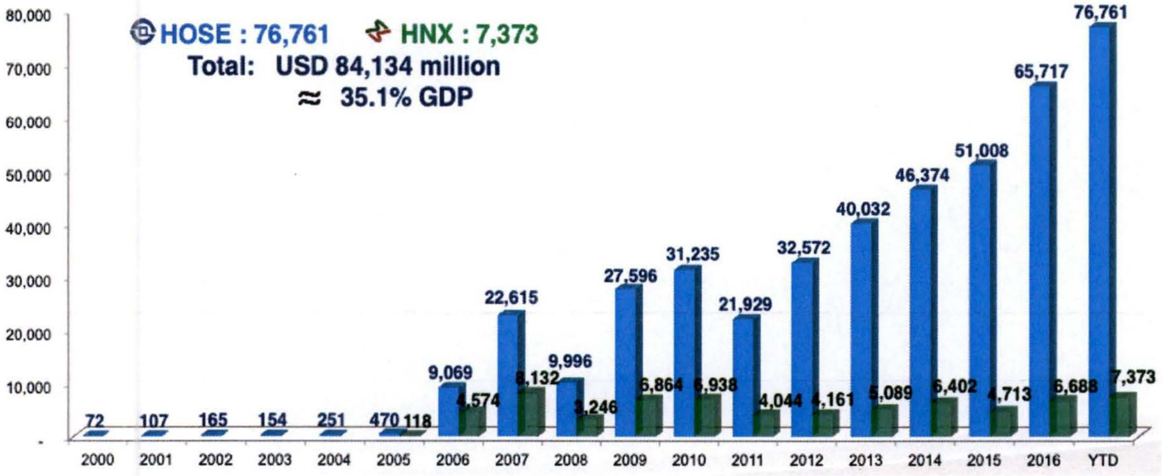
a) Source of funding

Stock market was established in Vietnam in early 2000s and have become an important channel for firms to raise fund to finance their investments. Even though banks are still the main source of finance for Vietnamese firms, the Vietnam stock market has grown rapidly during the last two decades in terms of the number of listed firms and market capitalization.

From a limited number of four listed firms at the establishment, there are currently more than 700 listed companies in the two official stock exchanges and many more in the over the counter market. In addition, there is an increased presence of foreign investors in the Vietnam stock market. Foreign investors are expected to bring many benefits including providing liquidity and stock price destabilization for the stock market. Foreign investment in Vietnamese firms is also considered an alternative source of finance and transparency improvement in Vietnam stock market.

We can see from the picture 23 that the capitalization is increasing gradually from its launch to 2016. The development of stock market is an increasingly important channel for mobilizing capital or funding in Vietnam, and for stimulating economic growth.

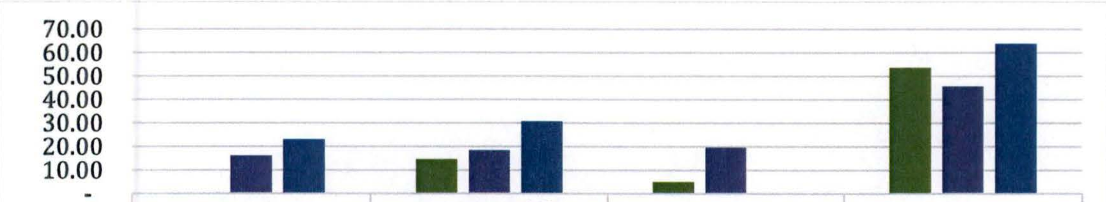
Figure 22: Stock market capitalization



Source: Market overview; Hochiminh Stock Exchange, 2017

To have an overview of how is the level of capitalization of Vietnam compared to the rest of the world, we can look at the general picture as below:

Figure 23: Stock market capitalization to GDP (%)



	Vietnam	Lower middle income	Low income	High income
■ 2004	0.41	14.62	5.02	53.61
■ 2012	16.25	18.38	19.73	45.71
■ 2014	23.14	30.68		63.81

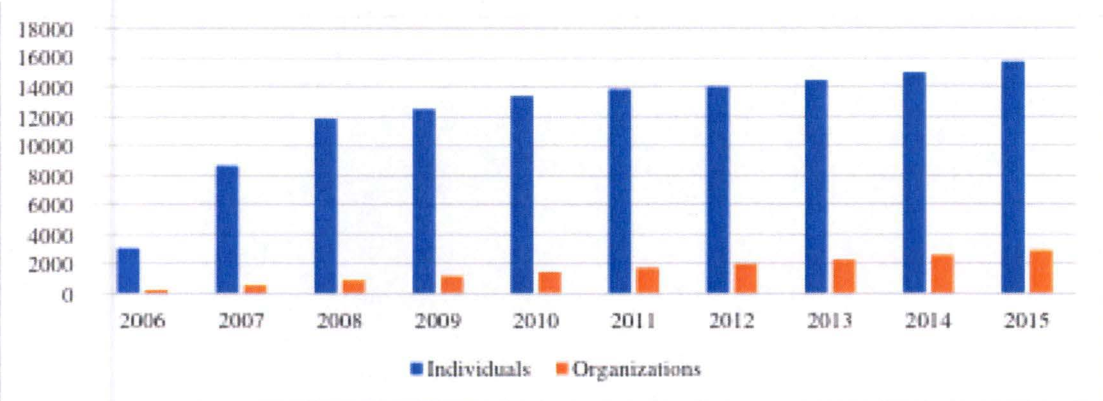
Source: World Bank

Figure 23 shows that Vietnam's stock market capitalization to GDP was extremely low in 2004, only 0.41%, whereas it was 14.62%, 5.02% and 53.61% respectively for the average of LMI, LI and HI countries. It is probably due to the fact that Vietnam just established a stock market in 2000. However, the growth was quite rapid. The ratio increased to 16.25% in 2012 and 23.14% in 2014, just a little bit smaller than the average of LMI countries, a significant progress in the evolution of the financial market in Vietnam.

b) Attract higher number of foreign investors

After 16 years of operation, the development of the Vietnam Stock Exchange has also been explained by the contribution of both domestic and foreign investors. Foreign investors' activities in the stock market have been still prudentially controlled. In 2003, foreign ownership in listed companies was limited up to 30% of company capital. However, since September 2005, the Government has expanded the limitation of foreign securities in investor ownership from 30% up to 49% (except companies in the banking field). The new legislation abandoned the limit of the ownership percentage of foreign investors. Accordingly, except for the international commitments of Vietnam as integration and business conditions, the proportion of foreign ownership is unrestricted in public companies, unless stated in company rules.

Figure 24: The number of foreign investors in the VSE during 2006-2015



Source: "Forecasting and risk management in the Vietnam Stock market", 2018

Before 2005, the role of foreign investors was not featured in the Vietnamese stock market. Financial liberalization definitely allows foreigners to increase their presence in Vietnam. Since 2006, foreign investors have participated quite actively in the market. In 2006, there were 3,050 individuals and 239 organizations with trading codes. By the end of 2015, the Vietnamese Stock Depository (VSD) had granted stock transactions code for 18,607 foreign investors, including 2,879 organizations and 15,728 individual investors, increasing 99.65% and 17.43%, respectively, compared to those in 2010 (Figure 24).

Moreover, the amount of capital transactions by foreign investors in the VSE has been increasing significantly (Figure 25). In 2009, foreign investors purchased nearly 70.26 million shares and sold approximately 65.56 million shares. Foreign investors have focused on purchasing bluechips stocks with high market value and selling stocks with low value. The net buying value of foreign investors reached its record of USD 805.68 million in 2010. In general, foreign investors' participation has increased market liquidity for transactions worth approximately 26.32% of the total market trading, which could result in better and more efficient capital allocation. Additionally, foreign investors' participation has contributed to making corporate governance more transparent and closer to international practices and thus to promoting the image of Vietnam's economy

Figure 25: The comparison of transaction value of foreign investors and the overall market trading

Source: "Forecasting and risk management in the Vietnam Stock market", 2018

c) Increase of international bonds and notes outstanding

In addition to the domestic bond market, Vietnam have been opened to the international pool of saving. Table 7 reveals financial accessibility of Vietnam to the international bond market. Significant jumps of international bonds and notes outstanding for ASEAN5 and Vietnam are observed from 1998 to Jun-2015. Thailand has its foreign bonds and notes outstanding at 20.28 bn. USD in Jun-2015 while Indonesia and Singapore are the top two countries at 83.13 and 78 bn. USD respectively. However, compared to these countries, Vietnam has an insignificant amount of international bonds and notes outstanding, but it is increasing over years.

Table 7: International bonds and notes outstanding for the ASEAN 5 and Vietnam

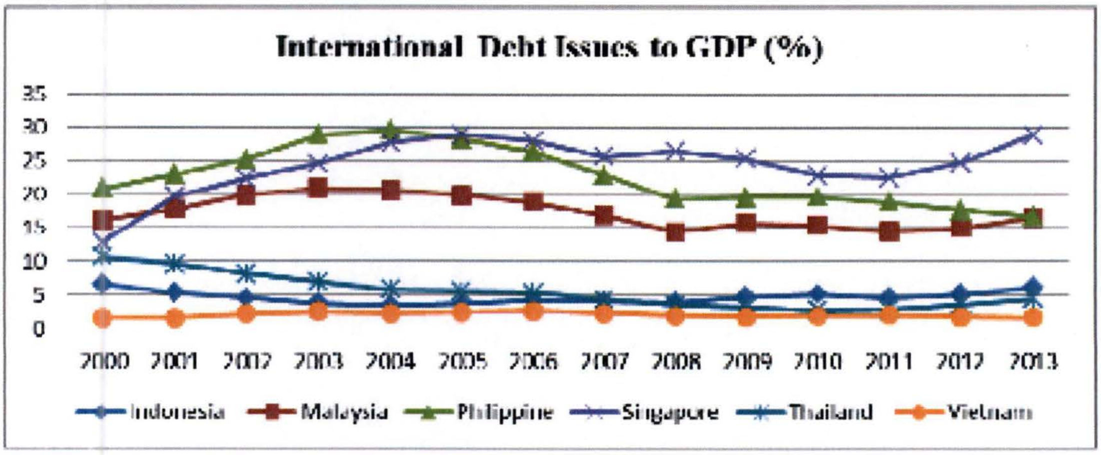
End of Year (Dec)	BIS: International Bonds and Notes Outstanding (bn USD)					
	IDN	MYS	PHL	SGP	THA	VNM
1998	16.13	12.02	14.63	7.24	15.12	0.54
1999	12.27	14.62	18.04	10.05	13.98	0.54
2000	10.46	15.57	18.69	14.41	12.63	0.54
2001	8.6	17.18	18.66	20.85	9.82	0.54
2002	8.38	22.84	22.6	19.93	8.96	1.04
2003	8.84	22.9	26.68	26.61	8.16	1.04
2004	9.51	28.39	28.06	33.85	8.49	1.04
2005	13.09	28.47	29.53	36.68	10.19	1.77
2006	16.94	31.44	32.07	42.17	10.91	1.74
2007	18.78	31.82	32.44	47.02	9.15	1.9
2008	21.9	32.33	31.78	48.73	8.88	1.87
2009	32.26	32.75	36.18	48.63	7.84	2.03
2010	36.84	39.46	39.92	53.01	9.26	2.9
2011	41.25	40.96	41.65	53.06	10.19	2.9
2012	51.71	49.94	45.15	72.25	16.45	2.91
2013	61.22	53.68	46.2	75.08	18.41	3.11
2014	69.65	55.14	46.04	76.68	20.93	4.12
Jun-15	83.13	60.08	48.66	78	20.28	4.12

Source: "Forecasting and risk management in the Vietnam Stock market", 2018

d) Access to international debt issues

To gain access to international saving for the regional economic development, ASEAN has increasing rely more on external sources. The amount of international debt issues to GDP as indicated in the Figure 26 shows that there is an increasing trend in most of the countries, including Vietnam and except perhaps only for Philippine. Thailand and Indonesia, the two nations hit hardest in the 1997 financial crisis, have been keeping the ratio of international debt low as it is viewed as one of the reasons creating financial risk and economic instability.

Figure 26: International debt issues for ASEAN5 and Vietnam



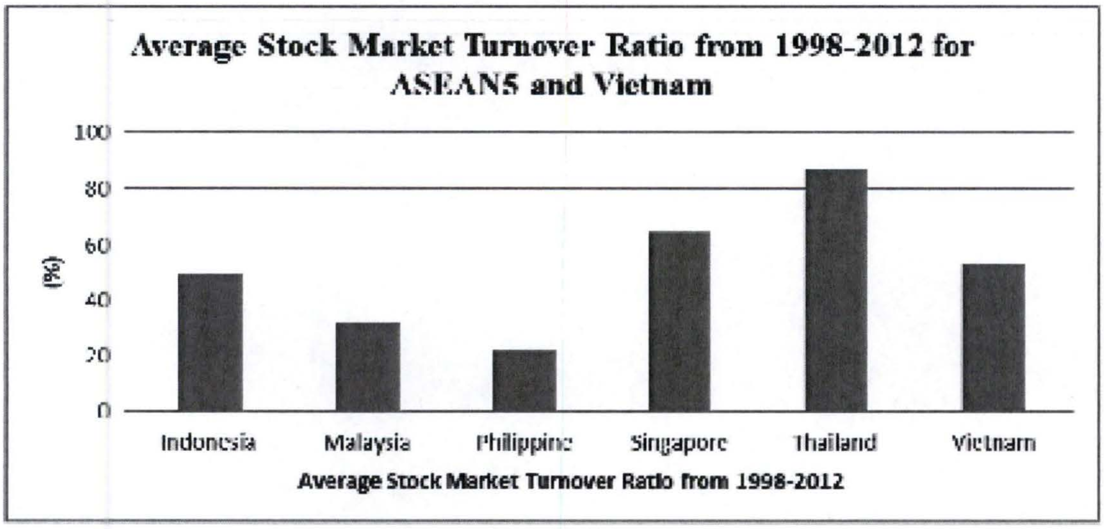
Source: Capital market development in Asean economic community issues and oportunities for other subregions of the Asia-Pacific region, UNESCAP, 2016

Recognizing that Vietnamese capital markets are relatively small and illiquid with limited range of financial products and services, capital market integration or collaboration will enhance the possibility of access to larger and diversity pools of capital resource. By allowing for greater investors and issuers of various financial instruments opens up a wider range of financial products required for both liquidity and diversification purposes.

e) Efficient financial market

A common benchmarking of financial market efficiency is to consider the stock market turnover ratio as it is argued that an efficient financial market is expected to provide, or at least sending signal by digesting available information rationally, a priori information necessary for the players (investors, speculators, and regulators) to make appropriate decisions. Greater market turnover suggests more exchange of information and reactions in the market and hence, greater degree of market efficiency. The data on stock market turnover ratio for Vietnam illustrate an increase investment in the respective equity markets. The trend has been picking up after 1997 financial crisis and the turnover has risen consistently with greater degree of financial liberalization policy which allows for freer international capital flows. Figure 27 shows that the turnover ratio have been high (greater than 40%) in Thailand, Singapore, Indonesia, and Vietnam.

Figure 27: ASEAN5 and Vietnam financial market efficiency



Source: Capital market development in Asean economic community issues and oportunities for other subregions of the Asia-Pacific region, UNESCAP, 2016

f) Better regulation

The market becomes better regulated. For instance, Ministry of Finance of Vietnam established Vietnamese Accounting Standards (VAS) in 2003 referring to International Accounting Standards (IAS). The country is also expected to adopt International Financial Reporting Standards (IFRS) to the current VAS by 2020 to enhance comparability and improve transparency; and in fact, some Vietnamese companies already apply IFRS in order to meet the requirements of integration and globalization, to attract more foreign investment, or to expand investment opportunities to other countries.

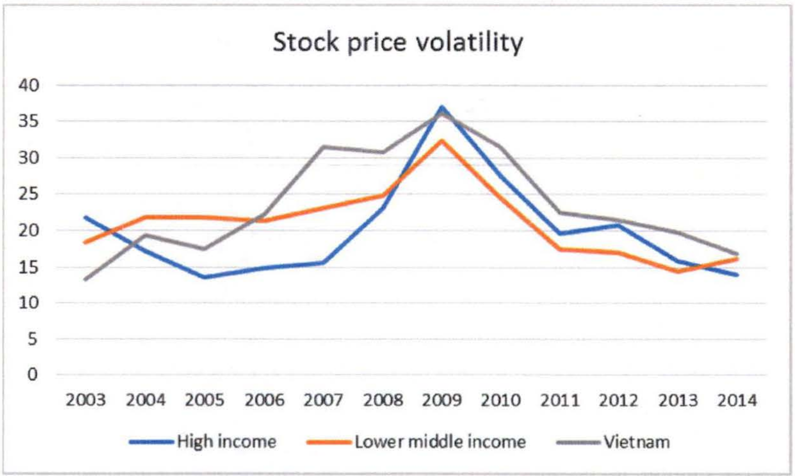
*3.2.3.2 **Negative impact***

However, opportunities always come together with challenges. The involvement of giant foreign investors created market distortions, speculation, and bubbles in the stock market of Vietnam. The quick evolution was accompanied with high volatility.

a) Stock price volatility

Similar to most of emerging markets, Vietnam market is small and fragile to even small shocks. Stock price volatility is a matter of concern for all market participants and policy makers as volatility can exert pressure on the economy. Since the Asian Financial Crisis in 1997, there is a increasing concern that foreign capital may cause extreme volatility in emerging markets causing significant loss for these fragile economies (Bekaert & Harvey 2000). This issue can be more severe as Vietnam is still small and open economy which is vulnerable for even small shocks in the global market. Moreover, Vietnam is in the infant stage of equity market development.

Figure 28: Stock price volatility



Source: World Bank

Figure 28 illustrates that stock price volatility in Vietnam is higher than the average of LMI and HI countries most of the time. It also peaked in 2009 due to the impact of the global financial crisis.

b) Low credit rating

One of the causes why the flow of foreign funds do not go to the financial markets of developing countries that have a high rate of return is due to an imperfect market as a consequence of sovereign risk and asymmetric information. Based on the rating issued by investment rating agencies, Vietnam have a high level of sovereign risk, which is indicated by the relatively low rating.

Table 8: Credit Rating ASEAN5+Vietnam

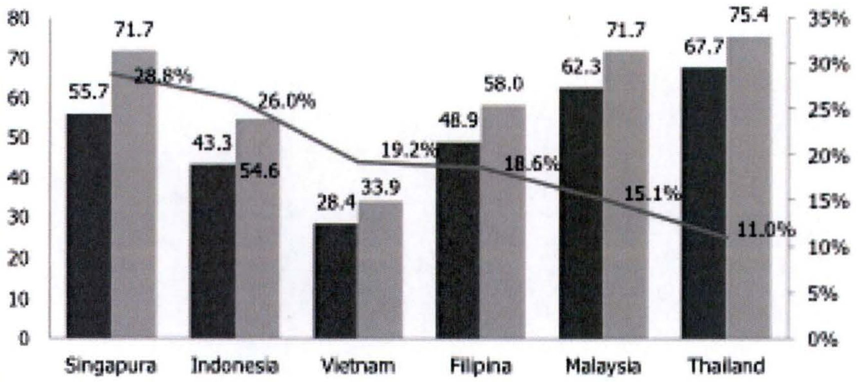
Negara	S&P Rating		Moody's Rating		Fitch Rating		TE Rating	
Malaysia	A-	STABLE	A3	STABLE	A-	STABLE	66	STABLE
Indonesia	BB+	POSITIVE	Baa3	STABLE	BBB-	STABLE	46	STABLE
Filipina	BBB	STABLE	Baa2	STABLE	BBB-	STABLE	53	POSITIVE
Singapura	AAA	STABLE	Aaa	STABLE	AAA	STABLE	98	STABLE
Thailand	BBB+	STABLE	Baal	STABLE	BBB+	STABLE	63	STABLE
Vietnam	BB-	STABLE	B1	STABLE	BB-	STABLE	29	STABLE

Source: "Potential impact of Integration of financial services on economic growth Asean5+Vietnam", 2017

c) Low value of corporate governance

Meanwhile, the asymmetry of information on financial markets can be indicated by the value of corporate governance (CG) in the stock market. The low value of corporate governance in a country indicates a high degree of information asymmetry between the company and the public. The low value of the CG of Vietnam indicates a lack of efficiency. This will affect the flow of information from the company issuers to the public, leading to some stocks whose value is undervalued or overvalued due to the asymmetry of information. Those factors above, sovereign risk and asymmetric information, which causes ASEAN financial markets do not experience a large flooding flow of foreign funds even though the ASEAN financial markets promises a high rate of return.

Figure 29: Corporate Governance Emiten in ASEAN



Source: "Potential impact of Integration of financial services on economic growth Asean5+Vietnam", 2017

d) Large bank lending-deposit spread

Looking at the efficiency in financial market measured in two folds, we assess how cost effective the market delivers funding services to those who needed and the other is to consider the efficiency of the financial institution involved. A relatively narrow lending-deposit spread at the same level of risk indicates a more efficient banking system. Average bank lending-deposit spreads for ASEAN5 and Vietnam shown in Table 9 suggests that Malaysia has been relatively more efficient in the banking sector. By contrast, Vietnam bank lending-deposit spread is quite large, meaning that the financial market is quite inefficient

Table 9: Money market efficiency for ASEAN5 and Vietnam

	Bank Lending-deposit Spread					
	Indonesia	**Malaysia**	**Philippine**	**Singapore**	**Thailand**	**Vietnam**
Average from 2000-2013	5.44	2.94	4.11	4.84	4.41	3.39
SD	1.17	0.74	0.89	0.37	0.53	1.18
Max	7.68	4.31	5.82	5.24	4.92	6.90
Min	3.07	1.64	2.52	4.12	2.92	1.94

Source: Capital market development in Asean economic community issues and oportunities for other subregions of the Asia-Pacific region, UNESCAP, 2016

In short, it is not suprising that financial market integration have brought many opportunities and external sources to fund the Vietnamese economy. The increasing presence of foreign investors and foreign transactions contributed to the liquidity market and the efficiency of financial market. The involvement of foreign element in financial market also pushed the authorities to be more prudential and urged them to better regulate and supervise the market. However, financial integration was accompanied with high volatility in stock price, market distortions, speculation, and bubbles in the stock market of Vietnam.

IV. CONCLUSION

In the first parts of this project, it is clear that financial globalization is a quite natural process in an economic environment that is evolving continuously. Basically, it is beneficial for all the countries participating in this process. We acknowledges the benefits from capital flow liberalization—funding the economy, the higher efficiency in resource allocation, technological improvement, simulation of domestic financial sector development—while also emphasizing the risks of capital flows, including higher volatility and increased vulnerability to capital account crises. However, the degree to which a country can benefit from the opportunities of open markets varied, according to empirical evidences. Also, the risks seems to be magnified for countries that are still lagging in financial and institutional development.

This paper do not uses new data and new econometric techniques to investigate the impact of international financial integration on economic growth of Vietnam. Instead, I attempted to provide insights on how Vietnamese economy and financial system integrated to the world financial market and tried to establish a link with the economic performance. To sum sup, from the examination we can see that financial integration did contribute to the economic performance by many ways:

- GDP increased dramatically in the beginning of Vietnamese integrations waves along with low inflation, augmentation of FDI influx, improvement of trade volume.
- Banking system integration allows to increase domestic savings, to develop a strong and diversified financial intermediation system with new instruments and to boost competition. Besides, globalization opens markets opportunities abroad, favorises the transfer of technology and management techniques, promotes innovation and enhance governance, and leads to better regulatory and supervisory practices.
- Financial market integration is a source of funding, a channel for mobilizing capital which contributes more and more to stimulate the economic growth. The globalization allows to attract more foreign investors and increase their presence in the Vietnamese financial market. The capital transactions increased, leading to a more liquid market and more efficient market. Vietnam could have access to international pool of savings, increase their international debt issues and international bond and notes.

On the other hand, financial integration have brought many challenges to the financial system in particular and to the economy as a whole:

- In time of global recession, the Vietnamese economy was heavily affected: GDP slowed down, inflation soared and FDI influx fell sharply due to the economic downturn which affected the investment of foreign investors.
- Banking performance deteriorated over time due to the inefficiency in the allocation of capital, the prevailing of non performing loans problem, the complexity of cross-ownership. Banking system remained fragile because of the low profitability and excessive risk taking and the high share of short term funding.
- The involvement of foreign investors created market distortions, speculation, and bubbles in the stock market of Vietnam, resulting in a higher stock price volatility. The problem of low sovereign rating and low corporate finance (resulting from an asymmetry of information) prevents Vietnam from receiving large flow of foreign funds even though the Vietnamese financial market promises a high rate of return.

In brief, financial integration and globalization have an important role on the economic growth, Vietnam obviously made use of the benefit of this trend and could benefit more from it. However, the challenges and risks accompanied with this process still remained. The analysis of these risks, their origin and possible implications, remains on the top of supervision authorities' agenda. Coping successfully with these challenges continues to be vital to fostering sustainable growth and development in Vietnam specifically and also in many parts of the world and is hence a matter of global interest.

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