



ASIA PROGRAMS  
79 John F. Kennedy Street, Cambridge, MA 02138  
Tel: (617) 495-1134 Fax: (617) 495-4948

232/6 Vo Thi Sau Street, District 3, Ho Chi Minh City  
Tel: (848) 932-5103 Fax: (848) 932-5104

## **POLICY DISCUSSION PAPER NO. 1<sup>1</sup>**

### **Macroeconomic Instability:**

### **Causes and Policy Responses**

#### **I. Overview**

The Vietnamese economy has entered a period of uncertainty and potential instability. While this situation is due largely to domestic factors, it is compounded by heightened volatility in the global economy. In the short term, the Vietnamese economy is not well-positioned to deal with a global price volatility and slower growth. In the worst case scenario, a sudden reduction in the short term capital inflows that Vietnam needs to finance its current account deficit would necessitate a sharp slowdown in economic growth. Slower growth would hurt the poor and give rise to social and political tension. A deeper recession would derail the country's medium term development plans. Greater flexibility and responsiveness to changing conditions are therefore needed to avoid this undesirable outcome and keep the country on track to join the ranks of the middle and eventually upper income countries.

This short paper argues that a series of resolute and coordinated policy interventions is needed to restore macroeconomic stability, cushion the impact of the global economic downturn, and keep Vietnam on the path of sustainable growth. Specifically, the Vietnamese government must quell price inflation, reduce fiscal and trade deficits and slow down money and credit growth through a consistent and synchronized set of policy interventions. Gradual deflation of the real estate price bubble is needed in order to avoid a sudden collapse in prices, which would, if it occurred, destabilize the financial sector with potentially serious contagion effects for the real economy. Successful implementation of these policy prescriptions in the near term, and maintaining a stable economic environment over the medium to long term, will require greater policy coordination than the Vietnamese government has demonstrated in recent years. The government's economic policy apparatus is at the moment fragmented, excessively sensitive to political pressure, and lacking in technical expertise. Our main message to the government is that deeper integration into the international economy requires the development of professional and accountable public institutions that have the capacity to react quickly and effectively to changing global and domestic conditions.

*It must be emphasized that this paper is intended to provide a rapid analysis of the current macroeconomic situation and a framework for considering policy responses. More research is needed to devise specific and detailed policy proposals. Therefore this memo does NOT recommend specific policies, as these need more complete and up-to-date knowledge and careful management.*

---

<sup>1</sup> This paper is the first in a series undertaken in the context of a policy dialogue initiative with the Vietnamese government coordinated by the Ministry of Foreign Affairs. It has been prepared by a team of policy analysts from the Harvard Kennedy School and the Fulbright School, including Nguyen Xuan Thanh (thanhnx@fetsp.vnn.vn), Vu Thanh Tu Anh (anhvt@fetsp.vnn.vn), David Dapice (david\_dapice@harvard.edu), Jonathan Pincus (jonathan\_pincus@harvard.edu), and Ben Wilkinson (ben\_wilkinson@harvard.edu). The paper draws upon research conducted with support from the US Department of State and UNDP. The opinions, findings, and conclusions stated herein are those of the author(s) and do not necessarily reflect the views of the United States Department of State, the United Nations Development Programme, its Executive Board or its Member States.

We recommend five immediate actions to *create the conditions* for a return to macroeconomic stability. These are:

- **Control public investment.** The root cause of price inflation in Vietnam is overinvestment in the public sector, including investment by state owned enterprises, central government and local authorities. Until control over public investment is re-established, inflation will continue to accelerate. The government must immediately develop a “triage list” of public investment projects consisting of a rank ordering of investments to be suspended or cancelled in the event that macroeconomic conditions do not stabilize. The list should be based strictly on technical (rate of return) criteria and not political considerations.
- **Stabilize property prices.** Bank lending to real estate development must be curbed in order to avoid potentially serious turmoil in the banking system in the event that the property bubble bursts. A land and buildings tax must be implemented to raise revenue and to achieve an orderly correction in the property market. This policy should be combined with a thoroughgoing reform of zoning and land use laws and regulations to make them more transparent and accountable.
- **Curtail international commercial borrowing.** An immediate moratorium should be placed on international commercial borrowing in the state sector to be reviewed periodically until macroeconomic conditions stabilize.
- **Restructure the State Bank of Vietnam.** The government must immediately prepare a plan to restructure the State Bank of Vietnam and to develop and apply the monetary policy instruments of a modern market economy. This will require external advice from central banking specialists, including former central bankers from within the ASEAN region and other international technical experts with specific experience in the restructuring of central banks in ASEAN countries.
- **Create an apex institution for economic management.** This agency, analogous in function to Singapore’s Economic Development Board and similar institutions in the region, should be empowered to coordinate macroeconomic policy and to achieve discipline and consistency in the state sector. Officials of this institution must be selected and promoted on the basis of merit and ability, earn salaries comparable to levels available in the private sector, report directly to the Prime Minister and possess the authority to override the decisions taken at the ministerial level.

## II. Analyzing the Macroeconomic Situation

Vietnam has enjoyed over fifteen years of relative macroeconomic stability. For most of this period, Vietnam’s economic links with the rest of the world were largely limited to trade, official aid flows and private remittances. However, the country’s accession to the World Trade Organization and other trade and investment agreements, combined with the relaxation of control over domestic private transactions, have broadened and intensified Vietnam’s international economic relations. Foreign direct investment and portfolio capital flows have increased sharply and the financial sector is more open to international competition. Today’s macroeconomic turbulence is directly related to the domestic challenge of upgrading macroeconomic management for the WTO era. Inflation is now in double digits, and far higher than in neighboring countries. The trade deficit is projected to reach \$17 billion, or over 20 percent of GDP – a level that signals vulnerability to a sudden change in investor sentiment. Very high rates of investment combined with a sizeable fiscal deficit have resulted in rapid growth in aggregate demand. Massive capital inflows have generated asset price inflation, most apparent in the form of real estate and land prices that are unreasonably high in many provinces, not only the major cities. These imbalances have built up at a time of global economic uncertainty in the wake of the sub-prime lending collapse in the US, high global energy and food prices and a resulting slowdown of the US and other major economies. Vietnam’s capacity to ride out this period of global economic turbulence depends crucially on the restoration of domestic macroeconomic

balance and less reliance on short term capital inflows. Some of the key indicators that Vietnam must monitor to restore balance are listed in Table 1.

*Table 1. Factors contributing to inflation and an unstable macroeconomy*

Issue	2007	Goals in 2008
Fiscal deficit	5.8%	Less than 5%
Money and credit growth	30-40%	Less than 20%
Trade deficit/GDP	18%	5-10%
Real lending rates	-3.5% (year end)	1-2% (More than inflation rate)
Public investment/GDP	20%+	10-15%

The factors listed in Table 1 are inter-related. Each is impossible to address in isolation or by one branch or agency of government acting alone. For example, high rates of money and credit growth fuel inflation and imports. Yet credit growth in Vietnam is driven in large part by high levels of public investment, which in turn are linked to the fiscal deficit. Monetary measures alone will not solve the problem. Large capital inflows (not just FDI, but also “hot money” portfolio flows into stocks and real estate) inject liquidity into the system and finance the trade deficit. When these flows rise to very high levels, it is desirable for the monetary and fiscal authorities to “lean against the wind” by restraining public sector borrowing and building up foreign currency reserves to protect the economy in case of a sudden shift in investor sentiment. The government must also curb the growth of public spending and widen the tax base to reduce the growth rate of aggregate demand. The monetary authorities need to induce savings and lower the rate of investment through the management of interest rates.

Vietnam’s economy is overheating. This is evident in high and accelerating inflation, a widening trade deficit and the asset price bubble. The reason for this bout of instability is self-evident. Massive capital inflows, including short term “hot money”, have injected liquidity into the economy and stimulated credit growth. At the same time, the public sector has done its part to drive the national investment rate to more than 40 percent of GDP. The result is investment-led growth (and an excess of investment over domestic savings) that has pushed domestic capacity to its limits. Improving the efficiency of investment is an essential medium term goal. In the short period, the government must act immediately to restore macroeconomic balance by reducing the rate of public investment. Public investment must be concentrated on public goods that remove critical bottlenecks to growth, for example major roads and ports linking exporters to world markets, primary and secondary education and urban infrastructure including electrical transmission and distribution. Scarce public funds must not be used to substitute for private investment, such as real estate development, stock market speculation, and even the development of power generation and toll roads. The government must find ways to involve private capital in the provision of essential infrastructure to increase supply, reduce costs and improve quality.

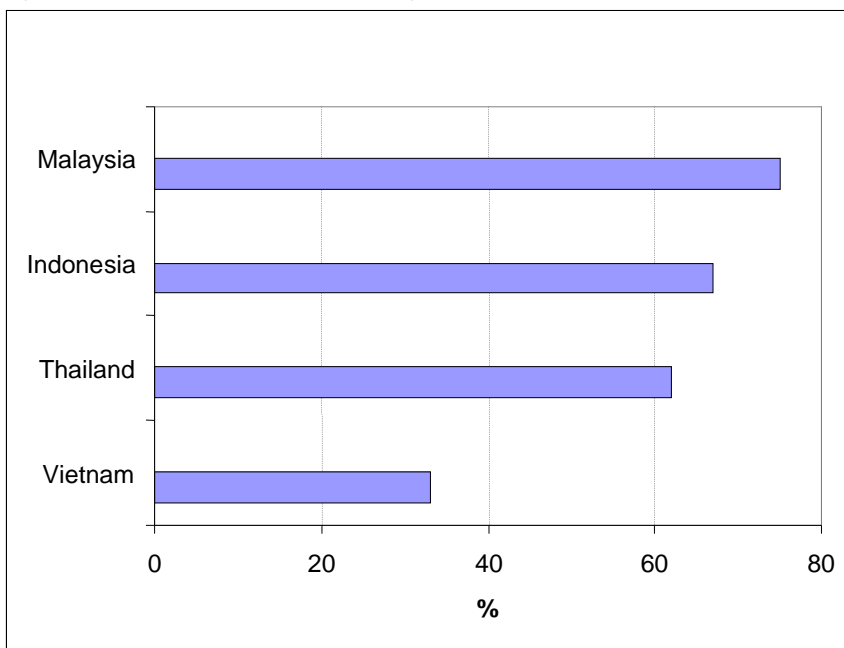
The asset bubble in real estate is a potentially serious threat to the Vietnamese economy in several respects. As we analyzed in *Choosing Success*, Vietnamese firms are diverting resources from their core businesses to pursue speculative investments in land. When banks lend to firms and households to buy assets at inflated prices, they expose themselves to risk. When many banks lend to many firms and households to buy assets at inflated prices, the entire financial system is at risk. This is what happened in Japan in the early 1990s, and underlies the “sub-prime loan” crisis in the US today. We need better information about the extent of property lending in Vietnam, and more effective enforcement of prudential regulations.

Table 1 also lists a series of desirable policy outcomes for 2008. It should be emphasized that these are intended as indicative and that further research is needed to add precision to these estimates. Yet few

economists would argue with the desirability of reducing the rate of inflation from 8-12 percent in 2007 down to 4-6 percent in 2008. Slowing money and credit growth is a prerequisite to stable prices. Reducing the fiscal deficit is an important policy variable, which in turn would likely have the effect of reducing the trade deficit.

The level of foreign exchange reserves is a crucial variable during periods of instability. Foreign exchange reserves function like shock absorbers, protecting the country against the worst effects of unexpected events such as a sudden fall in export prices bad weather or bad weather at home. Given that Vietnam is anticipating a \$17 billion trade deficit in 2008, the country also expects an equivalent amount in capital inflows. If plans and commitments for imports are made but short term capital flows diminish or even reverse, it would be very difficult to meet the country's foreign exchange requirements without a squeeze on domestic demand. As shown in Figure 1, Vietnam's foreign exchange reserves at the end of December were about one-third of 2007 imports. In contrast, Indonesia, Malaysia and Thailand – with much smaller short term capital flows – had two-thirds to three-quarters of their annual imports in reserves at the end of 2007. (The importance of adequate reserves is a lesson that these countries drew from the 1997 crisis.) In the current circumstances, a much higher level of foreign exchange reserves would be one way to “buy insurance” against unfavorable developments. Just to equal its neighbors, an end-of-2008 level would have to be in the range of \$40-50 billion. Such a level is not easy to reach in the next few quarters, but suggests the extent of prudent adjustments that are needed.

Figure 1. Reserves as a percentage of imports (end 2007)



### III. Understanding Inflation

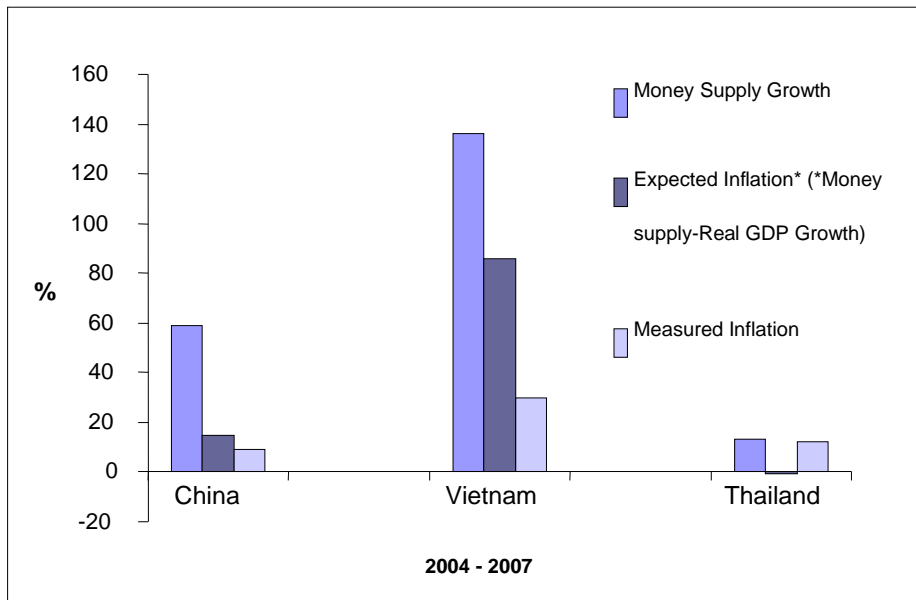
Inflation has many causes. Cost-push inflation results from sudden price rises for things that people and business need to buy regardless of the cost, like food and energy. Oil prices approaching \$100 per barrel drive inflation because energy is an essential input into production and transport. While rising energy and food prices have certainly made Vietnam's inflation worse, the fact that inflation in neighboring countries using more energy per capita is much lower than in Vietnam shows that domestic factors are more important. According to official figures, the inflation rate in Vietnam was 12.6 percent in 2007. It is likely that the actual figure is considerably higher, perhaps over 20 percent. Even measured by the official figures, however, Vietnam's was the highest rate in the region.<sup>2</sup>

<sup>2</sup> See *Choosing Success*, page 52.

The two main domestic factors are unsterilized capital inflows and unrestrained public investment. The State Bank of Vietnam was unable to prevent capital inflows from generating a rapid increase in the domestic money supply. At the same time, public sector borrowing increased sharply to finance investment in state-owned enterprises and other projects. As a result there was “too much money chasing too few goods.” From end of year 2004 to year-end 2007, money supply in Vietnam grew 137 percent while real output grew only 27 percent. Some of the excess money in the economy was used to bid up asset prices, particularly land, and buy imports. The rest of it is price inflation.

Figure 2 shows measured and expected inflation in Vietnam, China, and Thailand. It is interesting to note that in China, the expected and actual inflation levels were very close. In Thailand, the money supply and real GDP grew by about the same amount, but political uncertainties led to an inflation rate of about 5 percent a year as people decided to hold less local currency (Baht) per unit of output.

Figure 2. Measured and expected inflation



This analysis of the causes of inflation suggests two immediate policy responses. First, the State Bank of Vietnam must “sterilize” capital inflows, or sell VN dong-denominated instruments to withdraw liquidity from the system that is injected when foreign currency is exchanged for VND. Second, public investment must be more selective, focusing on projects that generate the highest possible output growth per unit of investment. Too much of Vietnam’s public investment portfolio is unproductive, in other words projects that are chosen for political or administrative rather than economic reasons.<sup>3</sup>

#### IV. Structural Weaknesses of the Current Government Apparatus

The economic management system in Vietnam was not designed to address the challenges of a globally integrated economy. At present three ministries share responsibility for economic policy, but their decisions are not consistent or coordinated. The Ministry of Planning and Investment aggregates spending (investment) plans with no attention to the overall macroeconomic situation. The Ministry of Finance controls recurrent spending but has no power to limit capital spending, and therefore cannot manage fiscal policy. The State

<sup>3</sup> The construction of deep sea ports in Central Vietnam, including the Van Phong container transshipment port, is one example of economically irrational investment. See *Choosing Success*, page 37. State-owned enterprises are also borrowing heavily to speculate in property markets, which increases the money supply and directly bids up asset prices.

Bank of Vietnam does not function as a genuine central bank. The base interest rate has no bearing on commercial interest rates, and therefore SBV is forced to rely on imperfect tools such as reserve ratios, administrative guidance and injections or extraction of liquidity from the banking system. Indeed, current lending and deposit rates in banks are well below the inflation rate. This in itself tends to make financial assets less attractive and encourages businesses and firms to borrow to buy assets.

*Table 2. An Economic Policy Apparatus in Disarray*

Agency	Function	Weaknesses	Needed changes
State Bank	Set and implement monetary policy	Over-reliance on administrative measures; insufficient autonomy	Broaden trading band of VND; effective monitoring and supervision of banking sector; use of full range of monetary policy instruments
Ministry of Finance	Set and implement fiscal policy	Absence of revenue strategy; no control on capital budget; limited control over current spending; much spending is off-budget	Bring all spending on budget; increase transparency; widen tax base (especially land/buildings tax); establish overall fiscal framework
Ministry of Planning and Investment	Allocate capital spending	Politically motivated investment priorities	Eliminate wasteful public investment projects; transparent cost-benefit analysis of investment decisions

Such problems would be of concern at any time, but are especially critical when the global economy is entering a period of turbulence. Vietnam cannot make macroeconomic policy on the assumption that capital flows will remain at current levels, or that external demand for Vietnam's exports will continue to grow at current rates. Vietnam needs a more prudent macroeconomic stance to make the economy more resilient in the face of challenging external conditions.

## V. Policy Recommendations

This section lists five policy changes required immediately to reduce inflation and restore macroeconomic stability.

### 1. *Coordinate monetary and fiscal policy*

Monetary and fiscal policy must be consistent and coordinated. Restrictive monetary policy will fail if fiscal policy remains expansive. Cutting public investment will not reduce inflation if capital inflows are not sterilized and if commercial lending rates remain below the inflation rate.

The economy is overheating. Monetary and fiscal policy must reduce the rate of growth of aggregate demand. This is more difficult in the context of international integration. Higher interest rates could attract additional foreign capital, which would accelerate money supply growth, increase the pressure on SBV to increase interest rates and lead to even more capital inflows. More exchange rate flexibility would not solve the problem, since an appreciation of the VN dong would encourage imports, hurt exports, and widen the trade deficit. This is precisely the problem faced by the East Asian economies prior to the 1997 crisis. It is vital that Vietnam immediately suspends all plans of state owned corporations to borrow large sums on international capital markets.

### 2. *Establish an apex economic policy institution*

Coordination of fiscal and monetary policy is essential. The current structure is fragmented and dysfunctional, and if left unreformed will eventually result in an economic crisis. The government must concentrate economic policymaking in the hands of a single body. Whether this entity is an existing agency or a newly established one, it must possess both a sophisticated understanding of the national and international economies and the power to translate this knowledge into policy, including the authority to overrule line ministries, local government, and, critically, the state owned conglomerates. In the event of a crisis, the agency must be empowered to cancel investment projects that it deems wasteful or unnecessary. Indeed, one of the first tasks of this body should be to develop a series of contingency plans, consisting of integrated package of policies that can be deployed in event of heightened economic turmoil.

Accurate information and timely analysis is a basic prerequisite for effective policymaking. One of the most worrisome aspects of Vietnam's current economic vulnerability is the fact that policymakers and the leadership lack the information they need to make informed decisions. Crafting effective policies to address the issues listed in Table 1 above will require information including accurate measurement of inflation, trends in property prices, the quality of bank lending portfolios And wage and employment trends. Critically, the government must assess the economic returns to public investment projects. Government economists should be able to analyze the complex linkages between monetary, fiscal, exchange rate and capital flow variables.

It must be emphasized that developing the analytical and policymaking capacity needed to improve Vietnam's macroeconomic situation will be virtually impossible if the existing personnel system is retained. In order to attract and retain highly skilled personnel, the apex economic policy institution must be able to pay salaries equal to or greater than the private sector; of equal importance, hiring and promotion must be rigorously merit based.

### *3. Restructure the State Bank of Vietnam*

At present the State Bank of Vietnam lacks the authority, instruments and management structures to function as a genuine central bank. This situation is rooted in both political and technical factors. Politically, the Bank lacks the autonomy it needs to make and enforce decisions strictly on technical criteria. Since the 1997 crisis, Southeast Asian countries have, to varying degrees, all moved to grant their central banks increased autonomy; the State Bank of Vietnam is by far the least autonomous in the region. The Bank's technical capacity is also limited. SBV lacks faith in its own monetary instruments, and therefore tends to prefer administrative directives (such as Decision No. 3 regarding lending for investment in the stock market). These administrative interventions reflect a "central planning" approach to monetary policy that is ill-suited to the complexities of a modern, globalized market economy. SBV must learn to use interest rates and open market operations more effectively; but this would also mean making its operations more transparent and accountable.

Managing the central bank in a modern market economy requires a set of highly specialized skills. SBV must immediately secure the advice of independent and experienced international experts. Central banking has changed in important ways over the past fifteen to twenty years. Every central bank in the ASEAN region has responded to these changes. They have undergone fundamental restructuring of their organizations, operations and staffing. They have appointed specialized international technical experts to help them with this process. This expertise does not come cheaply. But it would be much more expensive to attempt to build a modern central bank without the benefit of expert technical guidance. To avoid conflicts of interest, ensure confidentiality and promote domestic policy ownership, these experts should be selected and paid for directly by the Vietnamese government, not by international donors. Well-functioning central banks in ASEAN such as the Monetary Authority of Singapore and Bank Negara could help SBV identify the appropriate experts.

### *4. Control public investment*

Approximately \$100 billion in proposed public investment projects have been either approved or are being seriously considered. This does not include investments to be undertaken by state-owned enterprises. Unless

this figure is reduced sharply, Vietnam will lose control of its macroeconomy. The government must immediately develop a “triage list” of projects that are currently planned or underway but that must be suspended or cancelled. The list must be compiled strictly on the basis of technical criteria (such as each project’s economic rate of return) with no political interference. Larger ASEAN countries have used such triage lists to establish fiscal priorities in times of economic turbulence. An immediate moratorium on commercial international borrowing for public projects must also be imposed immediately pending a review of priorities. Finally, steps need to be taken to change the way in which public sector projects are selected to reduce the amount of waste and leakage in the system.

##### *5. Stabilize real estate prices*

The bubble in real estate is a threat both to Vietnam’s continued economic growth and to social and political stability. If the bubble were to “pop” as happened in Japan in the early 1990s and Southeast Asia in 1997, the impact would be painful and disruptive. Because the banks are exposed to the property market, a sudden fall in prices could threaten the solvency of some banks and faith in the banking system. Instability could spread from the banks to the real economy. A sudden drop in prices would also result in a rapid reduction in the capital inflows that at present finance Vietnam’s trade deficit. The government should attempt to let the air out of the bubble slowly to avert a price shock. A critical first step is to determine the extent of bank lending to real estate speculation. Without accurate data, Vietnamese policymakers will be unable to assess systemic risks to the financial system or formulate effective responses. Moving forward, the most effective way to do so is through an effective tax on buildings and property. Close supervision of banks is also needed to ensure that they are not unduly exposed to risky property investments.<sup>4</sup> On the supply side, zoning and land use rules need to be more transparent and predictable to ensure that local officials are not in a position to ration the supply of urban land and benefit from the resulting price spikes. More transparency and accountability in land use regulations would also reduce political tensions surrounding the reclassification of land and land compensation schemes. It may be prudent to instruct state-owned firms to restrict or cease speculative real estate ventures.

---

<sup>4</sup> Close supervision of banks, particularly of newly established joint stock banks, may require “on site” measures such as dispatching inspection teams to bank officers because reports may not accurately reflect the true extent of lending.