

# The Unintended Consequences of Successful Resource Mobilization: --- Financing Development in Vietnam

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The views expressed in this paper are those of the authors alone and do not necessarily reflect those of the Fulbright Economics Teaching Program or the Harvard Kennedy School

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## **Executive Summary**

The total amount of development finance generated by Vietnam has been exceptionally high from all significant sources using all standard measures of comparison. However, there are many potential unintended consequences of Vietnam's successful resource mobilization, with significant implications for the future financing of development. There are several steps the government can take to mitigate these risks.

The principal vulnerabilities created by Vietnam's mobilization of substantial resources for development finance fall into two main categories: threats to macroeconomic stability caused by imbalances in the composition of funding; and risks for microeconomic management arising from imprudent financing structures.

The most serious macroeconomic threats are: public sector funds crowding out both access to and utilization of private sector funds; overleveraging of insufficient equity for unsustainable levels of debt; financial exclusion of low-income households and family enterprises; and flight of hot capital.

The most serious microeconomic risks are: maturity risk from over-reliance on short-term financing for long-term investments; foreign exchange risk from over-use of foreign capital for investments in non-tradable goods; credit risk from debt-financed speculation in asset bubbles; and fiscal gap risk from public sector dependence on unsustainable revenue sources.

The suggested ways of mitigating these vulnerabilities include: further deregulation and liberalization of the banking sector, coupled with government disengagement from commercial financing; further development of equity markets and more rigorous enforcement of prudential norms; further development of microfinance institutions, products, and delivery systems; introduction of market-based instruments to manage FPI speculative outflows, together with more effective monitoring of the private sector's external debt; further development of domestic long-term debt instruments; better coordination of monetary and fiscal policy; and continued implementation of comprehensive tax reform.

## **I. Study Objectives**

Vietnam has undoubtedly made tremendous economic and social progress over the past two decades, due in large part to its success in mobilizing substantial resources to finance both public and private development initiatives. However, in order to maintain its rapid pace of development and achieve its goal of becoming an industrial country by 2020, Vietnam must continue to generate a large and diverse pool of investment funds. Financing the necessary investment to achieve these ambitious goals presents an enormous challenge for Vietnam.

In this context, this study's objectives are to:

- conduct a comparative analysis of development finance trends in Vietnam;
- highlight successes to date; and
- identify the current challenges which were predominated created by past successes.

This study is intends to increase awareness both of the unintended consequences of successful resource mobilization in Vietnam since commencement of the *Đổi mới* economic reforms more than two decades ago, as well as their implications for future development financing in Vietnam.

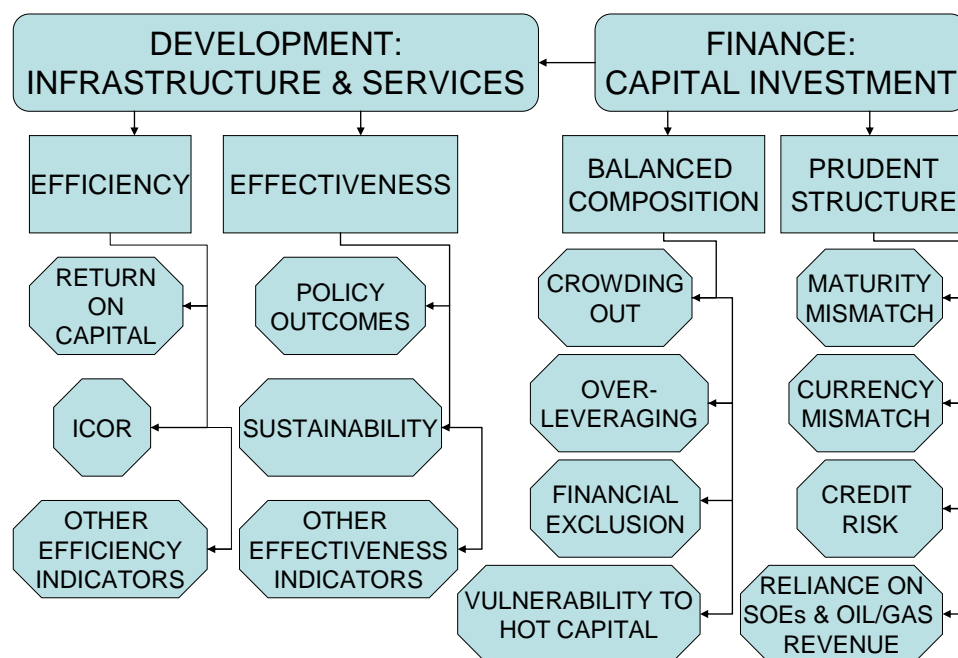
## **II. Analytical Framework**

As depicted in Figure 1, development finance can be thought of as capital investment in infrastructure and services, with analysis devoted to either the sources of funds (“finance”) or the applications of these funds (“development”).

This study will focus on where the money comes from, the “finance” component. It will explore macroeconomic vulnerabilities created by imbalances in funding composition (i.e., crowding out, over-leveraging, financial exclusion, and capital flight), as well as microeconomic risks that have resulted from imprudent financing structures (i.e., maturity and currency mismatches, credit risks, and reliance on unsustainable revenue sources such as state-owned enterprises, oil and gas sectors, and trade tariffs).

A companion paper (Dapice 2009) focuses on how the money is used, or the “development” component. It explores the results of development investments, utilizing efficiency performance metrics such as return on capital and ICOR (incremental capital output ratio) and effectiveness indicators such as achievement of policy objectives and sustainability of policy outcomes.

**Figure 1: Development Finance Analytical Framework**



Source: Developed by authors

Within the finance component, this paper will focus solely on capital investments rather than all types financing – it should not be mistaken for a comprehensive assessment of Vietnam’s entire financial sector. Thus, this paper is devoted to the following sources of finance:

- public investment, comprised of funds from the state budget, and official development assistance, or ODA, and state-owned enterprises (SOEs); and
- private investment, comprised of funds from domestic sources, foreign direct investment (FDI), and foreign portfolio investment (FPI).

To place this analysis in comparative context, this paper will utilize both longitudinal data, in most cases time series from 2000 through 2010, as well as data from countries sharing similar salient characteristics with Vietnam. Primarily, this study will look at the following eight countries:

- China and India, the largest and in many dimensions the most dynamic developing countries in Asia;
- Indonesia, Thailand, and the Philippines, original ASEAN countries whose past development mirrors many of the strategies and challenges of Vietnam’s current development path;
- Pakistan and Mexico, countries comparable to Vietnam in selected domains; and
- Poland often cited as one of the most successful ex-Soviet bloc countries in making the transition from a command to a market economy.
- Moreover, experience from more developed countries such as the United States, Japan, and South Korea... will also be analyzed to demonstrate which strategies may best benefit Vietnam.

A third important analytical distinction to make is between the level of funding that Vietnam has been able to mobilize and the composition and structure of this funding. The paper will focus on funding characteristics rather than aggregate funding levels, given that the total amount of development finance generated by Vietnam has been exceptionally high from all significant sources using all standard measures of comparison.

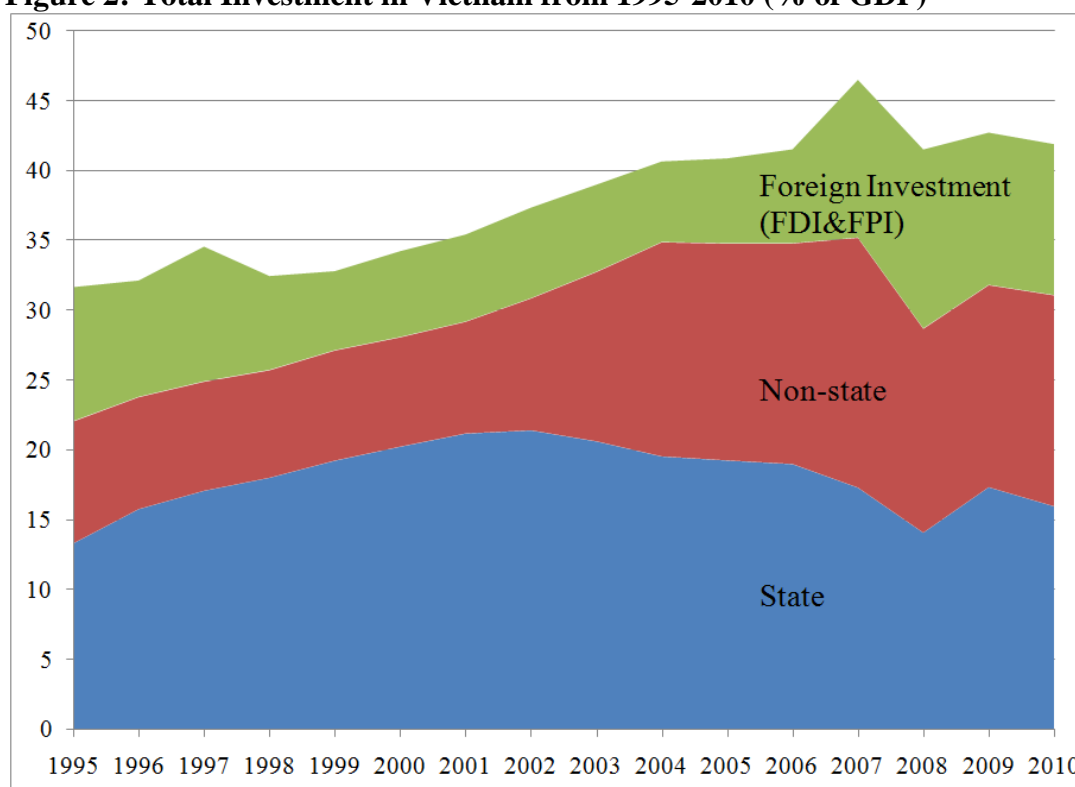
For example, as indicated in Table 1, total investment in 2010 has reached 41.9% of GDP. This is a significant increase from 31.7% in 1995, and 34.5% in 2000. Moreover, although there has been large swings in capital flows in recent years (2007 saw a surge in FPI inflows due to speculative asset bubbles, and then a reversed outflow due to Vietnam's macroeconomic instability and the global economic crisis), the total investment from 2004 until now has been at a consistent level of about 40 percent of GDP (Figure 2).

**Table 1: A Snapshot of Total Investment in Vietnam in 2000 and 2010**

Category	2000		2010	
	Tril VND	% GDP	Tril VND	% GDP
<b>Total Investment</b>	<b>151.2</b>	<b>34.2</b>	<b>830.3</b>	<b>41.9</b>
<b>Public investment</b>	<b>89.4</b>	<b>20.2</b>	<b>316.3</b>	<b>16.0</b>
State budget	39.0	8.8	141.6	7.2
ODA	27.8	6.3	68.3	3.4
SOEs	22.6	5.1	106.4	5.4
<b>Private investment</b>	<b>61.8</b>	<b>14.0</b>	<b>514.0</b>	<b>25.9</b>
Domestic	34.6	7.8	299.5	15.1
Foreign (FDI & FPI)	27.2	6.2	214.5	10.8

Source: Compiled from GSO and other sources

**Figure 2: Total Investment in Vietnam from 1995-2010 (% of GDP)**



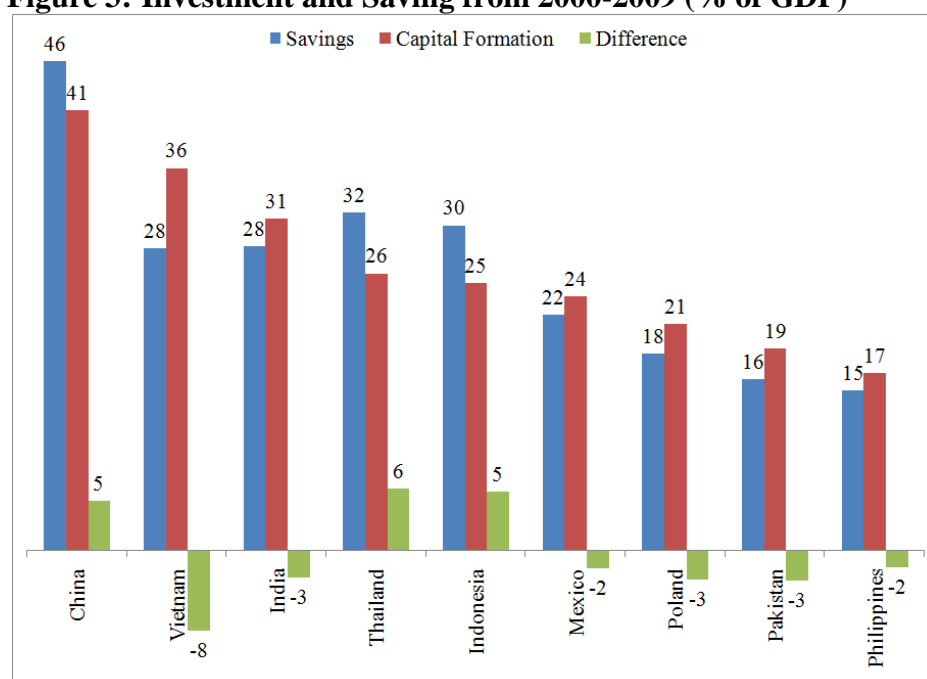
Source: GSO

Although investments from the state sector has declined from over 20% of GDP in the early 2000s back to the 1995 level (about 16% of GDP) in 2010, state investment remains a substantial portion of the total investment. This uneven allocation of resources has worsened (do you mean the uneven allocation has increased, or persisted) for two reasons:

First, the abnormal growth of some private enterprises in non-value-added sectors, such as land speculation, It is possible that these enterprises have some special connections with some state officials and authorities, which could result in or be the reason for connected lending and resource allocation.

Second, the reliability of the state sector's investment statistics is questionable (either an overestimation or an underestimation). For example, when providing statistics on bank credit, the State Bank of Vietnam (SBV)'s annual report listed Vietcombank (officially named Vietnam Joint-stock Commercial Bank for Foreign Trade) and Vietinbank (officially named Vietnam Industrial and Commercial Joint- stock Bank) among the state-owned commercial banks (SOCBs), while according to the Credit Information Center, a department under the SBV, these banks are among the joint-stock commercial banks (JSCMs).

**Figure 3: Investment and Saving from 2000-2009 (% of GDP)**



Source: WDI

Vietnam's level of investment has also been remarkably high when compared with countries of the same region or countries with similar characteristics. As Figure 3 shows, the average level of total investment between the years 2000 and 2009 as a percentage of GDP is second only to China. This record reflects a success story in terms of the ability of Vietnam to mobilize investment capital. Capital mobilization from outside sources was 2.5 times higher than that of comparable countries.

When Vietnam's total investment figures are disaggregated, they remain impressive. According to data from the Economist Intelligence Unit (EIU), over the past decade both

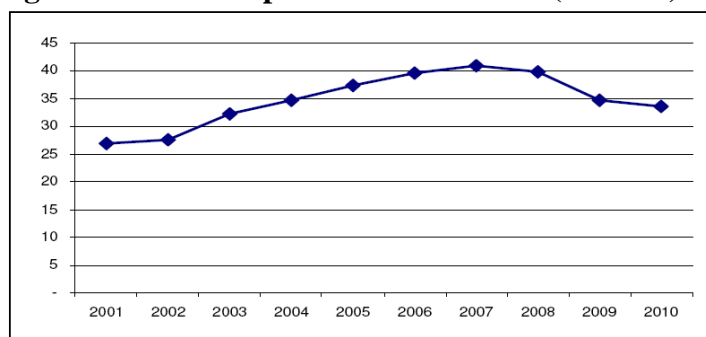
state budget revenue and expenditure as a share of GDP have consistently been higher in Vietnam than in comparable countries (Table 2).

**Table 2: State Revenue, Expenditure and Budget Deficit (% of GDP)**

Country/Region	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
<b>Budget Revenue</b>											
Vietnam	21.6	23.1	24.8	26.7	27.2	28.7	27.6	28.1	26.7	25.4	25.4
China	13.6	15.0	15.7	15.9	16.4	16.9	17.4	19.3	19.5	19.9	20.9
India	9.6	9.5	10.6	12.2	11.6	9.7	10.3	11.8	9.8	10.1	11.2
Indonesia	19.9	20.7	16.4	16.9	17.8	17.9	19.1	18.0	19.2	15.5	16.9
Mexico	18.7	19.2	20.4	21.2	20.7	21.1	21.8	22.0	23.5	23.6	22.2
Pakistan	14.9	13.8	16.0	14.8	14.1	13.8	14.1	15.0	14.6	14.5	14.8
Philippines	15.1	15.5	14.3	14.5	14.3	14.6	16.2	17.1	16.2	14.6	14.7
Poland	18.2	18.0	17.8	18.0	16.9	18.3	18.6	20.1	19.9	20.4	20.1
Thailand	15.1	15.2	16.7	18.2	18.4	19.5	18.8	17.8	17.7	17.5	18.2
<b>Budget Expenditure</b>											
Vietnam	24.7	24.4	27.7	29.5	29.9	31.3	31.6	34.9	33.3	32.8	31.3
China	16.1	17.3	18.3	18.0	17.7	18.1	18.2	18.7	19.9	22.1	22.5
India	15.1	15.3	16.4	16.7	15.4	13.7	13.6	14.4	15.9	16.6	16.2
Indonesia	23.9	23.0	17.7	18.7	19.1	18.2	20.1	18.7	19.8	17.1	17.7
Mexico	19.6	19.8	21.4	21.8	20.9	21.2	21.7	21.9	23.5	25.9	24.7
Pakistan	19.0	17.8	18.8	18.4	16.9	17.2	18.4	20.8	22.2	19.9	21.1
Philippines	19.1	19.6	19.6	19.1	18.2	17.3	17.3	17.3	17.2	18.5	18.5
Poland	20.3	22.2	22.6	22.4	21.4	21.2	21.0	21.4	21.8	22.2	23.2
Thailand	17.3	17.9	18.8	18.5	18.4	19.2	17.6	20.1	18.8	21.9	19.5
<b>Budget Deficit</b>											
Vietnam	-4.1	-2.8	-4.5	-4.7	-3.3	-4.1	-2.9	-7.3	-5.2	-6.1	-5.9
China	-2.5	-2.3	-2.6	-2.1	-1.3	-1.2	-0.7	0.6	-0.4	-2.3	-1.6
India	-5.5	-5.8	-5.7	-4.4	-3.8	-4.0	-3.3	-2.6	-6.0	-6.5	-5.0
Indonesia	-4.0	-2.3	-1.3	-1.8	-1.3	-0.4	-1.0	-0.7	-0.6	-1.6	-0.8
Mexico	-1.0	-0.6	-1.1	-0.6	-0.2	-0.1	0.1	0.0	-0.1	-2.3	-2.5
Pakistan	-4.1	-4.0	-2.9	-3.6	-2.9	-3.3	-4.3	-5.8	-7.6	-5.3	-6.3
Philippines	-4.1	-4.1	-5.4	-4.6	-3.9	-2.7	-1.0	-0.2	-0.9	-3.9	-3.8
Poland	-2.1	-4.2	-4.9	-4.4	-4.5	-2.9	-2.4	-1.4	-1.9	-1.8	-3.1
Thailand	-2.2	-2.7	-2.1	-0.3	0.0	0.3	1.2	-2.3	-1.1	-4.4	-1.3

Source: EIU

**Figure 4: Public Expenditure 2001-2010 (% GDP)**



Source: MOF (Vũ Như Thăng et al. (2010) op cit)

Data from the Ministry of Finance shows that Vietnam's level of state budget expenditure in the past few years has been very high (Figure 4) reaching 40% of GDP between 2006 and 2008. Although it has decreased in the past two years, public spending remains around 35%



of GDP. This is a very high when compared to similar countries at the same level of development.

However, rather than dwell on whether aggregate investment funds are sufficient or whether they have been well utilized, topics that warrant serious analysis but are well beyond the scope of this paper, we simply acknowledge Vietnam's prowess in generating development financing and instead focus on the possible implications of this funding composition and structure for Vietnam's future development.

### **III. Unintended Threats to Macroeconomic Stability**

Lack of balance in the composition of development financing in Vietnam has created several unintended threats to macroeconomic stability, the most alarming being:

- public sector crowding out of both private sector access to investment funds and private sector investment opportunities with these funds;
- overleveraging of equity for unsustainable levels of debt financing;
- excessive concentration on the formal sector while excluding small and family businesses; and
- vulnerability to flight of "hot capital" (FPI).

#### **a. Generation and Expenditure of Public Sector Funds Crowds out Private Sector Funds Access and Utilization**

With more than a third of total output spent on capital accumulation, Vietnam has one of the highest investment rates in the region<sup>1</sup>. Mobilizing such a large amount of investment funds is a formidable challenge, requiring efforts from public, private, and foreign sources. The focus of this section is on how generation of public sector funding sources and public sector spending has crowded out the private sector in terms of access to, and utilization of investment resources.

Funding for capital investment generated from public resources in Vietnam has been high when compared to other countries in the region. On average, Vietnam has spent almost twice as much of the central government budget on capital expenditure as other countries. According to the Asian Development Bank (ADB), state budget capital expenditure between 2000 and 2007 was 8.7 percent of GDP in Vietnam, while that of China, Indonesia and Thailand averaged around 3.5 percent (Table 3). If Vietnam includes off-budget investment expenditures of between 3.5 and 4.7 percent of GDP, the total rises to as high as 13.4 percent<sup>2</sup>. Moreover, according to data from the Ministry of Finance, state budget investment spending between 2008-2010 was not significantly different from previous levels, except for 2009 when it jumped to 11% due to the fiscal stimulus package<sup>3</sup>. This means that state budget investment is taking up a large portion of total capital investment.

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1 World Bank (2006).

2 IMF (2007).

3 Vu Nhu Thang et al. (2010)

**Table 3: Capital expenditure of the Central Government Budget (% of GDP)**

Country	2000	2001	2002	2003	2004	2005	2006	2007	Average
Vietnam	6.71	8.36	8.44	9.72	9.24	9.44	8.84	8.87	8.70
China	3.66	3.80	3.86	3.45	na	Na	na	na	3.69
Indonesia	3.06	7.28	7.62	3.44	2.68	1.19	1.65	1.63	3.57
Thailand	3.93	3.72	3.74	2.86	3.22	Na	na	na	3.49

Source: ADB

At the project level, financing for basic infrastructure improvements has been at the heart of Vietnam's national investment scheme, heavily supported by borrowing from various sources. The World Bank estimates that 9 to 10 percent of GDP has annually been invested in electricity, transport, water and sanitation, and telecommunication improvements.<sup>4</sup> A majority of these infrastructure projects have been supported through the issuance of government bonds. For example, by the end of 2007, the total amount of government bonds for infrastructure projects reached 12.5 percent of GDP.<sup>5</sup> Given the law limiting state budget deficits to 5 percent of GDP, all government bonds are kept off-budget. By the end of 2010, public debts (mostly off-budget expenditures coming from ODAs and the issuance of government bonds) has come to 52.3% of GDP (Table 4). This exceeds the 50% level which is common to comparable countries in the region, according to Benedict Bingham, the IMF's country representative in Vietnam.<sup>6</sup>

**Table 4: Off-Budget Expenditure (% of GDP)**

Items	2004	2005	2006	2007	2008	2009	2010
Public debt		42,2	42,9	45,6	43,9	49,0	52,3
Education bonds		2,8					
Infrastructure bonds	5,0	10,6	10,3	12,5	na	na	na
Reform bonds (pre-2000 SOCB debt)	1,5						
Municipal bonds	2,6	3,5	2,5	3,0	na	na	na
Sovereign bond (mil \$)		750					1.000

Na: not available

Source: Compiled from data of MOF and the IMF

In terms of public debt, besides the guarantee for state enterprises (mostly SOEs), which reached almost 10 percent GDP by the end of 2010,<sup>7</sup> serious unintended consequences may result from the issuance of government international bonds to finance SOEs. It is not an exaggeration to say that Vinashin would not have experienced so much difficulty in recent years had they never received the \$750 million from Vietnam's first issuance of international bonds in 2005. Receiving an amount of cash equal to the firm's total asset value unsurprisingly creates problems. The problem was compounded when this \$750 million supported additional borrowings totaling over \$3 billion for Vinashin's widespread and careless investments, which led to the serious consequences that Vinashin is facing today.

4 World Bank (2006b).

5 IMF (2007).

6 <http://www.imf.org/external/country/VNM/rr/2010/091410.pdf>

7 Vu Nhu Thang et al (2010)

Notably, the Vietnam Development Bank, or VDB (formerly the Development Assistance Fund) has been a major off-budget public sector lender for infrastructure projects. VDB is a tax-exempt, government-backed fund with no reserve requirements that lends at heavily subsidized interest rates. According to World Bank estimates, in 2004, about 40 percent of VDB's resources came from ODA, 15 percent from the issuance of government bonds, 12 percent from domestic trust funds, 10 percent from the social security fund, and 6 percent from postal savings, among others<sup>8</sup>. Of the resources mobilized domestically, about 80 percent have been on-lent to SOEs. In 2004, VDB's outstanding loans amounted to 11 percent of GDP.<sup>9</sup> With regard to credits for development investment alone (not counting authorized on-lending ODA), between 2006-2009 VDB loaned out 160 trillion VND, and their total outstanding credits averaged 12% the market's total outstanding credit.<sup>10</sup> This is a very large portion for any financial institution.

In addition, the level of private equity in public infrastructure investment projects has been extremely limited. According to the WB, between 1994 and 2009, there were 32 public-private partnership (PPP) projects in Vietnam, with a total pledged investment capital of about \$6.7 billion<sup>11</sup>. This is equivalent to 2% of total public investment for the same period. More specifically, the government is still seeking private participation in various highway build-operate-transfer (BOT) projects, but the response rate has been low. The same is true for port, railway, and airport investments. The only exception has been in the telecommunication sector, where more competition and investment opportunities are open to private sector participants

These figures have two possible implications. If public funds have been invested wisely, businesses in Vietnam could have a relatively more enabling infrastructure for private sector investment, therefore providing a potentially higher return to capital. However, if public funds have been squandered, businesses in Vietnam have been both burdened with restricted access to funds and handicapped in competing for capital investment opportunities – they have been crowded out from accessing and utilizing investment funds.

Evidence from a stratified sample survey of 629 private enterprises and 117 SOEs from 11 cities and provinces in Vietnam by Tenev *et al.* (2003) points to the latter, more negative set of implications. This survey found that, although Vietnam has one of the highest rates of investment in the region, lack of access to financing was nevertheless reported as one of the main obstacles faced by private domestic firms: two-thirds of the firms listed “lack of capital” as a constraint, and over 30 percent of firms reported lack of outside equity as a “major constraint.”

Why is it that Vietnam has invested so much of its public resources into capital accumulation, yet such a shortage of funding still exists? A closer look at the data reveals that the problem is not a shortage of funds, but rather a skewed allocation of funds. Over the last 10 years, more than half of total investment funds in Vietnam have been allocated to the state sector. While steadily increasing, the fraction of investment funds in the non-state sector was still only a third of total investment by 2010 (see Figure 2).

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8 World Bank (2006b).

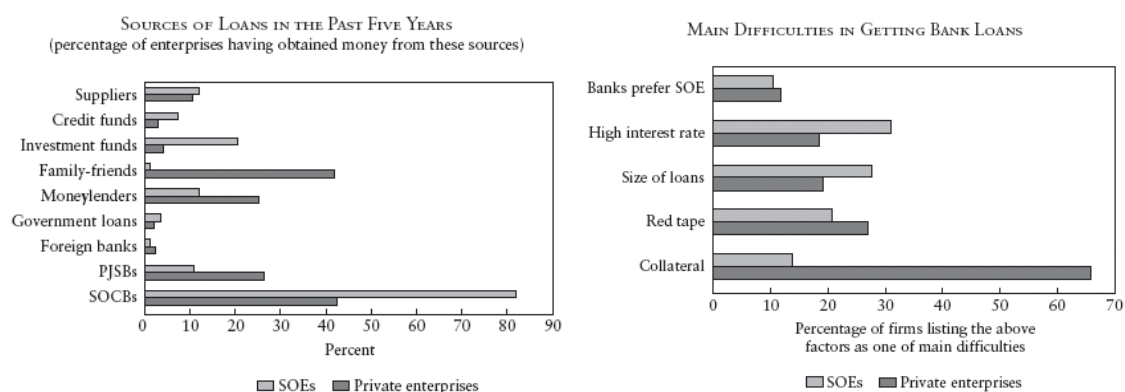
9 World Bank (2006a).

10 <http://www.vdb.gov.vn/Trangchu.aspx?ID=DETAIL&INFOID=619> and <http://www.vdb.gov.vn/Trangchu.aspx?ID=DETAIL&INFOID=532>

11 <http://www.thesaigontimes.vn/Home/doanhnghiep/chuyenlaman/48344/Mo-hinh-PPP-Kinh-nghiem-quoc-te.html>

As indicated in Figure 4, the study by Tenev *et al.* (2003) cited above shows that in their sample, two-thirds of private firms had some borrowing in the past five years, whereas the proportion for SOEs was close to 90 percent. While most of the borrowing by SOEs was done through state commercial banks, as indicated in Table 5, more than 70 percent of the total financing in the private domestic sector has come from retained earnings. The private commercial bank borrowing only accounted for up to 15 percent with the remainder financed through moneylenders (3 percent), and family and friends (9 percent). The study concludes that private firms and SOEs face encounter different access to channels of financing. For private enterprises, larger firm size, higher profit margin, and possession of certificate of land-use rights are positively associated with bank borrowing; while with SOEs none of these factors are significant. Unlike SOEs, the primary constraint on private enterprise borrowing is insufficient or unacceptable collateral.

**Figure 5: Loan accessing ability of SOEs and Private Enterprises**



Source: Tenev *et al.* (2003)

**Table 5: Structure of Financing of Private Enterprises**

Source	Vietnam (private)		Comparators					Vietnam (SOEs)	
	At start	At survey date	China	East Asia <sup>a</sup>	CIS	CEE	OECD	At start	At survey date
<b>Equity</b>	77.1	69.2						48.0	38.0
Personal savings/self-generated funds	61.4	57.3	56.6	33.9	53.9	70.5	39.1		
Savings from friends and family	8.6	7.2	3.0	5.0	4.5	4.0	1.3		
Institutional investors	7.1	4.7	7.5	3.9	10.3	2.7	10.8		
<b>Debt</b>	22.6	30.2							
Friends and family	6.6	5.7	2.9	4.9	4.1	3.3	1.0		
Informal moneylender	2.6	2.9	6.3	1.7	2.5	1.6	2.3		
<b>Banks</b>	11.0	15.4	9.4	20.5	13.5	5.2	16.6	28.0	36.0
Government loan program	0.1	0.3	1.1	0.4	4.6	7.4	2.0		1.1
Borrowed from suppliers	1.8	3.8	2.8	3.2	4.6	5.8	4.8	1.1	1.7
Borrowed from clients	0.8	2.1						1.3	1.8
<b>Other</b>	0.3	0.6						21.6	22.0
<b>Total</b>	100	100						100	100

a. Developing countries.

Sources: Survey data; Batra, Kaufmann, and Stone (2002).

Source: Tenev *et al.* (2003)

These figures reflect the ease with which most state enterprises can obtain credit from the state commercial banks with little, if any scrutiny of the capacity to repay these loans. Though there is no discrimination in written regulation, SOEs usually received more favorable treatment. Very few, if any state commercial banks have been able or willing to perform rigorous credit checks or undertake credible risk assessments of SOE loan applications.

Furthermore, most state commercial banks rely heavily on collateral for their lending decisions, which tend to be inflated for SOEs. Nonetheless, the average value of collateral provided by private firms is still equivalent to 173 percent of the value of the loan, compared with 130 percent for SOEs<sup>12</sup>. Furthermore, private enterprises also face many more administrative hurdles than do SOEs in processing loan requests at state banks. All of these requirements magnify the gap between state and the non-state enterprises in accessing commercial credit for investment.

Unfortunately, we do not have an updated data set similar to Tenev *et al.* (2003). The blossoming of the banking sector (both in quantity and asset values) would certainly improve access to capital for private enterprises. However, the privileged allocation of capital towards SOEs and the difficulties in accessing these funds for private firms, especially SMEs, still remain, as demonstrated by the Vinashin case, as well as subsequent research by Nick J. Freeman and Le Thi Bich Ngoc (2007).

With regard to Vinashin, the government's backing up (or more precisely, the government's bail-out) through a multitude of channels, including requiring banks to freeze the loans,<sup>13</sup> and asking VDB to provide loans for its salary payments<sup>14</sup>, are evidence of the safety net and state protection available to SOEs whenever they run into trouble. In such a non-transparent environment, the state-led loan programs provide better safety to banks and banking staff when their clients are SOEs, rather than private enterprises. There are very few SOCBs who are willing to examine thoroughly the credit risks or the borrowing portfolios of SOEs.

**Table 6: Obstacles to bank loans for SMEs**

<b>Items</b>	<b><u>Hanoi</u></b>	<b><u>Thai Nguyen</u></b>	<b><u>Lao cai</u></b>	<b><u>All locations</u></b>
Not enough collateral	3.47	4.36	4.25	3.94
No proof of asset ownership	2.94	3.11	3.11	3.03
Banking regulation too stringent	3.52	2.56	2.92	3.14
Banks demanding audited financials	2.92	2.18	2.38	2.14
Banks demanding a business plan	2.58	2.08	2.05	2.30
Difficulty in demonstrating management ability/skill	2.42	2.37	2.17	2.37
Loan sizes too small	2.84	2.93	2.90	2.89
Loan maturity too short	3.18	3.56	3.62	3.40
Interest rate too high	3.28	4.00	3.78	3.65
Poor skills of bank officers	2.59	2.72	3.38	2.72
Bank bias/favoritism to other firms	3.98	2.48	3.09	3.24

12 World Bank (2006b).

13 <http://bee.net.vn/channel/2043/201008/Khoanh-no-gian-no-cho-Vinashin-den-het-nam-2011-1765328/>

14 <http://www.hanoimoi.com.vn/newsdetail/Kinh-te/419340/cho-vinashin-vay-voi-lai-suat-0-de-tra-no-luong.htm>

Procedures too time consuming	3.75	2.46	4.23	3.27
Bank officers requiring kick-backs	2.88	1.60	2.00	2.18
<b>General Index (mean of above 13)</b>	<b>3.10</b>	<b>2.80</b>	<b>3.07</b>	<b>2.97</b>

1 is the best and 5 is the worst

Source: Nick J. Freeman and Le Bich Ngoc (2007)

According to a survey of 200 SMEs in Hanoi, Thai Nguyen, and Lao Cai in 2007 by Nick J. Freeman and Le Thi Bich Ngoc (Table 6), SMEs were facing difficulties accessing banking capital. Not having enough collateral assets was the largest obstacle for the SMEs. That is, after four years, the problem of collateral assets has not improved since 2003. Moreover, interest rate burden and the short durations of the loans made it even more difficult for SMEs to service their loans. Indeed, the interest rate burden has become even more serious with the macroeconomic challenges and inflation in the past few years.

Another factor is the state's bias towards certain clients. This number is especially high in Hanoi (3.98 of 5 – the worst), where most of the SOEs and SOCBs are located. The connected lending behaviors as a result of relationships with state officials will be discussed in the analysis below.

A positive factor in the banking system has been the increasing proportion of joint-stock commercial banks, shown in Table 6. Within just 5 years, JSCMs have taken up a quarter of the total market, or a third of the SOCBs. This means that non-state firms have better access to capital. However, the difficulties faced by non-state firms, mostly SMEs, cannot be further improved while the JSCBs remain under the control of large enterprises. There are signs of the formation of Japanese's styled *keiretsu* – a successful model that has also brought Japan much trouble<sup>15</sup>. In a non-transparent environment, the formation of *keiretsu*-styled enterprises or the propagation of hidden relationships among the banks and large firms could bring more problems than solutions. This also would exacerbate existing imbalances in capital allocation, threatening the stability of the financial system, and the entire economy.

**Table 7: Composition of the Banking Sector in Vietnam**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
<b>Capital mobilization</b>										
SOCBs	78,4	80,8	80,5	79,5	78,1	78,6	70	58	56,1	49,7
Joint stock banks	11,3	9,2	10,1	11,2	13,2	14,3	22	29	35,9	42,8
Foreign bank*	10,3	10	9,4	9,3	8,7	7,1	8	13	8	7,5
<b>Lending</b>										
SOCBs	72	73	74	73	75	68	63	57,1	55,7	54,1
Joint stock banks	11	13	15	15	14	16	27	33,9	33,8	36,7
Foreign bank*	17	14	11	12	11	16	10	9	10,5	9,2

\*Including branches of Foreign banks or Joint venture banks

Source: Compiled from SBV's data and Suiwah Leung (2009).

15 <http://www.investopedia.com/articles/economics/09/japanese-keiretsu.asp>

## **b. Overleveraging of Insufficient Equity for Unsustainable Levels of Debt**

Capital investments in infrastructure and services must be funded with a healthy mix of debt and equity to ensure long-term financial viability. If investments are financed with excessive borrowing, they could contribute directly to macroeconomic instability by overleveraging insufficient equity for unsustainable levels of debt: any significant macroeconomic shock or microeconomic miscalculation could trigger massive loan defaults, which can in turn lead to systemic distress in the financial sector creating a feedback loop furthering macroeconomic instability. The East Asian Economic Crisis of 1997-98 provides a poignant warning of the dangers of overleveraged investments.

### Capital Structure of the Business Sector (%)

		2004	2005	2006	2007
Total	Liabilities	69	69	69	69
	Equity	31	31	31	31
SOEs	Liabilities	77	77	76	77
	Equity	23	23	24	23
Non-SOEs	Liabilities	61	64	64	63
	Equity	39	36	36	37
FEIEs	Liabilities	55	57	57	60
	Equity	45	43	43	40

*Source: Enterprise survey of GSO*

At the firm level, according to the enterprise census compiled by the GSO, the state sector is highly leveraged when compared to non-SOE and FDI capital structures. As indicated in Table 7, more than three-quarters of total investments by state enterprises have been financed with debt, whereas debt comprises about two-thirds of the capital structure for non-SOEs and slightly over half for FDI investments. These figures probably understate the difference in leveraging between SOEs and other enterprises, as the collateral value for SOEs is often inflated to meet the requirements for either the desired level of borrowing or the desired share of ownership.

Moreover, the borrowing rates of SOEs, especially economic conglomerates, have increased sharply in the recent years. For example, equity capital ownership of PetroVietnam decreased from 67.4% in 2006 to 55.6% in 2008. For Vinacomin, the corresponding numbers were 39.4% and 30.2%<sup>16</sup> Moreover, the overborrowing of firms like Vinashin results in serious consequences for the economy. The bankruptcy of DAEWOO over a decade ago in South Korea and the bankruptcy of Vinashin last year are expensive lessons that need to be examined thoroughly, especially the factors relating to the large debts accumulated and the state's preferential policies toward certain types of enterprises that are considered essential for the economy. Such policies would encourage these firms to overlook the hidden risks behind their attempts to accumulate resources and favorable treatment.

The problem of the private sectors limited access to loan funds is compounded by the absence of a vibrant capital market, making it difficult for profitable domestic firms to mobilize

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16 IMF (2010)

equity financing. The stock market in Vietnam – with two trading centers in Hanoi and Ho Chi Minh City - has been relatively small in size and volume. A large fraction of firms listed on these two trading exchanges have been former SOEs with privileged access to capital. In order for a private, domestic enterprise to be listed, they have had to pass certain high thresholds, effectively excluding most small and medium firms from the exchange. In particular, the minimum company size needed to conduct a public offering or to be listed is significantly higher than that of most domestic private enterprises. Thus, most equity financing in small and medium enterprises is done informally via a social network of family and friends.

### **Financial Exclusion of Low-Income Households and Family Enterprises**

Although almost all financial sector lending in Vietnam goes to formal businesses and consumer finance, in contrast, most of the economic activity in Vietnam is undertaken by rural households and urban family businesses: the informal sector accounts for about one third of total GDP and generates more than 70 percent of total employment in Vietnam.<sup>17</sup> This mismatch of funds with financing opportunities poses two main threats to macroeconomic stability: it concentrates lending, as all banks are essentially chasing the same clients in the same locations with the same products; and it excludes investments that could offer higher returns to capital.

A response in other countries has been to develop microfinance institutions, products, and delivery systems for the provision of essential financial services to low-income households and family enterprises – the most successful example of this to date in Southeast Asia is the microfinance market in Indonesia.

However, in Vietnam, the government views microfinance as a poverty alleviation tool rather than sustainable financial intermediation: it believes that it can best help the poor by income transfers via subsidized credit and savings programs. Thus, the government tries to help poor people through special programs implemented by state-owned financial institutions and its approximately 1,000 semi-state controlled People's Credit Funds. Since microfinance programs are not financially sustainable, they may not have a lasting impact in the long-term.

Non-governmental organizations (NGOs) also play a significant role: according to the International Labor Organization (ILO), there are 57 international NGOs now supplying microfinance services, mostly credit, in Vietnam.<sup>18</sup> Although NGO-implemented microfinance is a fertile ground for experimentation and innovation, these initiatives are often not sustainable and they are difficult to scale-up for greater geographic coverage.

In fact, there are two types of activities for official microfinance programs. First, programs targeting the poor are often subsidized heavily by the government or international NGOs. Second, at some People's Credit Institutions, borrowers are wealthier households rather than poor. Loan programs to the poor can make a difference in the long term, but they are not financially sustainable. Additionally, there is evidence that the existing programs are benefiting the non-poor population, and not the targeted poor households.

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<sup>17</sup> Minh V. Nguyen (2001).

<sup>18</sup> Le Lan and Nhu-An Tran (2005), p. 1.



A large source of microfinance in Vietnam consists of informal activities called *hụi* or *họ*; these are Vietnamese ROSCAs - Rotating Savings and Credit Associations for relatives, friends, and neighbors to pool and distribute their savings. ROSCAs were once illegal in Vietnam, but are now permitted. Although *hụi* or *họ* do help to mobilize savings, their function is as much social as financial, and they complement rather than substitute for formal financial services.

In sum, Vietnam does not yet have a commercially-based model for the delivery of essential savings, credit, and payment services for most of its population, known elsewhere as the “unbanked majority.” Thus, there remains considerable potential in Vietnam to develop a much more inclusive financial sector, as indicated by the estimated demand for loans from the bottom of Vietnam’s economic pyramid, summarized in Table 8.<sup>19</sup> Consistent with these figures, the Asia Resource Centre for Microfinance (ACRM) estimates that 40 percent of households in Vietnam did not have access to formal credit sources in 2001.<sup>20</sup>

**Table 8: Adjustments and Estimates of BOP (Bottom of Pyramid) Loans**

<b>Provider</b>	<b>Total accounts to HHs/individuals reported</b>	<b>Adjustment for non-BOP and duplicate accounts<sup>21</sup></b>	<b>Total estimated BOP loans</b>
VBARD	9,000,000	6,123,600 (68%)	2,876,400 (32%)
VBSP	4,125,000	2,062,500 (50%)	2,062,500 (50%)
PCFs	1,000,000	750,000 (75%)	250,000 (25%)
MFWG members	284,400	142,200 (50%)	142,200 (50%)
<b>Total</b>	<b>14,409,400</b>	<b>9,078,300</b>	<b>5,331,100</b>

*Source: Vietnam: Developing a Comprehensive Strategy to Expand Access [for the Poor] to Microfinance Services, DFC and WB.*

### **c. Vulnerability to Hot Capital**

Hot capital was not an issue in Vietnam until early 2007, when asset markets were rising well beyond any level supported by economic fundamentals. These asset bubbles were fueled largely by a combination of a dramatic expansion of domestic credit and a tremendous spike in FPI. As described in Box 1, hundreds of trillions of VND were issued to sterilize foreign currency inflows. The amount of high power money increased by more than 10 percent of GDP and fed inflation, which approached 30 percent by the middle of 2008 – this was the highest level of inflation in Vietnam since the early 1990s.

This domestic macroeconomic instability was exacerbated by the onset of the global economic crisis, which triggered a sudden drop in capital inflows and a plunge in export market demand, as depicted in Figure 6. Furthermore, thanks to booming asset markets, many people felt rich and spent a lot of their new-found wealth on luxury goods, resulting in an acceleration of imports and a large trade deficit. Vietnam’s trade deficit has reached an

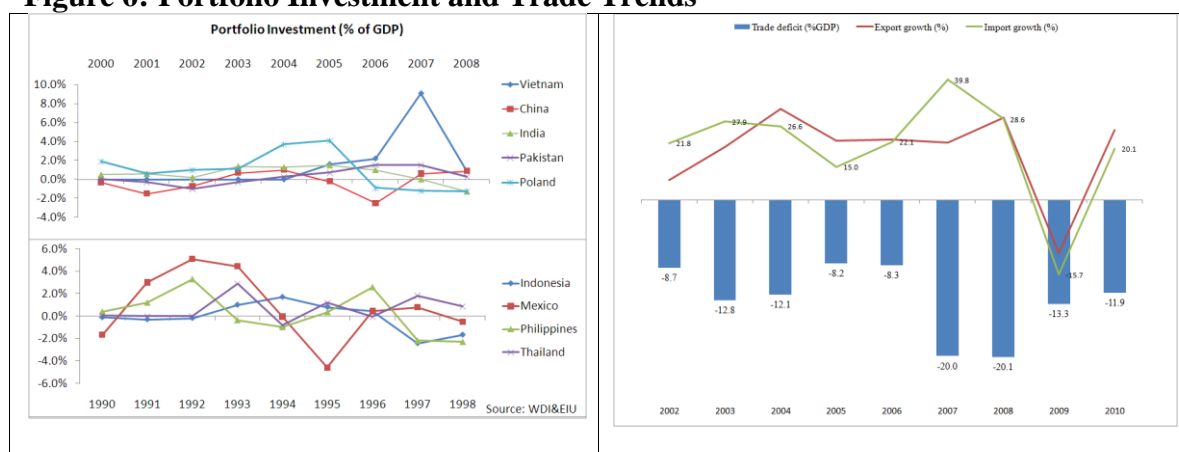
19 For a nice analysis of the potential and challenges for developing microfinance in Vietnam, see: *Conference Summary Report: Making the Transition to a Regulated and Financially Sustainable Vietnamese Microfinance Industry*, CEP Vietnamese Microfinance Conference, 14-16 May 2007, HCMC.

20 [http://www.bwtp.org/arcm/vietnam/I\\_Country\\_Profile/vietnam\\_country\\_profile.html](http://www.bwtp.org/arcm/vietnam/I_Country_Profile/vietnam_country_profile.html)

21 Authors’ estimates based on mission’s findings and interviews with institutions.

alarming level in the past 3 years. Subsequently, the asset bubbles burst, unemployment increased, and economic expansion dropped to the lowest growth rate of the *Đổi mới* reform era.

**Figure 6: Portfolio Investment and Trade Trends**



Source: WDI and EIU

### Box 1: Vulnerability to Hot Capital in Vietnam

In late 2006 and early 2007, a large amount of foreign capital poured into Vietnam. In order to maintain a stable exchange rate, the State Bank of Vietnam (SBV) bought about \$9 billion (USD) by using or issuing VND, while domestic currency sterilization was not given adequate attention. As a result, an amount of high power money equal to more than 10 percent of GDP was put into circulation, and the money supply (M2) increased by more than 50 percent within a year, resulting in very high inflationary pressures.

To deal with inflation, SBV introduced a series of measures such as increasing reserve requirements and interest rates, putting a cap on lending for securities trading, and requiring commercial banks to buy government paper.

One of the consequences of these policies was to create tremendous stress within the banking system, particularly in terms of liquidity risk. Interest rates began to soar, and the pressure on the domestic currency was very high. In the first quarter of 2008, the yield on government bonds was nearly 20 percent, and the forward exchange rate was more than 20 percent higher than the spot rate.

In short, instead of sterilizing domestic and foreign currency in a managed and synchronized manner, SBV conducted these two policy interventions in a blunt, rushed, and uncoordinated fashion, with serious consequences that contributed significantly to the turmoil of Vietnam's financial markets.

This recent trauma highlights Vietnam's vulnerability to hot capital undermining macroeconomic stability. While the direct impact of funds available for capital investment in infrastructure and services might be modest if much of FPI is speculative investment, the indirect impact on both the financial and real sectors have sobering implications for development finance. Vietnam's experiences over the past two years reflects those of Thailand and Indonesia during the East Asian Financial Crisis, and serve as a warning of the risks entailed in liberalizing Vietnam's capital account too quickly, as well as the need for more effective management of foreign capital flows.

## IV. Unintended Risks for Microeconomic Management

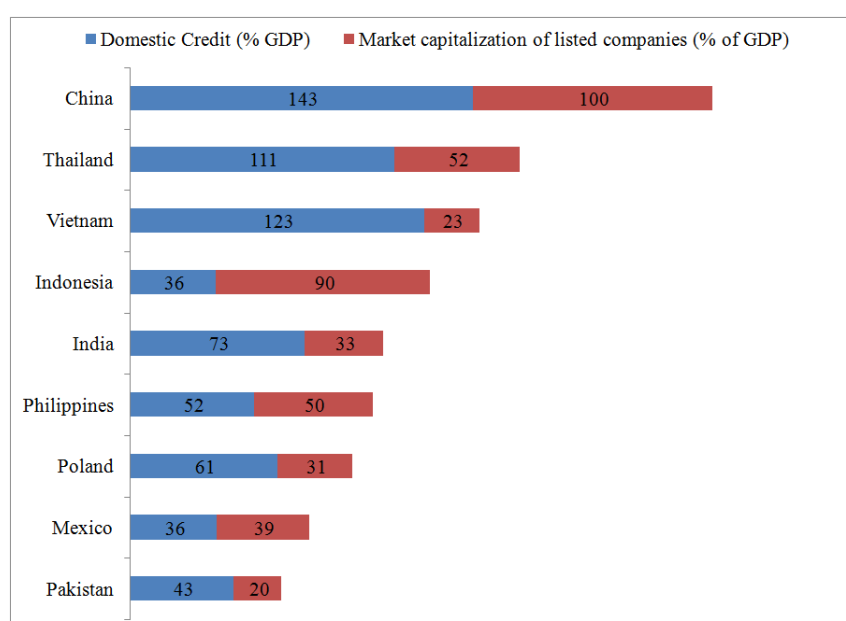
A lack of prudent financing structures threatens microeconomic management by posing several risks to the liquidity and solvency of development financing sources, the most important being:

- reliance on short-term financing for long-term investments, creating maturity risk;
- use of foreign capital for investments in non-tradables, creating foreign exchange risk;
- speculation in asset bubbles, creating credit risk; and
- reliance on unsustainable revenue sources such as SOEs, the oil and gas sectors, and trade tariffs, creating fiscal gap risk.

### a. Reliance on Short-Term Financing for Long-Term Investments (Maturity Risk)

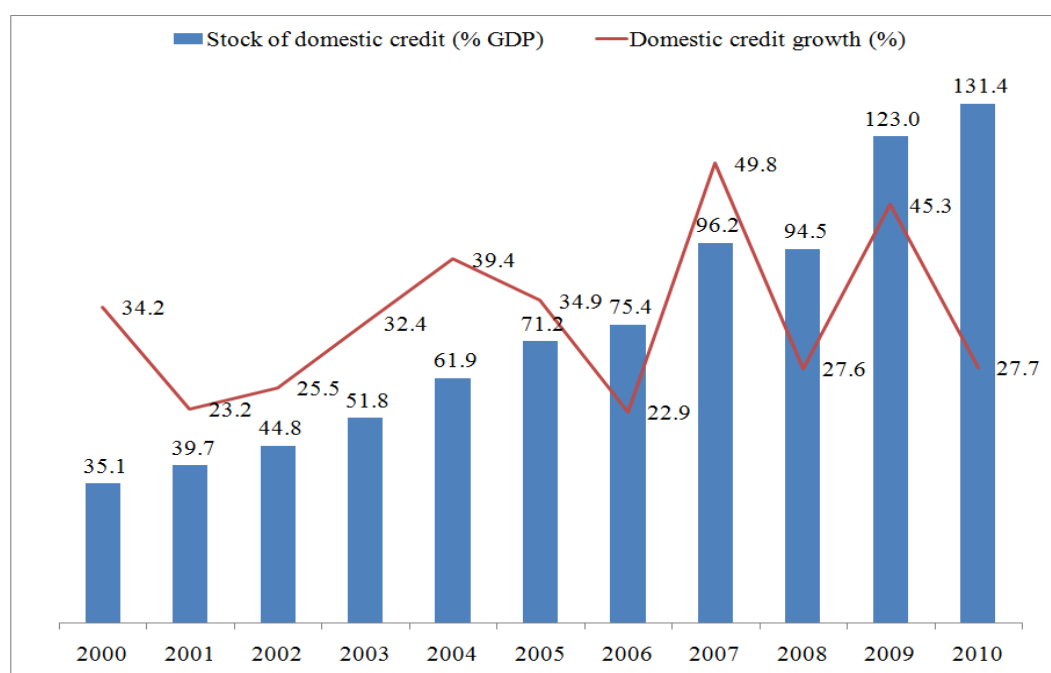
As indicated in Figure 6, Vietnam has a relatively greater reliance on its banking sector for financial intermediation when compared with other countries. By the end of 2010, domestic credit provided by Vietnam's banking sector reached 1.31 times GDP, while the combined capitalization of listed companies and bond markets was less than 40 percent of GDP (Figure 6 and 7). Since banks are funded mostly by short-term deposits, and thus, tend to extend relatively short-term loans, there is a tendency to imprudently rely on short-term financing for long-term investments in Vietnam. This mismatch between the maturity of funding sources and the expected life of financed investments constitutes a considerable risk for both borrowers and lenders.

**Figure 7: Composition of Financial Intermediation in 2009 (% of GDP)**



*Source: Compiled from WDI and EIU*

**Figure 8: Vietnam's Domestic Credit**



Source: EIU

Vietnam's reliance on banks for financing has been reinforced by the very high rate of domestic credit growth over the past decade. As indicated in Figure 6, the ratio of domestic credit to GDP tripled from 2000 to 2010 and in absolute numbers, domestic credit has risen 16.7 fold, or 32% annually for ten years. Moreover, Vietnam's credit growth rate has been highly uneven, giving rise to a higher degree of risk at both the macro and micro (i.e., firm) level.

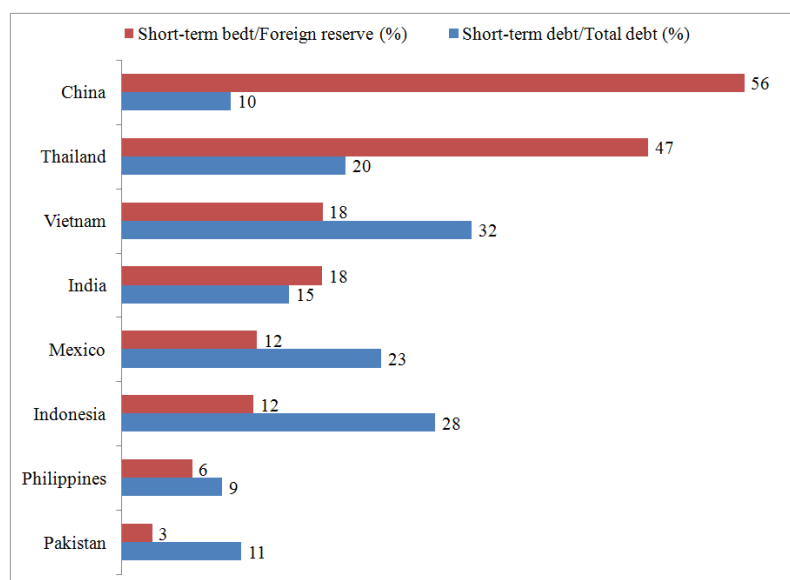
Thailand's experience during the 1990s shows that the use of short-term loans to finance real estate developments creates huge risks for the financial system. A small domestic bond market inhibited the development of a risk-free benchmark against which to price corporate issues and mark to market daily trading. With financing channels limited to bank loans, Thai businesses faced a severe liquidity crunch as the banking sector sharply curtailed its operations. Development of a liquid bond market would have enabled private and public sector issuers to finance long-term projects with long-term financing, thus reducing both financing costs and maturity risks.

Notably, although the ratio of financial asset over GDP, the so-called financial depth, of Vietnam has been very high in comparison to other countries at the same (or even higher) level of development, capital shortages still remain. Why are firms borrowing so much, but still lacking capital? One possible reason is that a non-trivial part of the borrowed capital is not being circulated. This means that there is a large hidden risk of bad debts inside the banks. It is possible that the banks know that their client firms are holding a substantial amount of overdue debts, but they are continuing to lend to these firms to "feed" their outstanding debts. This is even more probable in an environment with popular cross holdings between firms and the banks.

To decrease its dependence on, and minimize the risks threatening the banking system, Vietnam should give a high priority to the development of its domestic bond and stock markets.

## b. Foreign Capital for Investments in Non-Tradable (Foreign Exchange Risk)

**Figure 9: Short-Term Debt (% of total external debt)**



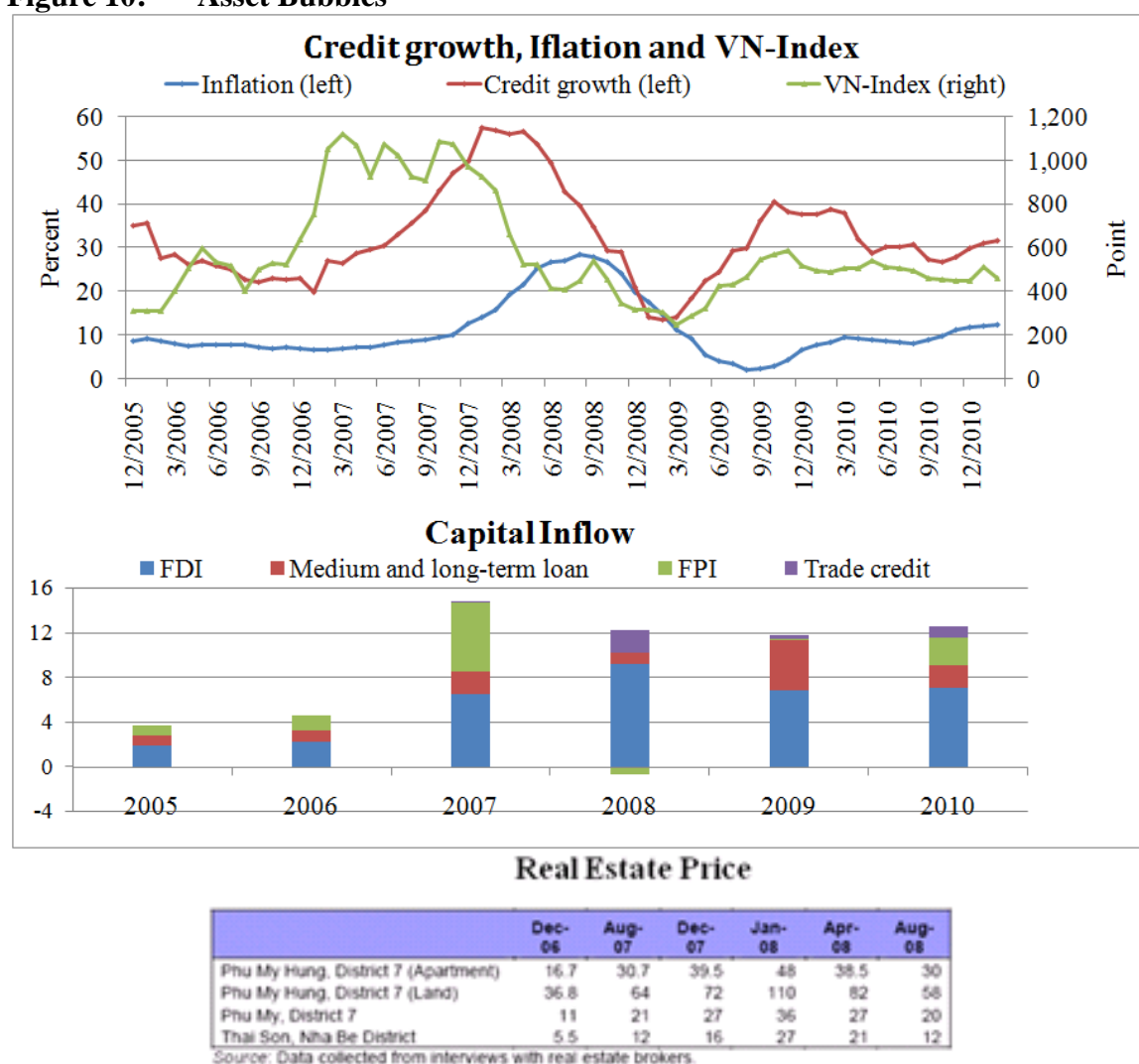
*Source: World Bank*

Two positive aspects of Vietnam's development financing structure are that most foreign debt is public, and most of this is long-term. Foreign commercial borrowing is only 8 percent of Vietnam's \$26.9 billion external debt (29.8 percent of GDP), and the remaining 92 percent is public debt comprised primarily of ODA long-term concessional loans. Unlike other ASEAN countries during the East Asian Financial Crisis, there appears to be little evidence that there is significant commercial borrowing for investment in non-tradable goods in Vietnam at present. In fact, this suggests that the potential for commercial loans from abroad is large.

Moreover, as indicated in Table 10, short-term loans account for less than one fifth of Vietnam's total external debt, so the possible impact of foreign creditors calling in or refusing to roll over loans during a crisis would be considerably less in Vietnam than it was in Thailand and Indonesia a decade ago, where short-term loans accounted for 42% and 25% respectively. However, Vietnam needs to be watchful of the proportion of short-term loans which at the end of 2009 reached almost a third of the national reserves. Meanwhile, information on private external debt, especially the external debt of FDI enterprises and trade credit of domestic enterprises, is either unavailable or unclear. Such information could reveal a very different situation.

### c. Speculation in Asset Bubbles (Credit Risk)

**Figure 10: Asset Bubbles**



As illustrated in Figure 10, the evidence for debt-financed asset bubbles in Vietnam in 2007 is plentiful and compelling. Stock price indices and real estate prices soared with the huge inflow of external capital and implementation of SBV's monetary expansion policy. In 2007, the influx of external capital was five times greater than the previous year, and money supply (M2) increased by about 50 percent. From December 2006 to December 2008, M2 totaled 50 percent of 2008 GDP. Loans for real estate and securities trading rose rapidly from almost nothing to more than 10 percent of total loans outstanding. By the end of June 2009, loans for real estate and securities trading totaled VND 195 trillion<sup>22</sup>, accounting for 12.8 percent of total loans outstanding. This same pattern recurred during the first quarter of 2009, when stock and property prices began to recover, and loans for real estate and securities trading dramatically increased in response to these price movements.<sup>23</sup> By the end of 2010, non-

<sup>22</sup> <http://www.sbv.gov.vn/vn/home/tinngheicuu.jsp?tin=692>

<sup>23</sup> <http://vneconomy.vn/2009071709081774P0C6/du-no-cho-vay-dau-tu-chung-khoan-bat-dong-san-tang-manh.htm>

productive credit reached 431 trillion VND, about 22% of GDP.<sup>24</sup> Among that, credit to the real-estate sector has reached 228 trillion VND and this only includes figures that were officially released from commercial banks.<sup>25</sup>

In fact, the actual number could be higher than what was claimed by the banks. These banks have an incentive to avoid the state's regulation on the accounting for large non-productive loans, or loans for speculative purposes (mostly real estates and stock investments). Moreover, there has been a large inflow of FDI into real estate in recent years.<sup>26</sup>

Asset bubbles entail significant credit risk because eventually they will burst leading to escalating loan defaults and plunging collateral values for assets used to secure these loans. This, in turn, creates liquidity and solvency problems for creditors, and risk of systemic implosion for the financial sector as a whole. The recent collapse of the United States housing market is a vivid example of the possible impact this can have on a country's financial system and real economy.

#### **d. Public Sector Reliance on Unsustainable Revenue Sources (Fiscal Gap Risk)**

Although, as pointed out in Section II, Vietnam has been extremely successful in public revenue generation, the more detailed analysis of Vietnam's revenue structure shown in Table 10 indicates a heavy reliance on four unsustainable revenue sources: the oil and gas sectors, SOEs, trade tariffs, and land fees. The combined revenue of these four sources accounts for more than seventy percent of the total state budget revenue.

**Table 9: Revenue and Expenditure Structure (% of GDP)**

Items	2002	2003	2004	2005	2006	2007	2008
<b>REVENUE</b>	23.1	24.8	26.7	27.2	28.7	27.6	28.1
SOE	4.7	4.7	4.5	4.7	4.8	4.4	4.6
Real Estate	1.0	1.7	2.4	2.1	2.1	3.0	2.6
Oil and Gas	4.9	6.0	6.8	7.9	8.6	6.7	6.0
Trade Tariff	5.9	5.5	4.9	4.5	4.4	5.3	6.1
Grant	0.4	0.5	0.4	0.5	0.8	0.4	0.5
Others	6.2	6.4	7.7	7.5	8.1	7.9	8.3
<b>EXPENDITURE</b>	27.7	29.5	29.9	31.3	31.6	34.9	33.3
In which: capital investment	8.44	9.72	9.24	9.44	9.07	9.81	9.15
<b>DEFICIT</b>	<b>4.54</b>	<b>4.71</b>	<b>3.25</b>	<b>4.10</b>	<b>2.93</b>	<b>7.30</b>	<b>5.24</b>

Source: GSO

The challenge is to adapt Vietnam's revenue structure to its changing economic structure:

- oil and gas are non-renewable energy resources, so they will be depleted over time;
- Vietnam's equitization program will continue to reduce the role of SOEs in the national economy;

24 <http://www.baomoi.com/Giam-ty-trong-du-no-cho-vay-linh-vuc-phi-san-xuat/126/5812233.epi>

25 <http://www.tiepthigiadinh.com.vn/chitiet/16935-du-no-cho-vay-bat-dong-san-dat-khoang-228-000-ty-dong>

26 <http://phapluattp.vn/20100430113653102p1014c1070/giat-minh-bat-dong-san-fdi.htm>



- Vietnam's accession to the WTO and its commitments under other trade agreements will require further lowering of trade tariffs.
- Revenues from land or land-use sales will likely fall,

**Table 10: Comparison of Revenue Structures**

Group of countries by GDP per capita	Total tax revenue (%GDP)	Tax structure (% Total tax revenue)					
		Total	CIT	PIT	Taxes on goods and services	Export-Import duties	Others
1/ Low income developing countries (GDP per capita of less than \$ 745)	14.10	100	19.28	16.62	43.30	16.40	4.20
2/ Medium income developing countries (GDP per capita of \$746-\$2,975)	16.70	100	15.47	16.03	51.80	9.30	7.40
<b>Vie Nam: - Total revenue of taxes, fees, including oil revenue</b>	<b>25.20</b>	<b>100</b>	<b>31.60</b>	<b>2.00</b>	<b>28.60</b>	<b>12.00</b>	<b>25.80</b>
<b>- Total revenue of taxes, fees, excluding oil revenue</b>	<b>18.40</b>	<b>100</b>	<b>18.70</b>	<b>2.67</b>	<b>39.20</b>	<b>16.40</b>	<b>22.30</b>
3/ High income developing countries (GDP per capita from \$2,976 to \$9,205)	20.2	100	8.91	20.49	53.1	5.4	12.1
4/ Developing countries on average	17.60	100	13.20	18.00	51.20	8.60	9.00
5/ Developed countries (GDP per capita of higher than \$ 9,206)	25.00	100	9.67	44.63	32.90	0.70	12.10

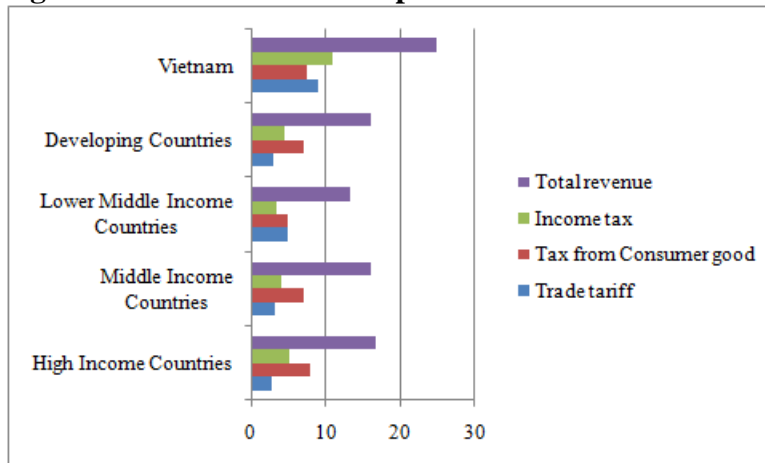
Sources: Alm and Wallace (2004) and Huynh (2007).

A key to successful revenue restructuring will be to improve direct taxation, particularly the personal income tax (PIT) for urban professionals and the corporate income tax (CIT) for private enterprises. For example, as indicated by Table 12, the PIT made up only 2 percent of Vietnam's total revenue in 2007, while on average, it was approximately 16 percent for both low-income and middle-income developing countries.

Vietnam policy makers will also have to decide if they would like to replace SOE-sourced revenue with other revenue sources, or simply reduce total public spending. While SOEs provide substantial revenue for the state budget, they also require substantial state funds to meet their investment needs, and as more SOEs are equitized, the state should be responsible for financing fewer of their capital requirements. Reduced state budget expenditures on SOEs would help to ease the crowding-out effect caused by over-investment in SOEs, leaving more capital available for private sector development.



**Figure 11: Tax burden comparison**

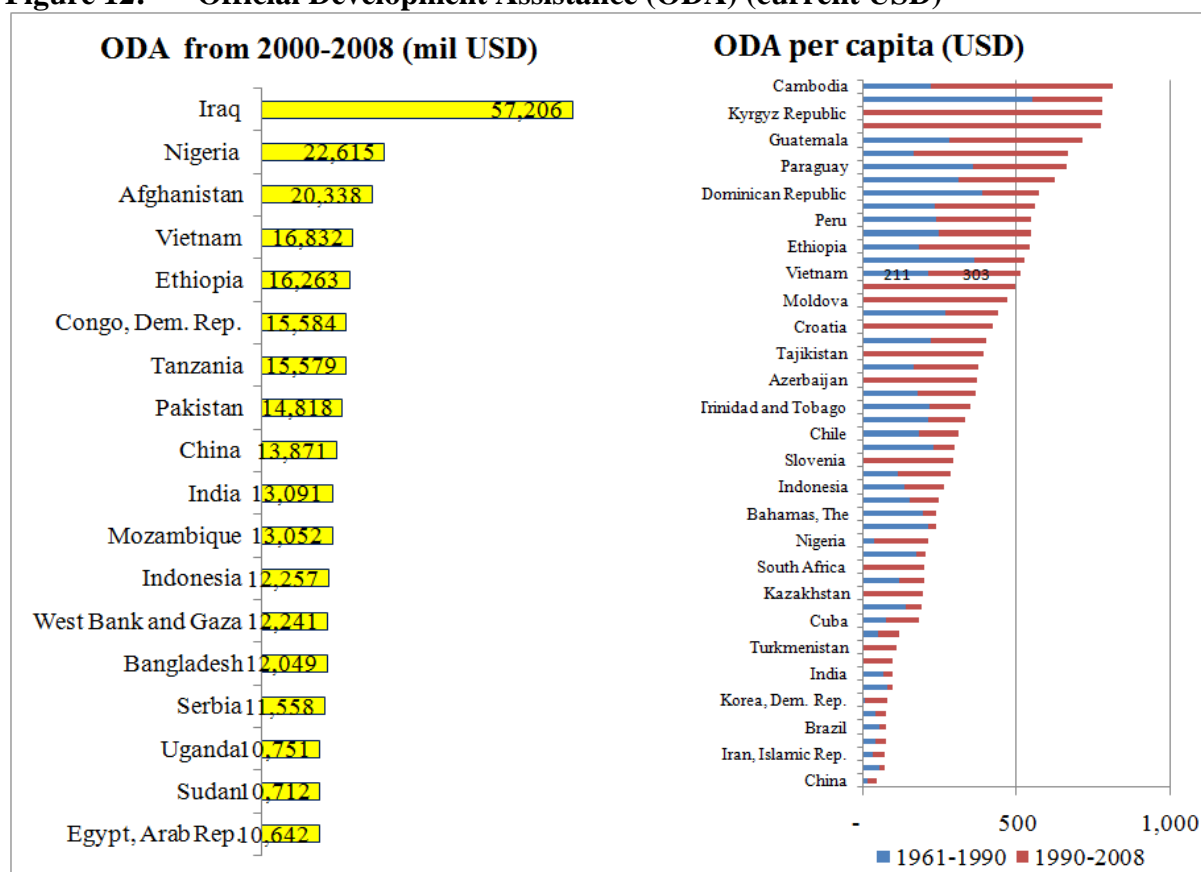


*Source: A sample of 65 countries between 1990-2004 compiled by Ludovica Gambaro, Jonna Meyer-Spasche, and Ashikur Rahman (2007) and data from MOF, cited from Vu Nhu Thang et al. (2010)*

As seen in Figure 11, a similar comparison in Table 11, there appears to be a larger tax burden in Vietnam compared with different country groups. A closer look would reveal that among the three tax categories, customs, goods and income taxes, only taxes on goods in Vietnam are on par with other countries, whereas customs and income taxes are much higher. Moreover, income taxes in Vietnam are very different than in other countries, such as the United States, the income tax (mainly personal income tax) is much higher. Income taxes in Vietnam are mostly corporate income taxes, which accounts for 36.7% of total tax revenue, while in the United States or South Korea it is less than 15%.<sup>27</sup>

<sup>27</sup> Vu Nhu Thang et al. (2010)

**Figure 12: Official Development Assistance (ODA) (current USD)**



Source: WDI

Another significant component of unsustainable public revenue is an off- budget source, ODA. As indicated in Table 13, Vietnam's total ODA has been higher than all other countries in our comparison group during 2000-2008. In fact, Vietnam has been second only to Iraq, Nigeria and Afghanistan, as a recipient of ODA. Moreover, as depicted in Figure 12, when comparing Vietnam with more countries going back to 1961, Vietnam's ODA per capita has been among the highest in the world.

As Vietnam's income rises and the priorities of ODA donors change, Vietnam's ODA inflow is likely to drop, creating another fiscal gap between development needs and development finance in Vietnam. This is indeed happening as Vietnam moved from the list of low income economies to middle income economies last year. Even if ODA inflows remain stable in the near future, Vietnam will at least have to pay a higher interest charge on ODA loans.<sup>28</sup>

Box 2 describes the experiences of boom and bust in Mexico and Indonesia in order to offer a glimpse of the dangers posed by the development finance challenges now facing Vietnam. Both of these experiences are vivid examples of what can happen when the threats to

<sup>28</sup> Vietnam might have had a different response towards moving from low- to middle-income economies. Vietnam seems to move out of the low-income list, or be promoted to the middle-come list as soon as possible, while Singapore, for example, did not want to join the OECD list for a long time. To some extent, the delay to move Vietnam up to the middle-income country group makes sense. This would help a country mobilize some cheap resources as a trade-off to holding a name of a low income nation.

macroeconomic stability detailed in Section III and the risks to microeconomic management detailed in Section IV are not effectively mitigated.

### **Box 2: Booms and Busts – The Experience of Mexico and Indonesia**

The abundance of resources, which appears in principle to be something auspicious, has brought about grave economic hardships for countries where the resource windfall has proven unsustainable. Two relevant examples are the 1982 Debt Crisis in Mexico and the 1997 Financial Crisis in Indonesia. In both of these oil-rich countries, the crisis was preceded by a long period of remarkable economic growth generated in part by a profusion of financial resources, and their experiences may shed light on the kind of challenges that the Vietnamese government may have to face in the future.

During most of the 1970s, Mexico, like many other countries in Latin America, enjoyed a period of accelerated economic development, with an average annual GDP growth rate of more than 6 percent. Driven by the dramatic increase in international crude prices and the exploitation of new oil fields, Mexico experienced large capital inflows and gained privileged access to international capital markets. During this period, the government engaged in profligate public spending, which it funded through large amounts of commercial loans. Whereas in the previous decades - not only in Mexico but all throughout Latin America - most of the government debt came from country-to-country lending or multilateral development organization loans, during the 1970s this changed dramatically. By the year 1982, only 12 percent of the region's foreign debt was owed to public entities, while the rest was mostly shorter-maturity, higher-rate private loans from commercial banks.

The economic situation began to change by the end of the decade. The resource inflows led to a real appreciation of the Mexican peso, weakening the non-oil exporting sector of the economy. Moreover, after the second oil shock in 1979, international interest rates increased, but the government continued with its fiscal mismanagement, assuming that the abundance of oil revenues was going to be long-lasting and that the increase in interest rates was going to be temporary. The opposite proved to be true. At the beginning of the 1980s, the oil price fell but interest rates in the United States and other OECD countries (where most of the commercial loans were coming from) stayed high at around 19 percent, in a context where almost half of Mexico's foreign debt was due within one year. Private sector capital began fleeing the country in light of these developments, and in spite of last-minute adjustments attempts by the government in early 1982, the crisis could not be averted. The peso devaluated 80 percent in February 1982, and international banks stopped lending to Mexico. In August 1982, Mexico defaulted on its debt. The inflow of resources stopped, and the creditors started to demand repayment of their short-term loans (Theberge 1999). The crisis resulted in the worst recession that Mexico had experienced since the 1930s, and it took it a decade to resume its growth path. With an average growth rate of 0.1 percent between 1983 and 1988, the 1980s became for Mexico, as for many other countries in the Latin America, "The lost decade."

In a similar fashion, for decades until the mid-1990s, Indonesia had been one of the fastest growing economies in the world, with an average annual GDP growth of 7 percent during the previous ten years. For a long time Indonesia benefited from vast amounts of external resources: ODA (especially concessional loans), FDI, and FPI. An important difference with the Mexican case is that, in spite of this abundance, the

Indonesian government implemented a sound fiscal policy, maintaining a balanced or surplus budget most of the time. Another source of foreign resources, the importance of which authorities were not aware at the time, was private sector offshore borrowing from commercial banks. These loans were mostly short-term, but it was a common practice to roll-over their maturity so that in practice they would work as higher-interest long-term credit. Such resources were frequently channeled into real estate development, infrastructure mega projects, and other long-term investments in non-tradables, with revenue for external debt repayment generated in local currency rupiah. In monitoring the situation, the Indonesian government focused on the standard indicator of exposure to foreign exchange risk - months of imports that could be covered by international reserves - and concluded that the country was in a solid position: while the recommended “healthy” level of reserves was more than 3 months, in 1997 Indonesia had almost twice that quantity at 5.4 months of coverage. The actual vulnerability of the economy, however, would have been evident if information about the ratio of short-term liabilities to GDP had been available by the time: unbeknownst to the government, the short-term external debt had accrued to an unsustainable 204 percent of international reserves (Rosengard 2002).

When the East Asian Financial Crisis hit after the collapse of the Thai baht in July 1997, many foreign creditors stopped rolling over their loans and started demanding repayment instead. Capital flight ensued, and Indonesia lost access to virtually all international capital markets. The government first tried to defend the rupiah, but these efforts and additional resources coming from the IMF proved fruitless. The current account deteriorated severely, and the exchange rate plunged, devaluating from 2,400 rupiah to the dollar in June 1997 to 16,000 in June 1998. During 1998 alone, the country lost more than 13 percent of its GDP, inflation reached almost 80 percent, and overall growth of the economy virtually stopped (Azis *et al.* 2001).

In spite of their differences, both of these experiences offer insights into development finance challenges now facing Vietnam. The problems in Indonesia were generated in the private sphere: in spite of Indonesia’s healthy fiscal situation, the financial crisis led to a balance of payments breakdown, and eventually to a national financial crisis and the resignation of President Suharto. It is not clear to what extent private debt in Vietnam may be facing similar maturity and foreign exchange risks, but is certainly advisable for the government to be aware of this possibility and to gather the necessary information to assess the current situation. In Mexico, it was unsustainable public spending that caused problems in the real economy and eventually provoked a financial crisis. Some local officers have estimated that Vietnam’s 2009 on-budget deficit might swell to 9 percent of GDP, excluding SOEs and the quasi-fiscal interest rate subsidy, a key component of the government’s economic stimulus package.

### e. Low efficiency in investment capital utilization

**Table 11: ICOR of selected countries**

	Period	GDP growth (%)	Investment (%GDP)	ICOR
Vietnam	1999-2009	7.2	37.4	5.2
Malaysia	1981-1995	7.2	32.9	4.6
Thái Lan	1981-1995	8.1	33.3	4.1
Trung Quốc	2001-2006	9.7	38.8	4.0
In-đô-nê-xia	1981-1995	6.9	25.7	3.7
Hàn Quốc	1961-1980	7.9	23.3	3.0
Đài Loan	1961-1980	9.7	26.2	2.7

*Source: Data of Vietnam is compiled from Bui Trinh (2010) and GSO, data of other countries is from FETP (2010)*

As mentioned earlier, this paper does not focus on the use of capital. However, a quick look is sufficient to reveal the low efficiency of capital utilization in Vietnam as compared to other countries. Between 1999-2009, Vietnam's ICOR reached 5.2, compared to only 4 in China, a country with similar level of investment and an average annual growth rate of 10% over the past two decades. In other words, Vietnam's capital efficiency is only a quarter of China's, and much lower than other countries in the same development stage. (Table 12). This evidence supports our argument that if public investment resources are wasted, Vietnamese firms and the economy overall will have to suffer from a lack of capital, and at the same time lose their competitiveness in investment opportunities.

Clearly, capital utilization efficiency is one of the factors leading to East Asia's success, and South East Asia's failures, as analyzed in *Choosing Success*, a research by the Vietnam Program at Harvard University in 2008.

## V. Conclusions and Recommendations

There are many potential unintended consequences of Vietnam's successful resource mobilization, with significant implications for the future financing of development. There are also several steps the government can take to mitigate these risks.

### a. Summary of Principal Vulnerabilities and Their Causes

The principal vulnerabilities created by Vietnam's mobilization of substantial resources for development finance fall into two main categories:

- threats to macroeconomic stability caused by imbalances in the composition of funding; and
- risks for microeconomic management caused by imprudent financing structures.

The most serious macroeconomic threats are:

- public sector crowding out of private sector funds access and utilization, or the crowding out from large private enterprises with complex cross-ownership structure

with financial institutions, a form of capital cronyism mostly in non-productive sectors or natural resource extraction;

- overleveraging of insufficient equity for unsustainable levels of debt;
- financial exclusion of low-income households and family enterprises; and
- flight of hot capital.

The most serious microeconomic risks are:

- maturity risk from over-reliance on short-term financing for long-term investments;
- foreign exchange risk from over-use of foreign capital for investments in non-tradable goods;
- credit risk from debt-financed speculation in asset bubbles; and
- fiscal gap risk from public sector dependence on unsustainable revenue sources.

## **b. Suggestions for Risk Mitigation**

Suggested ways of mitigating the above-summarized vulnerabilities include:

First, further deregulation and liberalization of the banking sector,<sup>29</sup> coupled with government disengagement from commercial financing would encourage market-based rather than politically-determined access to, and utilization of, development financing. Notably, the loosening of regulations and more liberalization in the banking sector would, in principle, force banks to function based on market principles. The government needs to minimize their administrative interventions in the market, but at the same time provides policy tools to prevent systematic risks. For example, despite some minor shortcomings, the SBV's issuance of Circular 13 in 2010, ensuring the overall safety level for the entire banking system, was a move in the right direction<sup>30</sup>. Meanwhile, regulations on interest rate ceilings or exchange rate ceilings, which seem to protect depositors or firms, could actually benefit powerful financial institutions who stand to make a profit. When the market becomes more liberalized, subject to overall protective regulations governing the entire system, capital will be more efficiently allocated to where it is most productive.

Second, the further development of equity markets and more rigorous enforcement of prudential norms in order to increase the pool of equity financing available and reduce lender abuse of standard lending ratios. Equity markets are one of the most important sources of long-term capital mobilization for enterprises. However, Vietnam's stock market, after a decade of operation with some listed firms capitalized at billions of dollars, has not served as the key channel for capital mobilization, and is still short of long-term investors (especially international investors). This means that an effective form of monitoring where investors vote with their feet has not materialized. The lack of transparency in the activities of listed firms, the lack of interconnection with the outside market, as well as the limited ownership of international investors are the major obstacles for the development of Vietnam's stock market.

Accelerating the equitization of SOEs and allowing them be listed on international stock exchanges would promote the development of Vietnam's equity market. Moreover, this

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29 For detailed recommendations, see Jay Rosengard and Huynh The Du (2009).

30 Huỳnh Thế Du (2010)

process would also prevent the concentration of public assets in privileged private hands through the equitization or privatization of the profitable subsidiaries of SOEs. A slow equitization process will create opportunities for profitable business activities or large incomes from SOEs to be transferred to privately owned subsidiaries, while the mother state company would suffer from a subsequently rising debt burden and risk exposure.

Third, the further development of microfinance institutions, products, and delivery systems to provide financial services to Vietnam's unbanked and under banked majority. The development of microfinance institutions must ensure autonomy and financial sustainability while proceeding toward two objectives. First, Vietnam needs an institution that facilitates the interaction between formal financial and microfinance institutions to ensure the most efficient allocation of capital (you may want to change this). We should also look to successful microfinance institutions in Vietnam or those in Indonesia or Latin America for guidance.<sup>31</sup> Second, Vietnam must pay special attention to the experience of the long lived ROSCO model and the behavior of long-term lenders, in order to discover the most reasonable policies and to formalize these types of lending activities in a more sustainable way.

Fourth, the introduction of market-based instruments to penalize FPI speculative outflows. The experience Chile, Malaysia, Thailand and other countries have with hot capital inflow taxation<sup>32</sup> offers important lessons for Vietnam, especially during times of extreme volatility which often brings more troubles than benefits.

Fifth, the further development of domestic long-term debt instruments to decrease borrower reliance on inappropriate short-term financing for long-term investments, especially from external creditors. The main difference between bonds and deposits (even long-term deposits) is the possibility of premature withdrawals for the latter. Bonds or long-term debts are long-term in the sense that the owners are not allowed to withdraw before maturity, while virtually all bank deposits are considered no-maturity deposits because owners can effectively withdraw their funds anytime. An important factor for the development of long-term debt market is a developed and flexible government bond market. It is very difficult to develop a healthy bond market in an environment where bond yields are higher than the interest rates that commercial banks can borrow from the SBV, allowing traders to make a profit out of the arbitrage opportunity analyzed above.

Sixth, coordinated monetary and fiscal policy to deflate asset bubbles in a gradual and managed fashion before they burst. As seen above, inefficient investment often goes into waste and corruption. A lucky and well connected few can make a fortune and spend their income on luxuries, contributing to inflation and the trade deficit, which fed the twin imbalances that Vietnam is currently bearing. Reducing expenditure together with tight monetary policies in the near future would ensure a better use of capital, and limit (the utilization on real estate?? maybe speculative real estate investments). Moreover, we need to manage the current incompatibility between fiscal and monetary policies. Keeping the refinancing rate and discount rate much lower than government bond yields encourage the distortion of capital flows. Banks no longer have an incentive to circulate capital for

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31 FIPED (2010)

32 Christopher J. Neely (1999)

productive use, preferring instead to borrow from the SBV and buy government bonds or to lend out in interbank market, making a profit from the gap in policy rates.

Seventh, the continued implementation of a comprehensive tax reform to adapt the public revenue structure to a rapidly evolving economic structure, and to replace unsustainable revenue sources with more resilient ones. The issuance of property taxes, especially real estate taxes, and a reasonable policy on personal income taxes would contribute to a more stable source of government income. First, experience from the United States, Indonesia, and other countries show that to have a successful tax system, it is necessary to decentralize the tax collecting process to the local government, so that they can benefit from this revenue source as well.<sup>33</sup> Second, there is something wrong when the wealthiest individuals on the stock market are not listed as personal income tax payers according to the tax agency. Vietnam's personal income taxes account for about 4% of total state revenues, compared to 50% (including social securities) in the United States. This means Vietnam's personal income tax in fact is only a payroll tax and taxes from household enterprises. Those who are supposed to pay are not among those listed as tax payers.

Eighth, more effective monitoring of the private sector's external debt to accurately assess Vietnam's exposure to foreign exchange maturity risk. The large gap between the VND and the USD deposit rates, and between domestic and international USD deposit rates, together with policies that tighten credit for the non-productive sector, would encourage outside borrowing from disguised enterprises. This can create many serious consequences for the economy. It is essential and urgent to tightly monitor borrowing activities from outside sources.

Ninth, to rely less on public-private-partnership (PPP) projects to solve Vietnam's infrastructure problems, because while this model may mobilize more capital, it does not improve the efficiency of capital. This paper shows that Vietnam's problem is not one of capital mobilization. Compared to other countries, Vietnam has mobilized a large amount of capital for development. The problem for Vietnam is how to make better use of these resources. Recent research by Dapice, Nguyen (2009), Ngo and Huynh (2010), show that shortages in Vietnam's infrastructure are due to expensive inefficient investment. Many projects have to pay a much higher investment cost than infrastructure construction cost, due to the very high compensation rate in areas where infrastructure has already been developed. We need to avoid partnership models with no incentives to developing Vietnam's infrastructure and strong incentives to maximize other objectives, such as land acquisition. Moreover, this model further encourages cronyism, evidently seen in the rapid growth of some private enterprises with close relationships to the state.

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33 Rosengard et al (2007)



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