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## ENTREPRENEURSHIP AND CREDIT CRUNCH IN VIETNAM: A RECURRING REALITY?

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*This paper examines whether and to what extent the Vietnamese economy have been suffering and is still suffering from a credit crunch in the context of its dynamic growth. The paper employs a systematic framework in the tradition of the credit view literature to assess the occurrence and the magnitude of the credit crunch considered like a major obstacle to the development of an endogenous entrepreneurship in Vietnam. By using a consistent approach based on several topics (interest rates, exchange rate, dollarization, monetary policy), the paper goes beyond macroeconomic indicators and anecdotal evidence. The framework also allows assessing how the credit crunch affects differently across the various sectors of the economy. The main results of the study show that the credit crunch is a widespread and permanent reality in Vietnam and its negative impact affects particularly the profitability of enterprises' productive investments. Furthermore, a protracted and heavy reliance on tight monetary policy, entailing high real interest rates, appears inappropriate for restoring a long-term market confidence. Therefore, it would be desirable to consider alternative policy instruments aiming new paradigms and that do not place further stress on the banking sector and on its lending to the corporate sector.*

**Keywords:** credit crunch; interest rates; exchange rates; monetary policy; firms investments; dollarization; Asian countries; Vietnam

### 1. Introduction

As frequently reminded by the Vietnamese Chamber of Industry and Commerce (VCCI - 2018), it is a subject of permanent controversy whether the Vietnamese economy is suffering from a structural credit crunch. While there is anecdotal evidence that even good firms are often finding it difficult to obtain credit to finance production and investment, macroeconomic data on monetary and financial developments do not unequivocally support the assertion that a credit crunch is occurring. A better understanding of this issue is crucial for the designing of appropriate policy actions and for the growth prospects of a dynamic emerging country like Vietnam. For example, it is widely held that when the growth process is mainly or partially led by export-driven demand, entailing a relevant transfer of resources from the non-traded to the traded sectors, a pervasive credit crunch could retard or even jeopardize such a transfer, thus undermining development prospects. This opinion is based on the

assumption that informational asymmetries play a major role in financial market

In this paper, after having defined the phenomenon of credit crunch and its complex relations with the macroeconomic analysis and the entrepreneurship (Section 2), we consider, with synthetic data, the current situation of financial development in Asia, with special references to Vietnam (Section 3). Thereafter (Section 4), we analyze the constraints of the monetary policy by reference to the theoretical trilemma (exchange policy, interest rates management, financial markets openness), taking in account the reality of dollarized or partially dollarized economies like Vietnam. In a following Section 5, we deal the consequences of a latent credit crunch generating interest rate risks and eviction effects against the corporate sector and against the SMEs. Eventually, in our conclusion, we try to suggest paradigms for a new policy oriented to the development of financial markets, especially bond markets, and mainly axed on a mobilization of an important

national savings to overcome a structural and latent credit crunch

### 2. The Concept of Credit Crunch and its Implications for the Entrepreneurship

According to the US Council of Economic Advisors (1991), credit crunch is “a situation in which the supply of credit is restricted below the range usually identified with prevailing market interest rates and the profitability of investment projects”. When a credit crunch occurs, it alters the relationship between credit availability and interest rates. Identifying a credit crunch in practice involves investigating the channels through which firms, banks, and economic activity are affected. For instance, both increases in the cost of borrowing and credit rationing is likely to lead businesses and households to shelve some investments or current expenditures for which funding is no longer available or has become too costly.

#### 2.1. Credit Crunch Reality and the Key Indicators of the Monetary Policy

Under normal circumstances, examining the evolution of the key macro variables --e.g. the relationship between monetary aggregates, interest rates, or other monetary policy instruments and nominal income -- may be sufficient to evaluate the monetary policy stance. If the key monetary policy instrument(s) are not in line with expected price and output developments (i.e., nominal production potential), then it can be concluded that the monetary policy stance is excessively tight (loose) since there is less (more) liquidity than is needed to accommodate nominal production.

In a crisis, however, assessing the monetary policy stance becomes complicated as the relationship between monetary policy instruments and nominal income changes drastically. Accordingly, it may be misleading to focus solely on key indicators of monetary policy for detecting “a credit crunch”. Analyses of monetary and credit aggregates need to be complemented with a more detailed investigation of the channels through which firms, banks, and households are affected by changes in monetary policy. In fact, as *Bernanke and Gertler* (1995) argue, when the economy is hit by a negative shock, it is often impossible to distinguish whether the usual deceleration in bank lending stems from a shift in demand or supply. On the one hand, the corporate sector may be demanding less credit because fewer investments are undertaken; on the other hand, it could be that banks are less willing to lend and, therefore, charge higher interest rates or decline more credit applications.

#### 2.2. The Propagation of a Credit Crunch

In order to address this problem of identification, we will rely on literature that examining the transmission of monetary policy restrictions through the credit channel. In particular, we will focus on the evolution of the spread between bank lending rates and rates on risk-free assets.

##### 2.2.1. Increases in the Cost of Borrowing and Credit Rationing

In a situation of monetary tightening and/or credit crunch, the external finance premium (*the difference in cost between funds raised externally and funds generated internally to the firm*) is likely to increase, thus increasing the cost of borrowing. Typically, this increase in the cost of borrowing is the effect of two channels: *the balance sheet channel* and the *bank-lending channel* (*Ding, Domac and Ferri- 2002*).

On the one hand, the balance sheet channel emphasizes the potential depressing impact of the monetary squeeze on borrowers' assets and profits, including variables such as borrowers' net worth, cash flow and liquid assets, which increases the risk premium. The increase in the level of interest rates triggered by the monetary squeeze raises corporate risks because it reduces both business profits and the value of assets firms have posted as collateral. This will generally increase the wedge between the interest rates at which corporates can borrow and the yields on risk-free assets.

As an additional contributing factor besides the *balance sheet channel* and the *bank-lending channel*, banks may not only restrain credit generally but also adopt more stringent lending policies vis-à-vis customers that are perceived to be less credit worthy -a phenomenon labeled “*flight to quality*”. That is, when a deposit drain squeezes their resources and/or credit risk heightens, banks will try to cherry-pick customers who are ex ante more credit-worthy: e.g. those having a more established credit record or able to post more collateral.

Moreover, whereas an assessment of changes in the cost of borrowing can be reasonably accomplished, it is extremely difficult to identify and measure credit rationing in practice. Intensifying credit rationing is certainly a relevant aspect in the credit crunch. One instance of credit rationing could be related to the *flight to quality* phenomenon that we referred to above. Another form could be a reallocation of bank assets away from lending to the corporate sector, and towards government securities and foreign exchange instruments.

2.2.2. Sectoral Issues

While sketching above the channels through which monetary tightening and credit crunch are transmitted to the economy, we have already made clear that some of these effects have asymmetric impacts across the various classes of customers. These aspects deserve further elaboration because they have important bearings on how to interpret the credit crunch and, especially, on which policy actions are best suited to mitigate its undesirable consequences.

**The balance sheet channel** in principle has a symmetric impact on the economy. It raises the risk premium and thus the cost of borrowing for all firms, irrespective of their financial structure. In practice, however, even the balance sheet channel will likely penalize the small and medium-sized enterprises (SMEs) more since they typically do not have access to the commercial paper market.

**The lending channel** and **credit rationing** specifically affect **bank-dependent borrowers**, i.e. those firms that cannot directly place liabilities on the open market and the equity market. This should particularly be the case for SMEs. In the first place, they are too small to justify the fixed costs entailed by listing securities. In addition, even when they intend to issue debt on the market, they would most likely refrain from doing so because given the low liquidity of their debt, investors would ask for very high yields, thus making issuance unattractive to SMEs. SMEs would also be specifically penalized by the **flight to quality**. Lenders perceive them to be more risky since they generally have a shorter track record and typically release less --and less structured-- information. (Bernanke and Lown - 1991).

Furthermore, when the credit crunch ensues, there may be an additional channel negatively affecting SMEs in terms of availability and cost of external finance that is **flight to quality (safety) by depositors**. Envisaging increased fragility of the intermediaries, depositors may shift their savings towards institutions that are perceived to be less likely to go bankrupt. For instance, **foreign banks** could be deemed safer than domestic ones; smaller banks may be viewed less likely to be bailed out by the government; and private banks are **less likely than state-owned banks to be covered by government guarantees**. Thus, an additional credit squeeze may hit those **customers borrowing from smaller banks, private banks, or domestic banks which are suffering from the deposit flight**, and typically SMEs depend more than other firms on small, pri-

vate and domestic banks' lending. The institutions that receive new flows of funds often have no established relationship with the borrowers of those institutions losing resources, and are thus less likely to make loans to those customers.

2.2.3 - Credit Crunch: A Simple Analytical Model

'Credit crunch' as a concept is often confusedly defined and casually employed. Many people use the term of 'credit crunch' loosely and in interchangeable way to describe a variety of phenomena including 'tightening of monetary policy', 'shortage in supply of funds', 'credit rationing by banks', 'credit slowdown', etc. It looks useful to explore more carefully the concept of 'credit crunch' and to differentiate it various terms

Let us resume now the preceding developments in a simple and synthetic model.

The interest rate paid by corporations and firms issuing debt on the market (the corporate debt market rate

$r_{CDM}$ ) can be expressed as:

$$r_{CDM} = r_F + r_{GRP} = r_F + \beta(r_L - r_F) \quad r_{CDM} = r_F + r_{GRP} = r_F + \beta(r_L - r_F)$$

- Where  $r_f$  is the risk free rate and will be provided by the government bond yield on the T-bill rate.

-  $\beta(r_L - r_F)$  stands for the general risk premium for the private sector and, by construction. It is measured by the yield differential between corporate and government bonds, or the spread between commercial paper and T-bill rates, weighted by  $\beta$  coefficient as a proxy

The following graph schematically depicts what happens as result of the **bank-lending channel** and contrasts it with the impact of the **flight to quality**. The graph has the loan quantity and the loan rate respectively on the x and y axes. Taking  $LD0$  as the demand for loans as given, we hypothesize for convenience that only the loan supply moves. The bank lending channel effect is represented by the parallel shift from  $LS0$  to  $LS1$ . Instead, the flight to quality effect is given by the shift with counterclockwise translation from  $LS0$  to  $LS2$ .

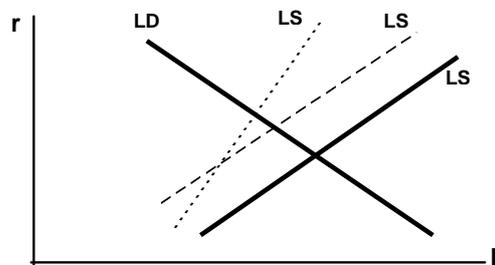


Figure 1: The Credit Crunch Process

### 3. Financial Development and Implications for the Entrepreneurship

This section provides broad measures of financial development in Asia, including market size and capital market openness. Table 1 provides a snapshot of the overall level of development in many Asian economies in 2018, as measured by the share of bank credit, bonds, and stocks in gross domestic product (GDP).

Clearly, there is a huge range of development, from low-income economies with relatively rudimentary financial systems to sophisticated financial centers such as Hong Kong, China, Japan, Korea and Singapore. The mix of funding by source also varies significantly, as the share of funding from bonds and stocks tends to rise with the level of per capita income and financial sophistication.

- Highly financially developed economies tend to show overall financing ratios of over 300% of GDP, including Hong Kong, Japan, Korea, and Singapore.

- Total financing in economies with intermediate level of financial development range from 100% to 300% of GDP, including the People's Republic of China, India, Indonesia, Malaysia, Philippines, Thailand, and clearly Vietnam with a percentage of almost 195%.

- The other economies (Cambodia, Lao PDR, Myanmar) have overall financing levels less than 100% of GDP.

**Table 1:** Total finance as percentage of GDP - 2018

Countries	Bank Credit	Gov. Bonds	Corporate Bonds	Market Capitalization	Total
Cambodia	72.5	....	....	.....	72.5
Indonesia	168.7	26.4	10.8	71.5	277.4
Lao PDR	18.9	...	....	----	18.9
Malaysia	135.3	51.7	46.3	26.3	259.6
Myanmar	41.1	....	....	....	41.1
Philippines	106.3	27.5	7.5	25.2	166.5
Singapore	140.8	50.2	32.5	88.4	311.9
Thailand	134.7	53.1	21.2	97.7	306.7
<b>Vietnam</b>	<b>121.8</b>	<b>19.5</b>	<b>1.8</b>	<b>51.7</b>	194.8
P's R. China	155.2	52.2	20.0	64.1	291.5
Hong Kong	217.9	41.1	27.5	1029.1	1315.6
Japan	245.1	198.6	14.6	85.9	544.2
South. Korea	141.7	51.3	74.3	99.8	367.1

Source: World Bank Financial Development Index Database

Within the financial sector as a whole, the banking sector tends to develop first, and the importance

of the banking sector in Asia finance is well known. Table 1 shows clearly that the banking sector gets the largest share of aggregate finance in all economies, except Hong Kong and Singapore.

**Table 2:** Banking sector development in Vietnam (Bank credit as percentage of GDP)

2000	2003	2010	2015	2016	2017	2018
30.4	53.6	88.3	102.8	109.4	116.7	121.8

Source: State Bank of Vietnam SBV

As we can see, in Vietnam, the bank credit increased strongly since the Doi Moi period, fostering a financial inclusion of households and firms and contributing to growth process in a significant way.

Because of this preponderance of the banking system in the funding of the Vietnamese economy, the Central Bank monetary policy in terms of credit, interest rates, and exchange rate is of decisive importance to the business activity and entrepreneurship, and almost of exclusive importance for the small and medium enterprises.

### 4. The Constraints of Monetary Policy and the Entrepreneurship

Achieving noninflationary and stable economic growth is one of the most important mandates of macroeconomic policy makers. Conceptually, higher levels of exchange rate stability, financial market openness, and monetary policy independence would all help stabilize the economy, but policy makers cannot achieve all three policy goals to their full extent at any one time. This is the fundamental hypothesis-the "impossible trinity" or the "trilemma"-that dominates open macroeconomic policy making.

#### 4.1. The impossible Trilemma

The trilemma is often illustrated using an equilateral triangle as shown in the following figure with the three sides representing respectively exchange rate stability, financial market openness, and monetary policy independence. While it is possible to achieve the full extent of two policy goals, i.e., standing at one of the corners in the triangle, it is impossible to do so for all three sides simultaneously.

As only two-out of three-policy goals can be

achieved to their full extent, we observe three distinctive policy combinations: a) A fully open financial market and full monetary policy independence (thereby forcing the country authorities to adopt a freely flexible exchange rate regime)-b) A fixed exchange rate regime and full monetary policy independence (thereby forcing the authorities to close the financial market) –c) A fixed exchange rate regime and a fully open financial market (thereby forcing the authorities to give up monetary policy independence).



Thus, an ostensibly simple hypothesis of the trilemma could easily turn into a complex policy management in the open macroeconomic setting. The “trilemma constraint” states that policy makers have to select the levels of attainment for at most two out of the three policy choices with the last one automatically determined. Given this trilemma constraint, policy makers are expected to select a policy combination

that is the most suitable by taking into account their country’s economic, structural, and other conditions.

Asian countries are very diverse in monetary policies and currency regulations, as well as in the economic development levels. Moreover, they have gradually advanced from situations with a closed capital account to situations with an open capital market account in the last three decades.

Historically, the Asian financial crisis of 1997-1998 was a turning point in policy implementation for several Asian countries. As many Asian economies faced the dangers of the impossible trinity, they have implemented changes in the management of the exchange rate policy, of the monetary policy and the speed of capital account liberalization. Many economies shifted to floated or managed exchange rates, aiming to maintain monetary policy autonomy in the framework of partially liberalized capital accounts. Foreign exchange interventions and moderate capital controls were added to manage capital flows, as we can check it in the Table 3, where we consider the situation prevailing in the Asian countries.

**Table 3:** *Trilemma: monetary policy, exchange management and financial markets openness*

(\*) - An ‘Open’ country has virtually no capital controls on any asset over the sample period. This situ-

Countries	Income group	Exchange rate regime	Monetary policy target	Capital controls
<b>Northeast Asia</b>				
Japan	High	Free floating	Inflation targeting 2%	Open
China-PRC	Upper Middle	Crawling peg (USD)	No explicit framework	Wall
South Korea	High	Floating	Inflation targeting 2%	Open
Taipei-China	Upper Middle	Floating	M2 growth 2.5% - 6.5%	Open
Hong Kong	High	Currency board (USD)	Currency board (USD)	Open
<b>ASEAN</b>				
Indonesia	Lower Middle	Floating	Inflation targeting 4% +(-) 1%	Gate
Thailand	Upper Middle	Floating	Inflation targeting 2.5% +(-) 1.5%	Gate
Malaysia	Upper Middle	Managed (CNY)	No explicit framework	Wall
Singapore	High	Basket currency (REER)	Exchange rate targeting	Wall
Philippines	Lower Middle	Floating	Inflation targeting 3% +(-) 1%	Wall
Cambodia	Low	Managed (USD)	Dollarization	Wall
Lao PDR	Low	Crawling peg (USD)	Dollarization	Wall
Myanmar	Low	Managed (USD)	Dollarization	Gate
<b>Vietnam</b>	<b>Lower Middle</b>	<b>Basket currency (high USD)</b>	<b>No explicit framework De-dollarization</b>	<b>Gate</b>

ation is prevailing in Japan, Hong Kong, Taipei-China, Brunei-Darussalam and Singapore.

- A ‘Wall’ country has pervasive controls across all or almost categories of assets. China-PRC, Malaysia and Philippines belong to ‘Wall’ status

- A ‘Gate’ country uses capital controls episodically. Among these countries, we can quote Indonesia, Thailand, Myanmar and Vietnam

Source – TAKATOSI ITO (2017): *Monetary Policy and Central Banking in Asia – Routledge Handbook of Banking and Finance in Asia*.

It appears that the four low-income countries in ASEAN (Cambodia, Lao-PDR, Myanmar and Vietnam) belong to a camp of a near-fixed exchange rate to the US dollar. However, some parts of their economies are ‘dollarized’ and the degree of freedom for monetary policy is severely limited. In spite of a decreasing trend, the consequences of dollarization in Vietnam remain a stabbing problem.

### 4.2. The Trade-off Between Monetary and Exchange Rate Policy

Recent experiences clearly show that if the central bank fails to contain inflation, the exchange rate is likely to depreciate as the inflation rate soars. Conversely, if the exchange rate depreciates, whatever the reason, the inflation rate will increase as prices of imports soar. In fact, the central banks pursue the stability of exchange rate in order to achieve price stability and the link between the two is explicitly recognized. Hence, whether price stability and exchange rate stability are trade-off or complement is a fundamental empirical question.

In Figure 2, the pair of average inflation rate and the average change in the exchange rate over the period 2001-2017 is plotted for seventeen Asian countries. Both parameters are positively correlated. Higher inflation, as a domestic shock, tends to cause a nominal depreciation of the exchange rate, and the exchange rate depreciation due to internal or external reasons, would cause imported inflation.

Assuming a strong inflation leads to a significant exchange rate depreciation, the following regression result is settled. The slope coefficient is statistically significant at 1%. The result means that a 1% increase in the inflation rate tends to be associated with an exchange rate depreciation of 0.68% point.

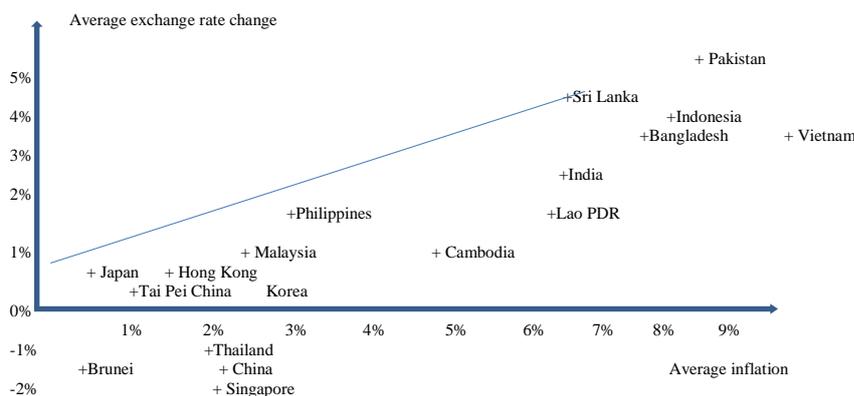
### 4.3. Inflation and Exchange Rate: The Vietnamese Situation

Resulting from an efficient monetary policy, the inflation process in Vietnam decreased significantly since the beginning of the present decade, which testifies a better control of several structural imbalances.

Nevertheless, we can conclude that in Vietnam, in a context of a dollarized economy, the high priority target of the central bank is to get a relative exchange rate stability. Vietnam’s authorities tightly manage the value of the dong. Until 2016, the State Bank of Vietnam (SBV) utilized a crawling peg exchange rate system, where the SBV would only periodically announce changes in the reference rate (i.e., the peg), usually in response to heavy pressure on the dong. In January 2016, the SBV announced a more flexible exchange rate policy that would allow daily updates to its reference rate, and stated that it would allow the dong to float within a previously established +/- 3 percent trading band.

The SBV stated that the new policy would entail a reference rate based on a weighted basket of eight foreign currencies - those of China, the European Union, Japan, Singapore, South Korea, Taiwan, Thailand, and the United States - though the SBV has not disclosed the relative weights. While these changes introduced greater de jure flexibility into the dong, in practice the dong has remained tightly managed, particularly against the dollar. Based on cross rates between the dong and the currencies in the basket, the SBV still appears to manage the dong far more closely to the U.S. dollar than to any other reference, and in very few instances has the dong reached the edge of the band during trading.

Sample: 18 countries (n = 1, 2, 3, ..., 18).  
 Variables are annual average of 2001-2017  
 $\Delta \epsilon_n = -1.42 + 0.68 \pi_n$   
 (-2.55) (6.11)  
 Adjusted R<sup>2</sup> = 0.71  
 t- statistic is shown in the brackets



Source - Author's calculations: World Bank and IMF Data

Figure 2: Trade-off between inflation and exchange rate movements

**Table 3:** Vietnam: Annual Inflation Rates %

Countries	Income group	Exchange rate regime	Monetary policy target	Capital controls
<b>Northeast Asia</b>				
Japan	High	Free floating	Inflation targeting 2%	Open
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<b>Vietnam</b>	<b>Lower Middle</b>	<b>Basket currency (high USD)</b>	<b>No explicit framework De-dollarization</b>	<b>Gate</b>

Source - State Bank of Vietnam and International Monetary Fund



Source: State Bank of Vietnam

**Figure 3:** Vietnam Exchange Rates (REER: Real Exchange Rate - NEER: Nominal Exchange Rate)

**4.4. Latent Dollarization: A Haunting Reality for the Entrepreneurship**

Even decreasing, at different levels, dollarization of bank assets and liabilities is a widespread and structural phenomenon in emerging economies and especially in Asia, as we can see in the following tables.

**Table 4.1:** Degrees of dollarization (2005-2017)

Countries	FC loans % total loans	FC liabilities % total liabilities	Countries	FC loans % total loans	FC liabilities % total liabilities
Russia	26.34	28.71	Malaysia	5.73	6.89
Turkey	26.87	40.63	Philippines	22.34	23.02
Cambodia	91.34	89.21	Sri Lanka	18.07	11.83
China PR	6.22	10.34	Thailand	8.56	10.33
India	7.61	7.68	<b>Vietnam</b>	<b>15.21</b>	<b>17.01</b>
Indonesia	17.78	19.04			

Source: International Monetary Fund

In Vietnam, despite a trend decline, dollarization remains a latent phenomenon inspiring several measures in the field of monetary policy.

Among the variety of reasons for agents to hold foreign currency balances, the currency substitution hypothesis points to the importance of foreign exchange risk effects. The hypothesis holds that the perceived risk of holding exclusively domestic currency increases when the exchange rate is floating. Sharp depreciations of the domestic currency would cause a large drop in revenues in dollar terms for the banks' clients, thus reducing their ability to service dollar debts.

As regards the monetary and the assets substitution view of financial dollarization, several authors link the phenomenon to the recollection of prior experiences of high inflation rates. With rampant inflation in mind, economic agents have a propensity to protect their purchasing power and value of financial or monetary assets through currency and/or assets substitution. In this regard, theoretical literature interprets dollarization as a currency substitution phenome-

**Table 4.2:** Vietnam: Deposit dollarization degrees (Foreign currency deposits/Total deposits) (%)

1992-1995	1996-2000	2001-2004	2005-2010	2011	2012	2013	2014	2015	2016	2017	2018
41.9	38.4	33.9	26.9	17.5	15.6	14.1	12.4	12.3	9.9	9.1	8.7

Source: International Monetary Fund

**Table 4.3:** Vietnam: Dollarization loans degrees (Foreign currency loans/Total loans) (%)

1992-1995	1996-2000	2001-2004	2005-2010	2011	2012	2013	2014	2015	2016	2017	2018
37.3	35.6	31.4	24.7	16.5	13.7	13.3	12.4	9.1	8.0	7.5	7.6

Source: International Monetary Fund

non, as a response to economic instability and high inflation. In conditions of hyperinflation, dollarization is typically quite widespread because the public seeks protection from the cost of holding assets denominated in domestic currency. Thus, volatile levels of inflation are said to be the chief reason for dollarization. The theory developed thereafter is well known as the ‘*currency substitution view*’ and focuses primarily on the use of foreign currency as a means of payment.

Since the Fisher equation holds, standard models in this vein explain the ratio between domestic and foreign currency nominal balances (FC) as a function of the nominal interest rates in domestic (i) and foreign (i\*) currency.

$$FC = f(i, i^*), \text{ where } f' < 0 \text{ and } f'' > 0$$

The uncovered interest parity basically explains changes in the exchange rate by the interest rate difference between foreign and domestic interest rates. Under this assumption, the inflation is ultimately reflected in the nominal exchange rate and expected inflation and as consequence should promote currency substitution. This view basically attributes a country’s current degree of dollarization to its high and chronic inflation - in particular, *expected inflation* and *nominal depreciation* are regarded as the key drivers of dollarization.

Dollarization creates balance sheet problems due to exchange rate fluctuations. It also involves some challenges at the micro and at the macro levels. Several authors point to its influence on inflation performance and, most prominently, the currency imbalance and associated financial fragility that it introduces for the economy as a whole. Financially dollarized economies tend to display higher infla-

tion rates, higher propensity to suffer banking crises, slower and more volatile output growth, without significant gains in terms of domestic financial depth. Financial dollarization influences the pricing behavior of firms and individuals. When the local currency depreciates against the dollar, it has immediate inflationary consequences for firms and households. Consequently, it appears that financial dollariza-

tion might pose certain risks to financial stability even in the case of developed and large financial intermediation (Vieira, Holland & Resende-2012; Marcelin & Mathur-2016). For these reasons, policymakers in highly dollarized countries intervene in forex markets to avoid bank crises that could result from banks' exposure to currency mismatch risk on their balance sheets.

Therefore, dollarization is not only a portfolio problem but also an insurance against expected volatility of inflation relative to that of real exchange rate. Market distortions, high inflation, shallow financial markets, and currency-blind financial regulations undermine confidence in the local currency. Such imperfections lead to additional frictions in credit markets along with moral hazard and adverse selection problems, as more borrowers and lenders prefer to transact in foreign currency, which in turn, results in a larger demand for foreign currency. Since liquidity in foreign currency is more restrained than that in local currency, and lenders apply stricter covenants for foreign currency loans, many projects with positive net present values (NPV) may come short of being funded (Marcelin & Mathur-2016).

#### 4.5. Interest Rates Differentials, De-Dollarization and ‘Repressed Dollarization’

If lending and deposit rates are still subject to interest rate ceilings, the central bank can use the ceilings as a policy instrument to alter monetary growth rate and economic activity. When sophisticated monetary policy instruments are not really available, ceilings on deposit and loan interest rates can be employed to affect real economic activity. By

altering the interest rate structure, bank balance sheets of the enterprises will be affected.

In a case of latent dollarization, changing interest rate ceilings can cause portfolio reallocation by households and commercial banks. Portfolio reallocation also takes place when the inflation rate rises and increased depreciation is expected. Under high inflation, the rate of return on dollar holdings increases, causing substitution of dollar deposits for local currency deposits in household portfolios. Thus, dollar substitution remains as long as the central bank cannot control inflation or prevent the expected depreciation of the local currency. Furthermore, as in the case of Vietnam, the phenomenon of *goldization* reflects the demand for inflation-hedged assets (Pham Thi Hoàng Anh – 2017).

Financial dollarization gives rise to currency mismatch, which can affect lenders and borrowers in the event of sudden deterioration of the exchange rate. Indeed, in dollarized or partially dollarized economies, shifts in the exchange rate have a substantial effect on financial holdings. During periods of sharp decline in the value of the domestic currency, financial assets and liabilities shift into foreign currencies, exacerbating downward pressure on the exchange rate. Central banks should focus on smoothing excessive volatility while allowing the exchange rate to adjust and help absorb shocks. In these economies, even with a flexible exchange rate, central banks face pressures to keep the exchange rate steady in nominal terms.

As a result and consequence, interest rates in the domestic currency are set at levels substantially higher than those on dollar assets. Banks in such states of the world prefer to lend to the government at these rates than to the private or corporate sector. Firms may benefit from lower on dollar debt, but face significant exchange rate or currency risk due to their dollar debts unmatched by their receivables nominated in domestic currency.

In Vietnam for instance, several de-dollarization policy measures are implemented and a downward trend in deposit and loan dollarization is clearly observed. For this purpose, the interest rates policy is a privileged tool to promote financial operations

in national currency, which implies high interest on VND and weak or even zero interest on dollar deposits. To analyze this phenomenon, let us consider the interest differentials using the interest parity theory and comparing the interest rates of two currencies and estimates changes in the exchange rate, where  $r$  is the domestic interest rate,  $r^*$  is the foreign interest rate, and  $E(\rho)$  is the expected exchange rate change (Le et al. – 2013; Pham Thi Hoang Anh - 2014 and 2017).

$$r = r^* + E(\rho) \text{ which implies Interest rate differentials} = r - [r^* + E(\rho)]$$

However, in most cases, interest rate parity, including covered and uncovered, does not hold because of unrealistic assumptions. This, therefore, will allow us to identify profit from arbitrage opportunities. We can see that the decreasing dollarization in Vietnam is led by a deepening spread between VND and USD deposit rates, meaning that in fact we are facing a ‘forced de-dollarization’ or a ‘repressed dollarization’, very costly if we consider the spreads and the high interest rates on VND deposits.

**Table 5:** Interest differentials in Vietnam

Years	Change in USD's value against VND (1)	USD deposit rate (2)	Total yield of USD deposit rate (3) = (1) + (2)	VND deposit rate (4)	Spread rates (5) = (4) – (3)
2010	5.52	4.5 – 5	10.02/10.52	13.88	3.36 /3.86
2011	10.01	2	12.01	14	1.99
2012	0.00	2	2	8	6
2013	1.00	1.25	2.25	7	4.75
2014	1.00	0.75	1.75	5.5	3.75
2015	3.03	0	3.03	5.5	2.47
2016	1.18	0	1.18	5.5	4.32
2017	-0.01	0	-0.01	5.04	5.05
2018	-0.02	0	-0.02	4.78	4.80

Source: IMF's International Financial Statistics; SBV; ADB Key Indicators; Pham Thi Hoang Anh

Moreover, in Vietnam, this interest rates management is completed by a lot of regulatory measures in several fields: restrictions to foreign currency loans; settlement of domestic transactions using FCD not permitted; reserve requirement on FCD, quotations of prices in FC banned; de-goldization measures; foreign exchange controls and tight controls on the parallel market... (Pham Thi Hoang Anh - 2017; Hidenobu Okuda -2017).

In Vietnam in fact, like in several emerging countries, the apparent decline in dollarization is

often the consequence of a ‘repressed dollarization process’ or ‘forced de-dollarization’ process. This process is sometimes the result of authoritarian regulations, but more often the result of interest rates differentials in favor of deposits and investments in local currency with heavy consequences on the firms’ managerial finance.

#### 4.6. Monetary Policy, Interest Rates and Exchange Rate Management: A Simple Integrative Model With Implications for the Entrepreneurship

Let us define a simple model of the Vietnamese monetary policy aimed simultaneously at limiting the inflation, stabilizing the exchange rate and repressing the dollarization.

- We suppose that there are two types of potential borrowers indexed by  $t \in [1,2]$ .

- Borrowers type 1, mainly big firms, are dollarized borrowers, meaning that they underwrite loans denominated in US dollars.

- Borrowers type 2, commonly SME, are mainly Vietnam Dong borrowers, more or less excluded from loans underwritten in US dollars.

- The expected return of the lender is  $E\Pi(r)$ .

- $r^*_{USD}$  is the equilibrium highest interest rate at which type 1 dollarized borrowers are willing or able to borrow.

- $r^*_{VND}$  is the equilibrium interest rate on loans underwritten in Vietnam Dong, of course depending on the central bank’s monetary policy.

Thus, we must distinguish between two credit demand functions, with different elasticities:

- A credit demand function from dollarized borrowers with two variables: the interest rate  $r_{USD}$  and the expected exchange rate  $\exp \rho$ .

- A credit demand function from VND borrowers with two variables: the interest rate  $r_{VND}$  and the expected exchange rate  $\exp \rho$ .

- The elasticity is higher for function (2) than for function (1):  $\xi(2) > \xi(1)$ .

Following this formalization, we can check:

- 1)- A tendency to VND depreciation implies:  $\exp \rho(a) > \exp \rho(b) > \exp \rho(c)$ .

- 2)-Therefore, the expected return of the lender  $E\Pi(r)$  is increasing with the same level of interest rate on loans denominated in dollars  $r^*_{USD}$ .

- 3)-Nevertheless, the result is also a rise of the equilibrium interest rate on the VND to limit the dollarization and the depreciation of the national currency:  $r^*_{VND}(c) > r^*_{VND}(b) > r^*_{VND}(a)$ .

- 4)-This relationship is obviously valid for deposit interest rates as for the lending rates.

The result of this simplified model is the following:

- In case of exchange rate depreciation or inflation worsening, only a significant increase of interest rates on local currency rates is able to limit the latent dollarization.

- A strategy of ‘forced de-dollarization’ or ‘repressed dollarization’ may only transform one problem (vulnerability to exchange rate shifts) into another (high local real interest rates).

- Unfortunately, the Vietnamese economy is still permanently facing this dilemma.

To overcome at least partially this structural handicap, it is indispensable to stabilize the exchange rate of the national currency Vietnam Dong.

#### 5. Interest Rates Policy and its Consequences: A Latent Credit Crunch

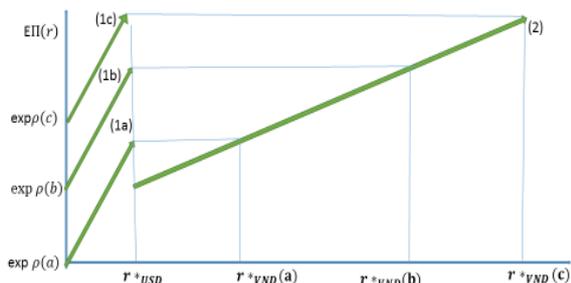
In Vietnam the monetary policy with the axis of ‘de-dollarization’ drives to comparatively high interest rates on deposits and loans in VND, even if they are diminishing. Interest rates remaining at a high level are constitutive of a credit crunch phenomenon.

##### 5.1. The Persistence of Structurally High Interest Rates

Under different concepts (deposit rates, lending rates, central bank policy rates, real interest rates) the situation in Vietnam and in some Asian countries confirm the preceding point of view, as we can check it considering the following data in Tables 5 and 6.

- The interest rates, either lending or on deposit, are decreasing as a trend in most of the Asian countries, as consequence of efficient monetary policies since the crisis of 1997-1998.

- Nevertheless, the most dollarized economies (Indonesia and Vietnam) are presenting the highest interest rates (respectively 11.17% and 7.41% for the lending rates in 2018).



(1) Credit demand function from dollarized borrowers (type 1) –  
 (2) Credit demand function from local currency borrowers (type 2)  
 (3) The expected return of the lender is  $E\Pi(r)$   
 (4)  $\exp \rho(a), \exp \rho(b), \exp \rho(c)$ : expected exchange rate.  
 (5)  $\exp \rho(a) \geq \exp \rho(b) \geq \exp \rho(c) \rightarrow$  Depreciation of VND exchange rate from (a) to (c)  
 (6) Consequence:  $r^*_{VND}(a) \leq r^*_{VND}(b) \leq r^*_{VND}(c) \rightarrow$  Credit crunch

**Figure 4**

- Moreover, in Vietnam the ‘de-dollarization’ policy drives to comparatively high interest rates on deposits and loans in VND, even if they are diminishing.

**Table 6: Interest rates in Vietnam (%)**

Interest rates	2011	2012	2013	2014	2015	2016	2017	2018
C.B. Policy rates (*)	15.00	9.00	7.00	6.50	6.50	6.50	6.25	6.25
Deposit rates	13.99	10.50	6.69	4.92	4.68	4.80	4.78	5.51
Lending rates	16.95	13.47	10.37	8.16	8.12	6.96	7.41	7.87
Gvt. Bonds yields (10-years) (**)	12.35	8.82	6.64	5.04	5.07	4.98	5.07	4.86
								30.06.2019: 6.39

Source: (\*) State Bank of Vietnam - (\*\*) Asia Bonds on Line: 10-Years Local Currency Government Bonds

**Table 7: Interest Rates in Selected Asian Countries 2018 (%)**

Countries	CH	HK	IND	KR	MY	PH	SG	TH	VN
CB Policy rates	2.25	0.21	4.75	1.25	3.00	3.42	0.96	1.50	<b>6.25</b>
Deposit rates	1.50	0.01	7.17	1.56	3.03	1.60	0.19	1.35	<b>4.78</b>
Lending rates	4.35	5.00	11.17	3.37	4.54	5.35	3.35	4.31	<b>7.41</b>
Gvt. Bonds yields (31.12.2018)	3.14	1.95	8.16	2.03	4.07	6.47	4.73	2.41	<b>5.07</b>

CH: China – HK: Hong Kong – IND: Indonesia – KR: Korea – MY: Malaysia – PH: Philippines – SG: Singapore – TH: Thailand – VN: Vietnam  
Source - Bloomberg and IMF

Very significant for the firms business plans, it is convenient to consider the ‘real interest rates’, e.g; the lending interest rate adjusted for inflation as measured by the GDP deflator, although the terms and conditions attached to lending rates differ by countries limiting their comparability. Nevertheless, the real interest rates in Vietnam look high comparatively to most Asian countries and moreover structurally unstable.

**Table 8: Real interest rates in selected Asian countries (%) – ( $r_{GRP} = r_{CDM} - r_F$ )**

Years	China	Hong Kong	Indonesia	Korea	Malaysia	Philippines	Singapore	Thailand	Vietnam
2011	4.02	1.12	4.59	4.11	-0.47	2.54	4.08	1.28	<b>-3.55</b>
2012	5.32	1.43	7.77	4.31	3.75	3.64	5.62	3.22	<b>2.29</b>
2013	4.88	3.11	6.38	3.76	4.43	3.65	5.63	3.29	<b>4.65</b>
2014	4.27	2.09	6.81	3.64	2.07	3.29	1.71	3.46	<b>4.43</b>
2015	4.25	1.31	8.35	1.11	4.97	6.20	1.70	3.84	<b>7.16</b>
2016	3.18	1.30	9.18	1.15	4.26	3.88	5.39	2.06	<b>5.79</b>
2017	0.28	1.29	6.55	1.21	4.09	3.23	4.37	2.05	<b>5.18</b>
2018	1.41	1.26	6.52	1.17	3.16	2.37	3.39	2.72	<b>4.23</b>

Source: CEIC and World Bank Data

A latent and structural risk of credit crunch could result from this situation, a situation that affected the Vietnamese economy which fell into recession in 2011, as a consequence of high lending rates. For this reason, the State Bank of Vietnam modified its

policy in 2012. By allowing commercial banks to provide again short-term dollars loans, the SBV could achieve its targets of credit expansion to promote economic growth. However, this hampered reductions in foreign-currency-denominated loans and finally a creeping dollarization could continue in 2015, and then 2016 and 2017 (Pham Thi Hoang Anh - 2017).

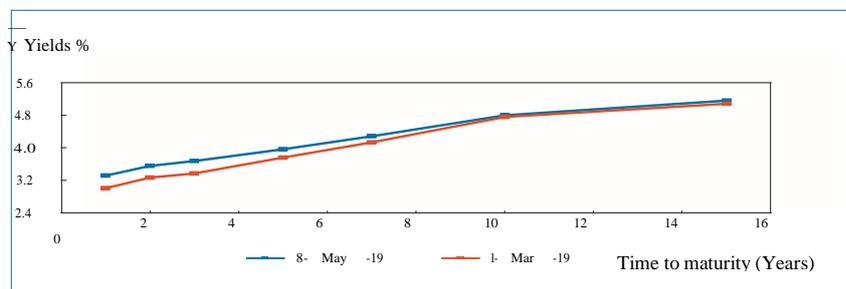
**5.2. Interest Rates and Growing Public Indebtness: A Structural Eviction Effect**

Often in a recurring manner, Vietnam is facing tensions on its sovereign debt and on the Treasury bill rates, as result of a public debt representing more than 57% of GDP and a fiscal deficit reaching 3.6% of this indicator.

Recently, the overall upward trend in bond yields was influenced by the uptick in deposit rates. Some banks raised deposit interest rates at the beginning of the year, to enable them to attract funds for mobilization. A regulation by the State Bank of Vietnam (SBV), which came into effect in 2019, reduced the ratio of short-term capital that can be used for long-term lending. Only 40% of a bank’s short-term capital can now be used for long-term lending, down from the previous allowable amount of 45%. As a

result, borrowing costs edged higher. The uptick in bond yields at the short-end of the curve can also be attributed to rising inflation expectations.

From this relatively high cost of public debt servicing results increased interest rates for the



Source - Bloomberg and Asia Bonds on Line

**Figure 5:** Viet Nam's Benchmark Yield Curve: Local Currency Government Bonds

firms, by a reallocation of bank assets away from lending to the corporate sector, especially the SME, and towards government securities and foreign exchange instruments.

Moreover, in Vietnam, the risk premium on lending remains high and even increasing during the recent years. This risk premium on lending interest rates charged by banks on loans to private sector customers minus the 'risk free' treasury bill interest rate at which short-term or medium-term government securities are issued or traded in the market.

**Table 9:** Risk Premium on Lending: Lending Rate minus Treasury Bill Rate (%)

2007	2010	2011	2012	2013	2014	2015	2016	2017	2018	June 2019
7.027	1.990	4.604	4.655	3.300	2.291	2.764	2.891	2.999	3.021	3.010

Source- World Bank; State Bank of Vietnam; CEIC Data Bloomberg Center Harvard Business School.

As we can see, the data reached an all-time high of 7.027% pa in 2007 and a record low of 1.990% pa in 2010 and after recorded significant increases to remain at a steady level during the last years, around 3.00%.

It appears that the large and growing Treasury and public sector borrowing in relatively tight financial markets exert strong eviction effects against companies and of course especially against the SMEs.

### 5.3. Volatility and Interest Rates Risks: Implications for Entrepreneurship

Using several statistical tools, we try now to assess the volatility of the interest rates, a volatility often causing major difficulties for Vietnamese enterprises, especially the SMEs, due to their insufficient equities and own liabilities.

As we can see, this situation results in a structural instability of the interest rates that often disrupts firms' economic calculations. With Philippines and Indonesia, Vietnam is presenting the interest rates highest means in the long-term and the highest volatility witnessed by the variances, the standard deviations and other significant indicators.

This high interest rate risk leads the entrepreneurs to discard projects with net present values considered too weak or risky. Indeed, medium and long-term investment and business plans require stable parametric data as regards the cost of the debts and available funds.

### 6. Conclusion: Entrepreneurship, Credit Crunch and the Emergence of New Financial Paradigms

The main purpose of this paper was to expand the scope of the credit crunch reality and to analyse the systemic risk determinants of the real interest rate in the Vietnamese economy. Vietnam is an interesting case study because, despite past high systemic risks, it managed to decrease financial dollarization and to limit structural inflationist tensions. But what most calls attention are the country's high real interest rates, compared to other Asian countries. For given systemic risks, high real interest rates and a credit crunch were the price to pay to limit dollarization.

Recognizing this crucial reality, *Le Duc Thuy* (2016), former Governor of the State Bank of Vietnam who led the monetary policy from 1999 to 2007, declared with relevance, 'the zero per cent dollar

deposit rate cannot persuade people to shift to deposit dong instead of dollars at banks. The mobilized capital in dollars is still higher than lent, which means that people continue hoarding dollars. For this reason, the goal of the fight against dollarization remains unstable, while the dollarization has increased'.

Some have argued that under the prevailing circumstances, rising real interest rates might fail to bolster market confidence or might even be counter-productive. For instance, in the context of the Vietnamese recession in 2012-2014, high real interest rates caused more harm than good by leading to risks of bankruptcies and thus undermining the prospect of loan repayment. Indeed, some of the features of the Vietnamese economy and of some East Asian economies, i.e. bank-based financial systems and high leverage, appear particularly conducive to a significant credit channel of transmission of monetary policy shocks. The magnifying effects stemming from this channel render these economies particularly vulnerable to monetary policy shocks,

**Table 10:** Interest Rates in Selected Asian Countries: Long-Term Evolution.

Countries	Indonesia 1993/2018	Korea 1997/2017	Malaysia 1997/2018	Philippines 1976/2017	Singapore 1978/2017	Thailand 1976/2017	<i>Vietnam</i> <b>1993/2017</b>
MEAN	16.331	6.60	7.142	13.25	6.61	10.23	<b>12.35</b>
Variance	27.736	8.08	4.989	34.93	3.69	19.64	<b>29.63</b>
Standard dev.	5.287	2.84	2.233	5.91	1.92	4.43	<b>5.44</b>
Skewness	1.799	1.71	0.273	0.81	2.08	-0.05	<b>2.40</b>
Kurtosis	3.623	3.61	- 1.139	0.46	4.41	-1.48	<b>7.57</b>
Coeff. Var.	0.322	0.43	0.301	0.45	0.29	0.43	<b>0.44</b>
Median	14.710	5.90	6.827	12.20	5.86	11.04	<b>11.03</b>
Max	35.720 (Sep. 1998)	15.28 (1998)	12.134 (1998)	28.61 (1985)	13.64 (1981)	17.21 (1981)	<b>32.18</b> <b>(1993)</b>
Min	10.480 (Aug. 2018)	3.37 (2016)	4.544 (2016)	5.53 (2014)	5.28 (2017)	4.33 (2010)	<b>6.96</b> <b>(2016)</b>
Previous obs.	10.550 (Jul.2018)	3.37 (2016)	4.585 (2015)	5.64 (2016)	5.35 (2016)	4.47 (2016)	<b>7.40</b> <b>(2017)</b>
Last obs.	10.480 (Aug. 2018)	3.48 (2017)	4.544 (2016)	5.63 (2017)	5.28 (2017)	4.42 (2017)	<b>7.87</b> <b>(2018)</b>
Obs. number	33	21	30	42	40	39	<b>28</b>

Source: Author's calculations from Bloomberg and CEIC Data

especially to a significant interest rate decided by the Central Bank. It is therefore indispensable, in our opinion, to apply the credit channel literature to explain the persistence of structural and recurrent credit crunch antagonistic to the emergence of an entrepreneurship.

It appears that a credit crunch affects recurrently some sectors of the Vietnamese economy, particularly small-sized banks and enterprises. Based on our findings we are inclined to conclude that protracted and heavy reliance on tight monetary policy and high interest rates to fight the latent dollarization can have perverse effects and may be counter-productive to restoring market confidence and stimulating entrepreneurship. It would therefore be desirable to consider other policy instruments which do not place further stress on the banking sector and on its lending to the corporate sector. A key challenge faced by many emerging markets is their heavy reliance on traditional commercial banking. Nevertheless, with the absence of robust debt and money markets, the ability of banks to increase their loan portfolio and to diversify the credit risk is limited by their access to deposits, especially in a context of persistent financial dollarization. This analysis implies some policy recommendations. Developing deeper domestic bond markets in developing countries is an effective means of fighting against financial dollarization and potential credit crunch. Some empirical studies reveal that the greater effectiveness of domestic bond markets in reducing dollarization arises when associated with

an inflation- targeting regime or a flexible exchange rate regime and in an established fiscal rule framework. Under such circumstances, domestic bond markets participation can reduce the interest rate risk and then set the bases for the greater effectiveness of monetary and fiscal policies in developing countries (Balima – 2017; Cy Young Park- 2016; Marcelin & Mathur - 2016).

Moreover, some socio-economic realities must be recalled. Vietnamese society is characterized by high levels of savings, as consequence of a strong growth, important gains in living standards, an emergence of a middle-class and of course a pre-eminent influence of cultural values. This phenomenon appears as a structural parameter of the Asian development process. The savings rates in Asia are especially high, higher than in most developed countries, if we consider for instance the G-7 countries. In this regard, Vietnam, even with an estimated low GDP per capita of \$2300 in 2017, presents a savings rate of 27-28 %, really more important than France (21%), Italy (19%), United Kingdom (12%) or USA (19%) and comparable to Germany (28%) (Vietnamese People's Army Newspaper - 2018; Boismery - 2017). These socio-economic realities should allow overcoming the handicaps of credit crunch against the entrepreneurship with the introduction of financial innovations in line for a promotion and an efficient management of national savings.

Financial innovations especially in emerging markets ought to make the movement of capital

more efficient, risk management more targeted, hedging better matched, and trading less costly. Financial innovations also ought to contribute to better management and transfer of credit risk, improved liquidity, more optimal portfolio diversification, and broadened credit risk dispersion. Without a renewed effort to foster financial innovation, the Vietnamese economy will under-perform its strong potential of entrepreneurship. The principal challenge for policymakers, then, is to strike an appropriate balance between financial openness that supports growth-enhancing innovation while at the same time implementing regulations and effective supervision that limit the potential risk of financial instability antagonistic to the emergence of a national and endogenous entrepreneurship. ♦

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### Summary

Bài báo xem xét liệu Việt Nam đã và đang đối mặt với tình trạng thắt chặt tín dụng trong bối cảnh tăng trưởng kinh tế nặng động hay không và mức độ thắt chặt tín dụng đến mức nào. Bài báo sử dụng khung lý thuyết hệ thống các quan điểm truyền thống về tín dụng để đánh giá thực trạng và mức độ thắt chặt tín dụng vốn được coi là một rào cản lớn đối với sự phát triển của doanh nghiệp ở Việt Nam. Sử dụng phương pháp tiếp cận nhất quán dựa trên một vài chỉ số (tỉ lệ lãi suất, tỉ giá hối đoái, mức độ đôla hóa, chính sách tiền tệ), bài báo không chỉ dừng lại ở các chỉ số và bằng chứng kinh tế vĩ mô. Khung lý thuyết cũng cho phép đánh giá sự tác động của thắt chặt tín dụng đối với các lĩnh vực khác nhau của nền kinh tế. Kết quả chính của nghiên cứu chỉ ra rằng thắt chặt tín dụng là một thực trạng phổ biến và kéo dài ở Việt Nam và các tác động tiêu cực của nó ảnh hưởng tới khả năng sinh lời của các khoản đầu tư của doanh nghiệp. Bên cạnh đó, việc phụ thuộc lâu dài vào chính sách tiền tệ thắt chặt, kéo theo tỉ lệ lãi suất cao, cũng không phù hợp với việc phục hồi niềm tin dài hạn trên thị trường. Do đó cần cân nhắc các công cụ chính sách khác nhằm đưa ra các mô hình mới không tạo áp lực đối với lĩnh vực ngân hàng và các khoản vay của ngân hàng đối với khu vực doanh nghiệp.