The role of bank credit toward sustainable development in Vietnam

The State Bank of Vietnam

1. Overview

After almost four decades of "Doi Moi" policy execution, Vietnam has made great achievements in many fields. The economy has developed comprehensively in both scale and quality, and people's lives have improved. In the financial system, the money market and credit institutions have played an important role promoting the system's effectiveness as a channel for capital mobilization and supply for production and business activities. As a state management agency in the fields of money and banking, the State Bank of Vietnam (SBV) has implemented suitable policies to develop the money market in a proactive, flexible and appropriate manner, ensuring that credit institutions have liquidity to provide capital to the economy. This has ensured the safety of the national financial system. However, the unpredictable world economic context – the deep impact of the Covid-19 pandemic, geopolitical tensions, supply chain disruptions, tightening monetary policy by major central banks – as well as some difficulties in the domestic economy have had great influence on the money market and the SBV's monetary policy management. Those challenges require the SBV to continue to improve its legal framework, including credit policies, to be flexible and proactive and to adapt to domestic and international developments. This will allow for smooth, safe and effective management of the market toward macroeconomic stability, inflation control, sufficient capital supply and safe operation of credit institutions.

2. The role of credit in economic growth in Vietnam

The financial system includes financial institutions (banks and non-banks), financial markets (capital market and money market) and economic institutions that govern their operations (legal framework, inspection and supervision mechanisms). In Vietnam, the financial system has been developing and gradually improving in all aspects. Financial institutions have been growing in scale and scope of operations, modernizing and gradually approaching international standards. In 2023, credit institutions in particular play a very important role, accounting for more than 93% of the total assets of all financial institutions. The size of the financial market has been increasing too. By the end of 2023, the size of bank credit had reached over 133% of gross domestic product (GDP) and that of stock market capitalization was at about 56.4% of GDP. The government, ministries and agencies have been continuously improving the legal system that regulates financial market operations by making laws, decrees and circulars to facilitate safer and more efficient operations for market participants. Inspection and supervision mechanisms have also been strengthened to ensure the safe and sound operation of the financial system.

In addition to the structure of the financial market, the role of bank credit and the money market is extremely important. When the capital market remains underdeveloped and immature, the economy's capital requirements, especially medium- and long-term capital, are met through bank credit. Between 2007 and 2010, the average growth rate of credit in the banking system was 36% per annum. Particularly, in 2007, it reached 53.8% to meet capital needs for economic development. However, excessively high credit growth in combination with competition in gaining market share in which credit institutions pushed deposit rates higher to have enough liquidity for lending resulted in maturity mismatch and high non-performing loan rate, posing threats to the safe of credit institution system. This pushes up interest rates, increases the number of non-performing loans and threatens the safe operation of the credit instutition system.[1]

Since 2012, the SBV has deployed monetary policy tools synchronously, in particular flexible management of a credit growth target for the credit institution system, thereby directing credit growth to a more reasonable level. The liberalization in certain interest rates and autonomy granted for credit institution in negotiating interest rates with customers have also allowed credit activities to better reflect market supply and demand, while respecting the risk appetite and business strategies of credit institutions. In addition, the legal framework for credit activities has been improved, in line with progress and digitalisation trends in the banking sector.

As a result, from 2012 to 2023, credit growth decreased to around 12–14% per year.[2] The economic growth rate increased gradually, from 5.2% in 2012 to 7% in 2019, before the outbreak of the Covid-19 pandemic. This shows a significant improvement in capital use efficiency during this period (see Appendix 1). The credit structure has shifted in line with the economic structure, focusing on the production and business sectors. Credit to potentially risky areas has been controlled; on-balance, the non-performing loan (NPL) ratio has been maintained at low levels. Credit institutions have improved their governance, operational capacity and prudential indicators, while at the same time accelerating the restructuring process, NPL resolution and cuts to market interest rates, contributing to macroeconomic stability and inflation control.

3. Challenges in credit policy management

Recently, the SBV has made many changes to its credit management. However, as Vietnam is a small transitioning economy with large openness, potential risks affecting the SBV's policy management are in several areas.

[1] Vietnam's ratio of credit to GDP is over 133% and continues to increase – the highest among low- and middle-income countries. The World Bank has continually warned about systemic risks and the safety of the national financial security associated with this.

[2] Annual credit growth over the 2019–2023 period was 13.65%, 12.17%, 13.61%,14.19% and 13.78% respectively.

First is the heavy reliance of economic development on bank credit, given that the capital market has not developed in proportion with its role as a medium- and long-term capital supply channel. Vietnam is among the countries with a high ratio of total banking system assets to GDP, at about 200% (the average ratio of the 10 countries in the Association of Southeast Asian Nations is 88.98%). Vietnam's credit to GDP ratio is the highest among low- and middle-income countries according to World Bank statistics, reaching over 133% (Appendix 2). Heavy reliance on bank credit poses potential financial risks, increasing liquidity risks because capital mobilization by the credit institution system is mainly short term while medium- and long-term credit accounts for a large proportion of total credit outstanding.

Second is the great deal of pressure from global economic uncertainty on the management of monetary policy in general and credit policy in particular. Recent shocks have intensified pressure on global inflation, forcing central banks to tighten monetary policy and leading to appreciation of the US dollar. This has affected investor sentiment[3] and triggered capital outflows from emerging markets, therefore putting pressure on exchange rates and interest rates in developing countries, including Vietnam. Tightening monetary policy to cope with inflationary pressures may cause a decline in both credit demand and the economy's ability to absorb capital. This would have a negative impact on domestic economic development goals in the medium term.

Third, according to the "excessive finance" theory of Arcand (2015), when financial depth exceeds a certain threshold, it will reduce economic growth.[4] Currently many countries maintain financial depth above the threshold of 100%, even 200%, challenging the theory of excessive finance. The negative impact of excessive finance on economic growth could be explained in several ways: (i) The larger the financial system is, the more difficult supervision becomes and risk taking increases, leading to the probability of fluctuations in the economy as well as increasing crises over time. (ii) Excessive development of the financial system will lead to uneven resource distribution, attracting a large number of high-quality workers to participate in the financial system, affecting other economic sectors and economic growth. With a high credit-to-GDP ratio, Vietnam may face the adverse impact of excessive finance on economic growth.

Fourth is climate change and more frequent extreme and unusual weather patterns, negatively affecting human health and leaving behind economic losses and impacts on Vietnam's sustainable growth. This raises the need for timely, appropriate solutions to minimize and adapt to the impacts of climate change. In particular, credit policy needs to aim at green credit by increasing the proportion of credit in renewable and clean energy in tandem with integrating aspects of sustainable development, climate change and green growth in lending programs and projects. These are big challenges considering that green credit is new in Vietnam, the legal and practical

[3] The US dollar index (DXY) increased sharply, approaching 115 in September 2022, up by more than 19% year to date and 23% year on year – the largest annual increase since 1981.

[4] According to this study, a non-linear relationship between the private sector credit-to-GDP ratio and GDP per capita is established when excessive financial conditions occur, ie when the credit-to-GDP ratio begins to enter the range of 80% to 100%.

foundations are inadequate, and green credit development policies have not been thoroughly implemented.

Finally, industry 4.0 and the application of new achievements in financial and banking activities have led to an increasing number of new products and methods in bank credit activities. This is both an opportunity and a big challenge for authorities to develop an appropriate legal framework for creating suitable development space for credit institutions in the context of digital transformation while ensuring the safety of credit activities.

4. Orientations for credit policy management

To promote the role of bank credit as an effective capital channel, meeting the capital needs of the economy, the SBV will focus on the following:

– Managing monetary policy in a proactive and flexible manner and in close coordination with fiscal and other macroeconomic policies, adhering to the priority objective of inflation control, contributing to maintaining macroeconomic stability and laying a solid foundation for sustainable and effective economic growth.

– Continuing to improve the legal framework to facilitate credit institutions' provision of a full and diverse range of products and services, and at the same time, improving people's access to credit, especially vulnerable groups; instructing credit institutions to safely and effectively grow credit and direct it toward the production and business sectors to create growth momentum; continuing to implement solutions to facilitate businesses' and people's access to bank credit.

– Instructing and facilitating credit institutions to strengthen their financial, governance and operational capacity to improve credit provision efficiency and reduce credit risk and the NPL ratio; restructuring credit institutions associated with NPL resolution, enhancing the quality and effectiveness of inspection and supervision to limit the use of loans for improper purposes, and strictly controlling credit in risky areas; giving early warning and taking measures to handle cases of potentially high credit risk, limiting the occurrence of risks and insecurity in the credit institution system.

– Continuing to consolidate the legal foundation for credit activities based on full compliance with the rules of the market economy, toward international standards and practices and in accordance with Vietnamese conditions; strengthening communication and dissemination of credit mechanisms, policies and programs in many forms so that people and businesses can understand and access bank credit policies, products and services.

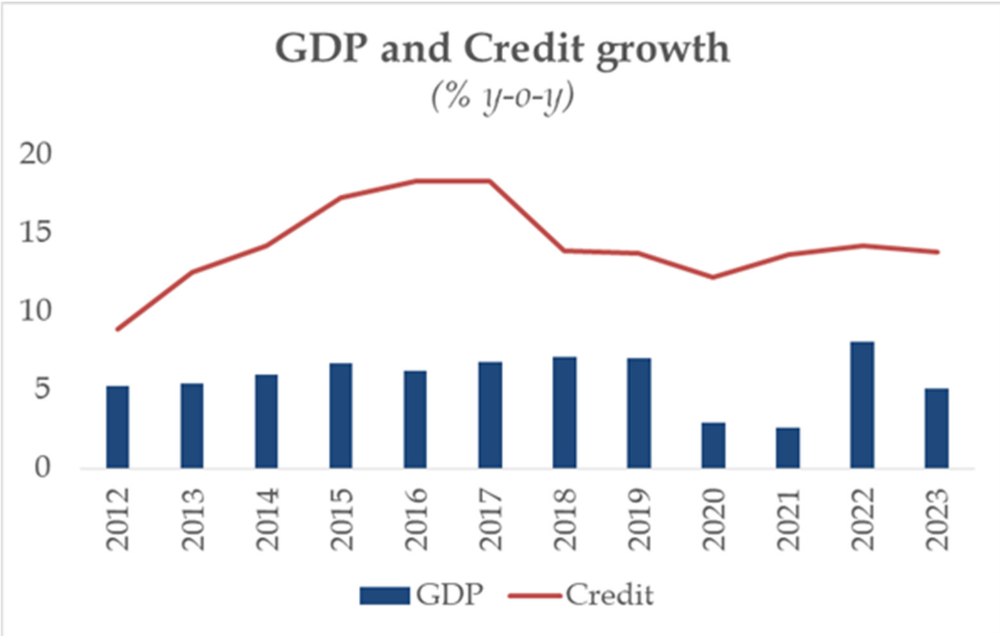
– Developing and communicating guidelines for green banking and green credit activities, incentives, support mechanisms and tools to encourage the development of green banking and green credit.

– Promoting digital transformation in the banking industry, applying new technologies to banking products and services, strengthening the connection and interoperability between capital and money markets to improve the efficiency and transparency of cash flows in the market and to monitor risks.

Credit growth and economic growth in Vietnam

in the 2012–2023 period

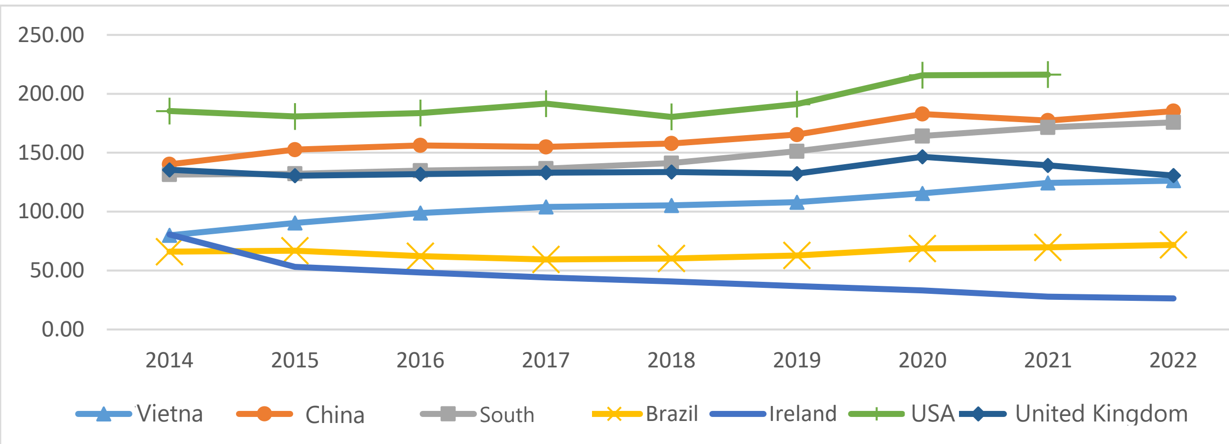
Appendix 1



Vietnam's credit to GDP ratio

Relative to other countries

Appendix 2



Sources: World Bank Database