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POLICY DISCUSSION PAPER NO. 3[1]

THE STRUCTURAL ROOTS OF MACROECONOMIC INSTABILITY

Overview

This paper responds to a request from the Vietnamese government for an analysis of the short and long term challenges confronting the Vietnamese economy. We believe that restoring macroeconomic stability *and* positioning the economy for long term growth will require fundamental, structural reform. We begin by comparing Vietnam's performance over the past twenty years to other countries in the region. This comparison reveals a set of worrisome trends which, taken together, raise questions about the sustainability of Vietnam's growth path. Part II examines the current macroeconomic environment and assesses the government's response to date. We conclude that, while government policy has succeeded in reducing macroeconomic turbulence in the short run, nothing has been done to address the structural weaknesses of the Vietnamese economy. The government has in effect treated the symptoms rather than the causes of the disease, with the implication that the problems experienced earlier this year will reappear when the fiscal and monetary stance is relaxed. Sustaining rapid growth cannot be achieved without strengthening regulation and supervision of the financial system, reducing inefficient public investment and imposing market discipline on large state-owned enterprises. Part Three analyzes the current health of the banking system and its relationship to the property market. In Part Four we look forward, and consider the structural challenges Vietnam will need to overcome in order to achieve the ambitious goals it has set for itself during the period 2010-2020. A series of policy recommendations is put forth in the final section. A discussion of Wall Street's ongoing financial crisis and its potential implications for the Vietnamese and global economies is included in an appendix.

Part One. **Structural Contradictions**

A. One country, two stories?

In recent months, Vietnamese officials have expressed concern with what they perceive to be a difference of opinion within the international policy community about the current state and future growth prospects of the domestic economy. Broadly speaking, these opinions fall into two categories. The "optimists" see that Vietnam has enjoyed a period of rapid and sustained economic growth since the early 1990s. Over the 17 year period beginning in 1991, real GDP growth has averaged 7.6% per annum. At this rate the economy doubles in size every ten years. As the distribution of income has remained reasonably stable, rapid growth has resulted in an historic fall in measured poverty. Vietnam has attracted large amounts of foreign direct investment and is widely regarded as an attractive destination for companies pursuing a "China plus one" strategy. The optimists' perspective is not without merit and may be proven correct in the long term.

[1] This paper is the third 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@fetp.vnn.vn), Vu Thanh Tu Anh (anhvt@fetp.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 BP Vietnam, the United States 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 BP, the United States Department of State, the United Nations Development Programme, its Executive Board or its Member States.

The other group, to which we belong, may be described as the "realists." We resist the label "pessimists" because we believe that Vietnam can achieve its goal of becoming a prosperous, modern society. While acknowledging Vietnam's achievements and immense potential, we see serious flaws in the current structure of the economy. Vietnam's growth prospects hinge crucially on the capacity of the country's leadership to demonstrate the political will necessary to address these challenges.

In any discussion of Vietnam's development strategy it is important to remember that Vietnam is still a poor country in comparison to most of its neighbors. The most recent ADB estimates put PPP income per capita of the average Vietnamese citizen at only two-thirds of the average Indonesian and about one-third of the average Thai's income. In other words, Vietnam is still in the early stages of economic development. The challenge facing policy makers is to create the conditions required to sustain and perhaps increase the rate of economic growth while maintaining price stability and Vietnam's favorable distribution of income.

One of the few advantages of following rather than leading the region in economic growth is the opportunity to learn from the successes and failures of neighboring countries. In trying to assess Vietnam's current situation in the context of its long-term goals, it is useful to compare its performance with historical episodes of rapid economic growth experienced in other East and Southeast Asian countries. Although every country follows a unique development path, shaped by history, culture, politics, the international environment and a host of other factors, successful countries share certain common features. Table 1 compares the large ASEAN countries plus the Republic of Korea and Taiwan.[2] The periods selected represent the two decades in which each country achieved its most rapid GDP growth rates. In other words, our intention is to compare extended periods of success rather than each country's average performance.

Export performance. This is a cornerstone of the optimists' story. Indeed, the only country in our sample to record an average annual export growth rate more rapid than Vietnam was Taiwan for the period 1963 to 1982. Vietnam over a short period of time has emerged as a major exporter of primary commodities like rice, coffee, fish and shellfish, pepper and rubber. Exports of light manufactures (garments, shoes and furniture) accelerated rapidly after 2000 and the implementation of the US Bilateral Trade Agreement. WTO accession will help Vietnam build on these successes and expand into new products and markets. Petroleum exports also grew rapidly in the period after 1999. Most of Vietnam's non-oil exporters are small private firms and foreign companies. State owned enterprises have not achieved much export success.

Table 1: A Comparison of Growth Episodes (average annual rates)

	% GDP growth	ICOR	% Job growth	% Export growth	% Trade balance/GDP	% FDI/GDP	% CPI increase
Vietnam 1991-2007	7.6	3.5	2.4	20.1	-8.69	5.9	12.8
Korea 1969-1988	8.4	2.8	3.2	19.2	-3.58	0.5	12.1
Malaysia 1977-1996	7.4	4.9	3.5	11.5	2.09	4.3	3.8
Thailand 1976-1995	8.1	3.6	3.0	13.9	-4.12	1.1	5.9
Taiwan 1963-1982	9.8	2.9	3.4	27.1	-2.26	n.a.	n.a.
Indonesia 1977-1996	7.2	2.8	2.9	4.8	2.8	0.9	9.6
Philippines 1961-1980	5.4	2.3	3.3	6.9	-1.8	n.a.	10.2

Sources: Calculated from World Bank World Development Indicators for all indicators except job growth (ADB) and IMF's International Financial Statistics (ICOR). CPI data for Vietnam published by GSO.

Job creation. In this category, Vietnam's performance is relatively poor.[3] Numerous domestic analysts have commented on Vietnam's "jobless growth" over the years, noting the asymmetry between the country's rapid

[2] Although structurally China bears some similarities with Vietnam, the country's size renders direct comparisons problematic. Singapore is not included both because it is a city state (lacking a large rural population) and because the Singaporean authorities did not make comparable macroeconomic data available to the public until the 1980s.

[3] The absence of a representative labor force survey in Vietnam makes it difficult to measure employment levels with any degree of certainty. Adequate funding and technical support to improve the existing surveys should be given priority by

growth of income and exports on the one hand and the slow growth in demand for labor on the other. No other country in our sample recorded slower job growth during their period of rapid growth. Even the Philippines, which could only manage 5.4% average growth during its best period, created jobs more quickly than Vietnam over the past two decades. Given that the Vietnamese economy must create at least one million new jobs a year simply to absorb new labor market entrants this record highlights the need for rapid growth in sectors that can draw young and older workers alike into higher productivity occupations.

Vietnam's performance with regards to job creation points to the main underlying contradiction in the country's development strategy. *Simply put, the state sector is not creating many jobs, yet it absorbs nearly half of business investment.* At the same time, the private sector, which does generate jobs, consists largely of small, undercapitalized firms that find it difficult to grow into medium and large companies because they find it so difficult to access land and bank loans.[4]

FDI Attraction. For the optimists, Vietnam's attractiveness as a destination for FDI is a key component of its success and future prospects. While a few analysts mistakenly focus on licensed rather than realized FDI, the actual inflows were high during the 1990's Asian bubble and have averaged almost 4% of GDP from 2000 to 2006, with much higher amounts in 2007 and 2008. Foreign invested enterprises have served as the engine of manufactured exports, leading the way in garments, footwear and other labor-intensive industries. However, as reflected in Table 1, Vietnam's heavy reliance on FDI is unusual. In the region, only the city states, and Malaysia have relied on FDI to such a degree.[5] Vietnam's FDI dependence is also partly responsible for the country's chronic trade deficits despite rapid export growth. Although many foreign-invested enterprises are export oriented, their production is also import intensive. Footwear producers import leather and sewing machines and export shoes. Electronics companies import components for assembly in Vietnam. These are certainly welcome investments in view of Vietnam's need to create jobs for its growing labor force, but in themselves they will not generate much of a trade surplus or industrial deepening. Indeed, since foreign-invested manufacturing firms also import capital goods, their net impact on the trade balance may be negative over the medium term. This is not an argument against FDI, since these firms provide other benefits to the economy including employment generation, transfer of technology and skills, access to foreign markets and the example of superior management practices. But these benefits depend crucially on the linkages that develop between FDI and domestic firms. Constraints to domestic private-sector growth have limited the development of supplier industries that benefit most from these linkages. Moreover, without established and durable relationships with local suppliers, foreign firms have fewer incentives to stay in Vietnam as labor and other costs rise.[6]

Efficiency of investment. Vietnam is wasting enormous amounts of capital. Economists normally expect that the marginal returns to capital will be higher in low income economies like Vietnam than in rich countries because capital is scarce relative to labor. Yet as shown in the table, Vietnam is among the least efficient users of capital in our sample. Only Malaysia, which wasted billions of dollars on failed state enterprises and subsidies to politically connected firms, posts a higher ICOR. Even Korea, famous for its large, capital intensive firms, recorded a significantly lower ICOR during its initial phase of rapid economic growth. If we

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the government and donors given the vital importance of employment to poverty reduction and economic growth. From available data, it appears that agricultural jobs have held about level since 1990 while most job growth has come from industrial and service sectors. These "modern" sectors have seen jobs grow at 5.7% a year. Agriculture now accounts for about half of all jobs.

[4] There are reportedly a small number of well connected private firms, but little can reliably be said about them except that they share favorable access to government contracts, land and capital with state enterprises.

[5] The reliance of the city states on FDI is understandable. Malaysia's heavy dependence on FDI also reflects weaknesses in the domestic economy. But with a small population and abundant natural resources, Malaysia had managed to record high growth rates and price stability over an extended period of time. Since 2000, growth has averaged about 5% a year.

[6] In July Sony announced plans to close its television assembly plant. The reason given is the phasing out under WTO regulations of the tariff structure that made it much cheaper to import components rather than finished products. There are reports that many other similar operations will follow suit. These assembly plants belonged to the "first wave" of foreign investment in the early 1990s. This trend suggests first that Sony and other manufacturers believe that they can make their products more efficiently elsewhere. Secondly, after nearly two decades, Vietnam was unable to develop the local supplier firms that might have given these manufacturers reason to stay.

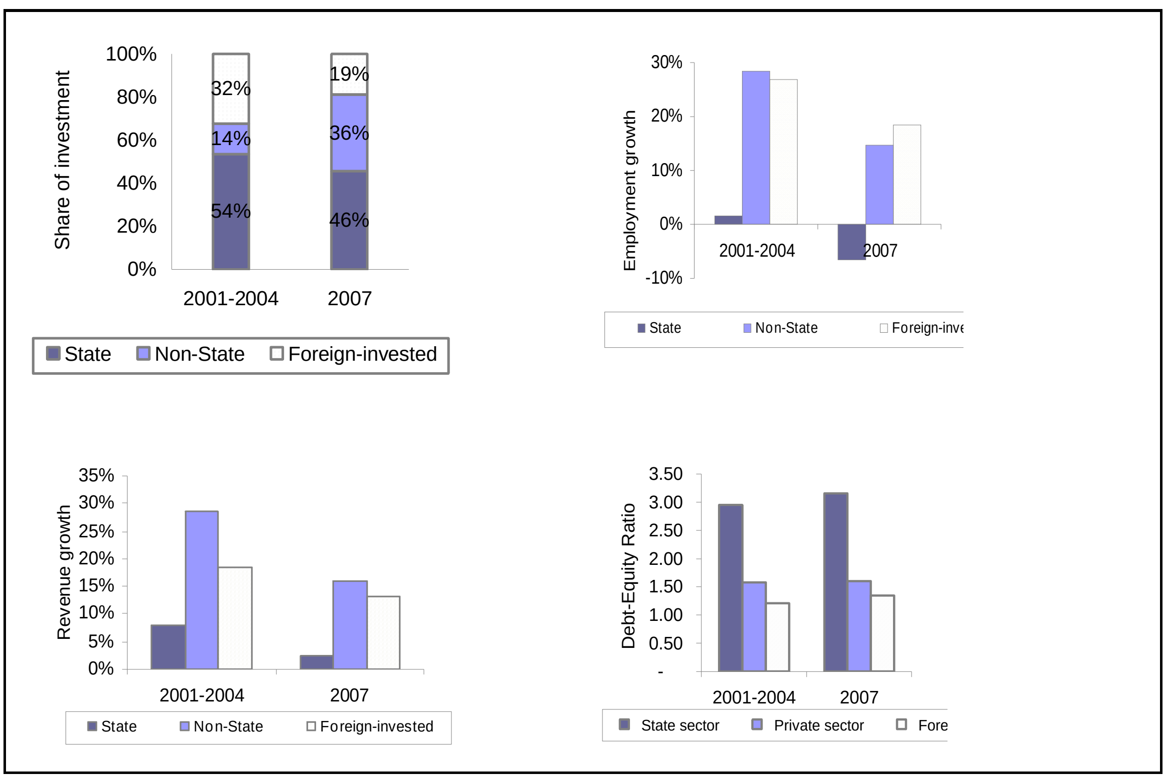
focus on the more recent period since 2000, the capital Vietnam needs to generate one unit of growth is even higher, with an ICOR of over 4.5. This is quite high for a poor country.

Ultimately, the source of Vietnam's recurrent bouts of price instability can be traced to the country's inefficient use of capital. As we have noted in previous policy discussion papers, Vietnam's growth is *investment led* rather than export led. Inefficient use of capital ties up the nation's resources and creates debt without generating commensurate increases in productivity. Heavy spending on projects that do not create value raises the country's import bill and draws labor into activities that do not increase average productivity. Price inflation in Vietnam should not be seen primarily as the inevitable result of rising global commodity prices or a one-off failure to manage capital inflows. Price inflation in Vietnam is a consequence of massive investments that do not contribute to the growth of national output.

B. The Principal Contradiction

The above analysis suggests that, despite Vietnam's achievements to date, there are real causes for concern. Chief among them is that Vietnam does not allocate capital efficiently. The following set of graphs illustrates the nature of the problem. Although the state sector lags the non-state and foreign firms in job creation and productivity growth, it continues to absorb nearly half of investment. According to the most recent enterprise survey data, the sector actually reduced its workforce by 7% in 2007. The state sector also produces few exports aside from minerals. Although state enterprises do not produce many exports, they do add to the trade deficit by importing capital and intermediate goods. And although some of them may *claim* to be profitable, the profits of at least the larger state owned firms would disappear if they were required to pay market prices for capital and land, and if they were forced to sell into competitive rather than controlled markets.

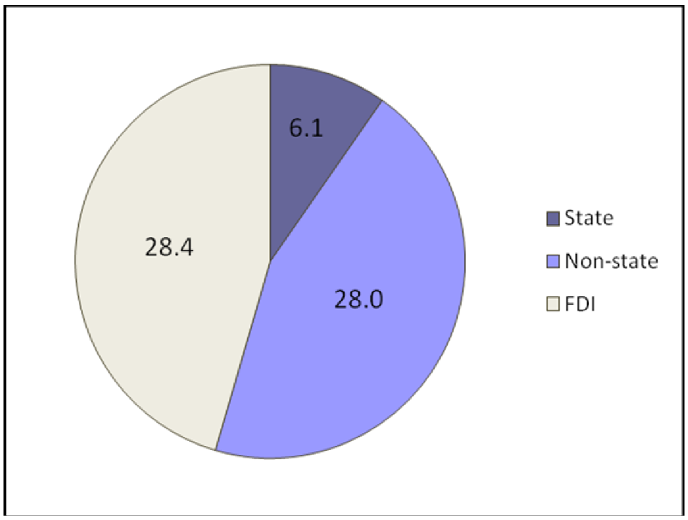
Figure 1. Performance Comparison: State, Private, Foreign



Source: Enterprise Surveys, relevant years

Figure 2 compares industrial growth from the first eight months of 2007 to the same period in 2008. While the state sector contributed less than 10% of real growth, the non-state and FDI sectors each contributed about 45%. Yet when assets are examined, the share of the state sector is close to one-half.[7] Some would argue that the reason that the state-owned enterprises do not contribute much to growth is that they must meet social as well as economic objectives, for example supplying power or fuel at subsidized rates. While these competing objectives certainly account for some of the lower profits of state companies, this is by no means the only reason. Moreover, the policy implication of this argument is that subsidies to state firms must be made explicit and transparent rather than implicit therefore hidden from the public. Transparency and accountability have become even more important as state firms diversify from their core businesses to seek profits in unrelated ventures in the financial and property markets.

Figure 2. Growth of Non-Oil Industrial Output January to August 2008 vs. 2007 (VND trillions)



Source: General Statistics Offices

Before proceeding to the main body of this paper, a caveat is in order regarding data availability. At present there is a paucity of reliable information regarding all aspects of the economy—including prices, wage and employment trends, trade, investment, savings and the health of the financial sector and the country's largest enterprises, both public and private. In addition, the government's capacity to analyze the information that it does have remains limited. The difficulties involved in accessing information and analysis imposes several avoidable costs on the economy. First, when it is not possible to track even basic economic indicators with precision, effective policymaking becomes exceedingly difficult.[8] Second, scarcity of reliable information and analysis sends a negative message to domestic and international investors who inevitably ask: what are they trying to hide? This is especially true with respect to the financial system. Third, when reliable information is hard to obtain, misinformation fills the void. Rumors and outright falsehoods are passed around and believed because official sources lack credibility.

Earlier this month the World Economic Forum ranked Vietnam 49th out of 52 countries in terms of financial system development, behind the rest of the Asian countries included in the study and just ahead of Nigeria. Vietnam ranked 50th out of 52 countries in both the strength of auditing and accounting standards and investor protection. Vietnam ranked 45th out of 52 in credit information.[9] The government must come to understand that markets of all sorts—but particularly financial markets—can only thrive if information relating to

[7] While state enterprises do not currently account for more than about one-third of bank credit, they may borrow abroad or from special facilities, thus increasing their effective share of total credit and assets.

[8] Donors have focused on their own needs, for example measuring poverty and tracking progress in the MDGs, but they have not done much to support the development of Vietnam's statistics gathering infrastructure.

[9] World Economic Forum, *Financial Development Report 2008*. The full report can be accessed on the internet at the following address: http://www.weforum.org/pdf/FinancialDevelopmentReport/2008.pdf.

economic conditions, policies, companies and transactions is readily accessible. Restricting access to data or the scope of financial and business reporting, either by companies or through the mass media, interferes with the normal functioning of the economy and greatly increases the risk of financial crisis. The creation of the National Financial Supervision Commission can help address this problem, but only if it is empowered to collect, verify and publish data, and to conduct objective and rigorous analysis based on this information.

PART II. **The Macroeconomy in 2008**

In recent months, the Vietnamese government has taken steps to stabilize the macroeconomic situation. The government deserves credit for its efforts to reimpose monetary and fiscal discipline. Raising fuel prices at a time of high inflation was not popular, but it was necessary. Imposing a moratorium on new bank licenses demonstrates an awareness of the kinds of discipline that will be required if the government is to restore its command over monetary policy. However, the fundamental contradictions described above have not yet been addressed. The state sector has been asked to tighten its belt, but it has not been forced to reform. Indeed, we are unaware of a single SOE chief losing his position due to poor performance, despite the fact that the state sector's profligate investment activities are acknowledged as an important cause of inflation. The stream of unnecessary and wasteful public investment projects has been temporarily slowed, but there is no evidence of a new strategy. Yet only a strategic shift can solve the current structural weaknesses and put Vietnam in a position to enjoy high rates of economic growth over the long term.

We have argued in earlier discussion papers that strengthening the institutions of macroeconomic policymaking is an essential element of the reform process. At present, coordination among the State Bank, the Ministry of Finance and the Ministry of Planning and Investment is poor. Data are withheld, are of poor quality and coverage or are simply not collected. Fragmentation of the decision-making process, both within agencies and among them, prevents the government from responding quickly and coherently to changing economic conditions. The government lacks the in-house analytical capacity it needs to provide decision makers with objective, rigorous assessments of policy options. Talented, well-trained young professionals are leaving government service, frustrated by personnel policies that favor loyalty and connections over merit. One of the main lessons from the financial turbulence of 2008 is that Vietnam cannot manage a complex, globally integrated economy with policymaking institutions designed for another era. Vietnam should follow the example of its ASEAN partners in conducting a thoroughgoing assessment and restructuring of key economic institutions beginning with the central bank and finance ministry.

A. Too Early to Declare Victory

Macroeconomic conditions have settled down recently after several torrid months. The gap between the official and curb USD-dong rates has narrowed, as has the monthly trade deficit in response to much slower credit growth since April. Although consumer prices are still rising, the pace of price inflation is very likely to slow after the fuel price increases are absorbed. As noted above, the Vietnamese government deserves credit for taking difficult decisions such as raising gasoline prices, issuing a moratorium on new bank licenses, and resisting pressure to lower base interest rates. This is all good news, but celebrations should not begin just yet.

1. Export Performance

The trade deficit for the first eight months of the year was $16 billion, and it is likely that the figure for the year as a whole will approach $20 billion.[10] This is a deficit of historic proportions, which compels Vietnam to rely heavily on risky capital inflows to achieve external balance. (As we note in Appendix I, Wall Street's worsening financial crisis may mean that international investors will be less willing to invest in emerging economies with unstable macroeconomic conditions.)

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[10] The World Bank deficit forecast was for $16.2 billion for all of 2008 in its recent report "Taking Stock," (June 2008; Table 4) but the trade deficit in just the first eight months of 2008 has been estimated at $16 billion by the GSO. If the GDP from January to August was $53 billion (consistent with $80 billion for all of 2008), the trade deficit was 30 % of output. This is a large amount and has seldom been observed in peace time anywhere for large countries.

The good news is that Vietnam's trade deficit is due to a surge in imports rather than poor export performance. Exports were up 39.1% in value terms for the first eight months of 2008 in comparison with the same period in 2007. Although Vietnam has certainly benefited from high mineral and commodity prices, the growth in exports is not solely due to price effects. As shown in Table 2, manufactured exports to the US have increased sharply in both volume and value terms this year.

Table 2. Selected Manufactured Exports to the US (% change per annum)

	2006/05	2007/06	Jan-Aug 2008/07
Export Value			
Garments	18.4%	36.1%	23.4%
Footwear	32.8%	8.4%	11.9%
Furniture	29.5%	36.2%	22.6%
Fish and crustaceans	0.6%	12.3%	0.0%
Export Volume			
Garments	20.0%	40.7%	25.0%
Footwear	33.5%	8.3%	6.1%
Furniture	86.0%	-21.4%	25.9%
Fish and crustaceans	-0.7%	3.3%	18.0%

Source: United States International Trade Commission, Dataweb

The challenge facing Vietnam is to maintain this excellent export performance in an increasingly competitive international environment. Of particular concern is the real exchange rate, which has appreciated as domestic inflation has outpaced international (dollar) inflation. Domestic price inflation also undermines competitiveness by creating pressures for wage increases as workers struggle to maintain their standard of living in the face of the rising cost of food, shelter, clothing, schooling, healthcare and fuel.

2. Foreign Direct Investment

Foreign direct investment (FDI) is generally regarded as less risky than portfolio flows such as foreign loans and equity investment through the stock market. Vietnam has enjoyed a huge surge in FDI commitments this year, leading some observers to declare that the country's large current account deficits are not a major cause of concern. This is naïve for several reasons. First, the composition of FDI is increasingly skewed to the property sector and to large projects (in excess of USD 1 billion). Citibank estimates that property-related FDI now accounts for one-quarter of total disbursements. Property markets are susceptible to cyclical swings, and because of long gestation periods they tend to generate boom and bust cycles. Moreover, properties do not directly produce exports, although one could argue that resorts and hotels could generate foreign exchange to the extent that they bring in foreign visitors that spend more than imported inputs used to service them.

More worrying is the fact that this year's FDI surge is largely due to the advent of a few mega-projects. In the first seven months of 2008, eight projects account for 75% of total registered FDI. Six of these projects are large property investments, including Brunei's new urban area development in Phu Yen, a Malaysian residential and university complex in Ho Chi Minh City, two huge resorts in Ba Ria-Vung Tau and another resort in Kien Giang province. The two non-property projects among the top eight are the Formosa Plastics steel mill project and a petroleum refinery. Vietnam is in effect betting its external balance on the willingness of these large investors to follow through on their commitments. This may be optimistic given the track record of large real estate investors in Vietnam and the rest of the region. Moreover, few details are available to the public on these investment plans. We cannot be certain that disbursements of foreign exchange at this level are needed even if the projects are implemented in the end.

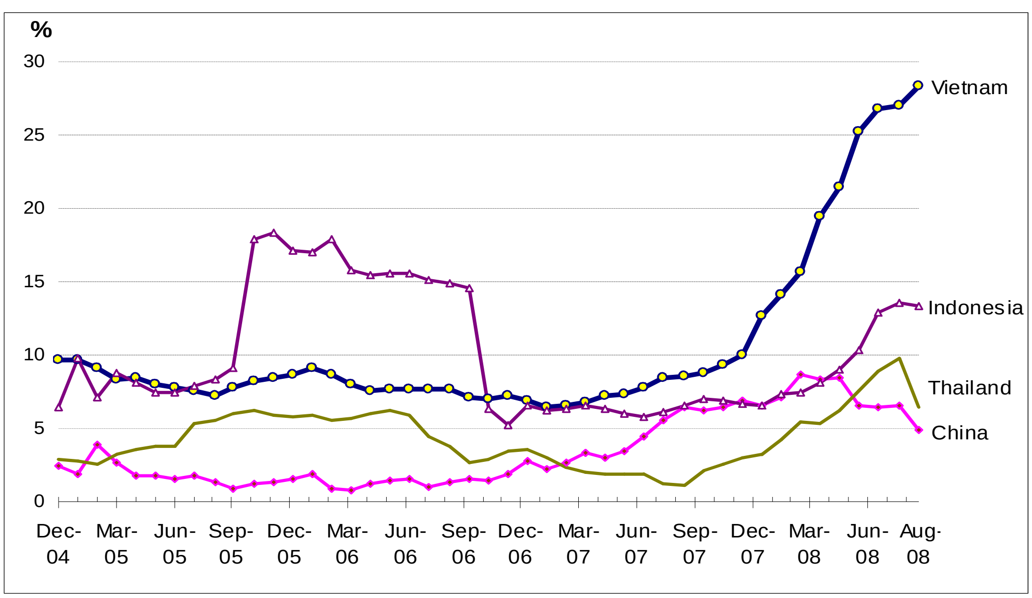
The eye-popping numbers attached to some of these projects raise questions about the accuracy of the cost projections and the motivations of the investors. Is it realistic to expect a foreign investor to invest upwards of four billion dollars in a new urban area located in a poor and remote province? Is a Malaysian tycoon really going to pour a sum of money that is larger than Vietnam's entire annual education budget into one university? (Indeed, the values of recently announced projects in Vietnam are at times considerably higher than similar projects undertaken in other countries—sometimes by the same investors—suggesting that announced numbers in Vietnam may not reflect real costs.) Prudent policy makers should look behind these numbers to determine the actual equity capital committed by the investors. It is said that foreign investors are encouraged to inflate investment numbers in order to impress local authorities as a means to accelerate approval processes and gain access to land in the best locations. To the extent that this is occurring it is a naïve and ultimately self-defeating policy, for it drives up the price of land and deters more serious investors, especially those in the manufacturing sector.

In addition to the speculative and unstable nature of these investments, even if implemented, they are unlikely to create the jobs that are urgently needed to absorb labor market entrants. It is therefore worrying that, during the first eight months of 2008, FDI in food processing and light manufacturing—two sectors that provide both a lot of employment as well as potential for supplier industries—totaled \$2 billion, in comparison with \$2.7 billion in 2007. It remains to be seen what happens during the last four months of the year. However, anecdotal evidence suggests that many foreign investors in labor-intensive, export-oriented industries are putting off investment decisions until macroeconomic conditions stabilize and other conditions, including transport infrastructure and electricity, improve.

3. Inflation

Reported inflation in Vietnam is currently in the 25-30% range. This has been attributed to rising world prices of food and fuel, though food and fuel prices have receded about one-third from their highs. It is more likely that rapid money growth and credit expansion have resulted in 2008 inflation rates two to four times those of its neighbors. The financial engineering of large state enterprises—notably the rush to open finance companies, banks and other finance-related firms—remains a major source of money growth. Figure 3 reports inflation rates in Vietnam and neighboring countries. If inflation were entirely due to external factors, we would expect Vietnam's inflation rates to approximate those in Thailand, Indonesia and China, countries that are also subject to the same external pressures.

Figure 3. Year-on-year Inflation Rates in Selected Asian Countries



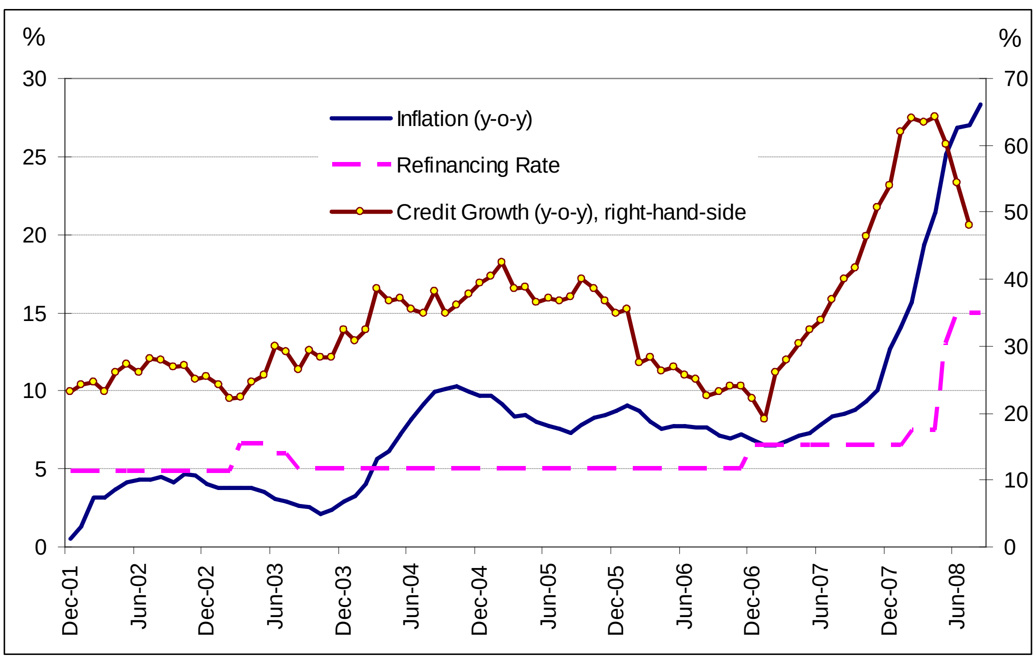
Source: Global Financial Data

Clearly, comparable countries have inflation rates well under those in Vietnam. If this were to continue (a likely 40% increase in prices in two years), escalating wage demands, currency depreciation and perhaps declining competitiveness would be very likely. The danger is that inflationary expectations will influence the behavior of enterprises and households, leading to industrial unrest, a generalized wage-price spiral and lower savings. Long-term investment would become more risky as both producers and consumers lose faith in the national currency as a store of value. Foreign firms, with outside access to finance, would probably increase automation and cut employment. Financial development would also be impossible.

Earlier in 2008, credit growth was more than 60% higher than the same period in 2007. Credit growth in 2008 is targeted at 30%, though the increase over the last three months has been close to zero. To control inflation credit growth cannot average more than 2% per month. Figure 4 shows the inflation rate, credit growth and SBV's refinancing rate. The strong correlation between inflation and credit growth is illustrated. Another pattern is that the refinancing rate, a key policy rate at which commercial banks can borrow from SBV, was kept almost constant throughout 2002-2006, while inflation and credit growth rates varied considerably, indicating the ineffectiveness of interest rate policy as an instrument of monetary policy. Only under the huge inflationary pressure in 2007-08, that SBV had to raise its refinancing rate. Even then, it remained well below the inflation rate.

The government was right to rein in credit growth this summer even at the cost of slower economic growth. As the inflation rate falls pressure will undoubtedly mount on the government to loosen monetary policy in an effort to accelerate growth. The problem is that although the economy has cooled, the structural problems remain. Vietnam's economy caught the flu, but a timely dose of medicine reduced the fever. Unfortunately, the virus is still in the system. Stop the medicine and the temperature will rise again. The virus is the absence of discipline in the financial system, which in turn reflects a breakdown in discipline in the large state-owned enterprises and conglomerates. Until these problems are solved, any attempt to loosen monetary and fiscal policies will simply reignite inflation.

Figure 4. Inflation, Credit Growth, and SBV's Interest Rate Decisions, 2002-2008



Source: IMF, International Financial Statistics

Credit data recently released suggest that the summer austerity package has slowed credit growth to zero in the last three months. If 40-60% a year growth is too high, zero is too low. Credit growth should probably average out about 2% a month to be consistent with price stability (single digit), with the destination of credit as important as the total amount lent. Weak banks make bad loans, especially if they are part of conglomerates – a bitter lesson learned from the Asian Crisis, and that may have to be relearned in the near future.

Part III. **Banking and the Real Estate Market**

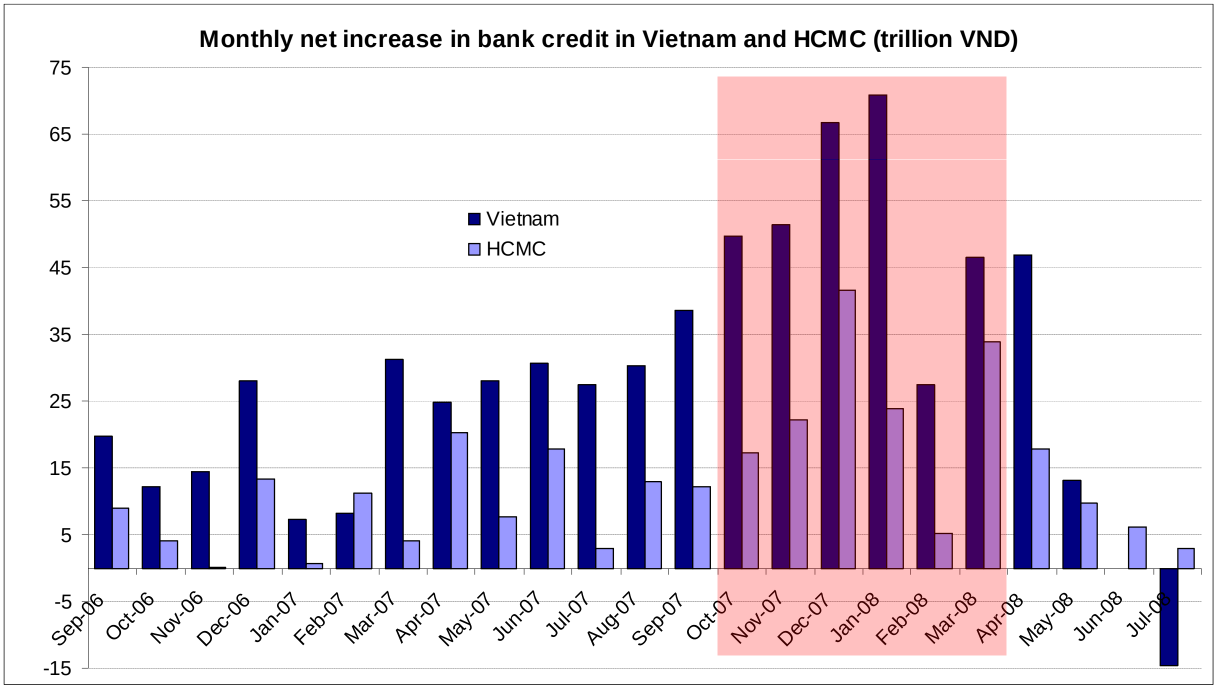
An efficient and stable banking system is the engine of long-term economic growth. Currently, many or even most Vietnamese banks are not managed in accordance with international standards. They take on too much risk, they are not sufficiently transparent and they do not make adequate provision against bad assets. Sound businesses find it difficult to raise working capital loans while some highly speculative ventures are funded. At the same time, large state corporations have opened or taken large stakes in joint stock banks, enabling them to leverage state assets like land and natural resources. Even more worrying is the spate of new finance companies, a sector that is essentially unregulated and therefore open to abuse. Bad loans made by under-regulated finance companies were a major cause of the Thai financial meltdown in 1997. Most of these companies were closed down in the aftermath of the crisis, imposing a massive financial burden on the government and the economy as a whole.

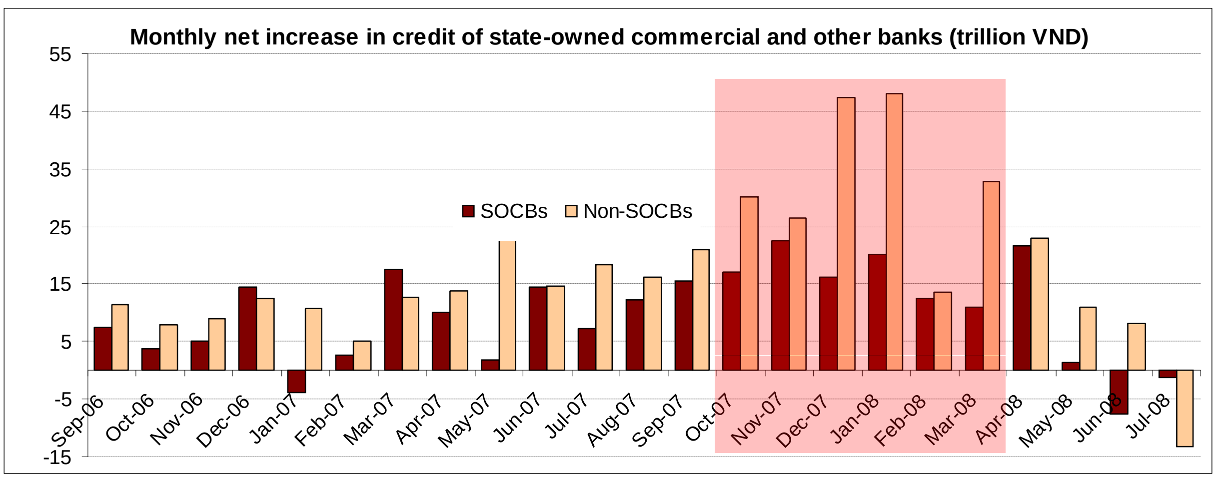
A. Overexposure to the Property Market

After a three-month period (April-June 2008) of raising deposit rates to attract depositors, tightening lending criteria and re-evaluating loan portfolios, losses are beginning to appear on the balance sheets of Vietnam's commercial banks. So far twenty banks, all of which are small joint-stock commercial banks, reported operating losses in July. However, up until now there has been no reliable data regarding the extent of property–related lending and non-performing loans (NPLs) of banks during the credit crunch that began in the first quarter of this year. However, an analysis of bank lending data from Ho Chi Minh City suggests that the banking system remains weak, and some of these banks may not be viable over the medium term.

It is now clear that the banks went on an unprecedented lending spree in 2007 and the first quarter of 2008. Figure 5 shows monthly increases in outstanding loans made by commercial banks in Vietnam in general, and Ho Chi Minh City in particular, which strikingly illustrates of the dimensions of credit growth. The bulk of credit growth occurred in Q4 2007 and Q1 2008 (except for the Lunar New Year period in February). December 2007, the peak of the boom, saw VND 41 trillion (US$ 2.6 billion) injected into the economy by HCMC banks. While some of this credit was related to Tet-related production and a surge in automobile and steel imports, the bulk of this increase was directed to real estate speculation.

Figure 5. Bank credit growth (trillion VND)





Source: IMF and Ho Chi Minh City Statistical Office.

Also clearly shown in Figure 5 is the fact that most of the boom in lending originated from joint-stock commercial banks. According to SBV, exposure to the property sector, including loans to both developers and buyers, has reached disturbingly high proportions at many banks. As of August 2008, two banks out of the total 41 have more than 50% of their loan portfolios in real estate finance. Another nine banks have property-related lending accounting for more than 30%, and another 9 more than 20%. Although we cannot know for sure, it is likely that these figures underestimate the extent of the problem given the inclination of some banks to misclassify property-related loans to conceal overexposure to the property sector.

Movements in real estate prices in Saigon South, the fastest growing and hottest property market in Ho Chi Minh City, show why the banks were so enthusiastic about property financing when they were flooded with liquidity. Their customers—consisting of real estate developers and speculators—were big winners in Vietnam's economic boom. Real estate prices peaked in January 2008, just a month after the peak in new loan disbursements. The implication is that many speculators borrowed money to acquire real estate at the peak of the market.

Table 3. Real Estate Price Movements in Saigon South, Ho Chi Minh City (million VND per m^2)

	Dec-06	Aug-07	Dec-07	Jan-08	Apr-08	Aug-08
Phu My Hung, District 7 (Apartment)	16.7	30.7	39.5	48	38.5	30
Phu My Hung, District 7 (Land)	36.8	64	72	110	82	58
Phu My, District 7	11	21	27	36	27	20
Thai Son, Nha Be District	5.5	12	16	27	21	12

Source: Data collected from interviews with real estate brokers.

The variable-rate nature of almost all of the property-related loans also left borrowers vulnerable to tightening liquidity. Property-related loan contracts typically specify a period of one-year for interest rates to be reset at a level equaling the prevailing deposit rate plus a spread of 3.7-4.3% a year. Of the VND 180,000 billion (US$ 11 billion) of net increases in credit extended by HCMC-based banks in the last 12 months, 70.3% was lent in the months of November 2007-March 2008. Thus, starting from November 2008, a large volume of loans will come due for interest rate adjustments. The repricing of these loans is likely to mean that borrowers must cope with rates of 20-21%, or eight or nine points higher than the original loans. Thus the end of this year could see a large wave of defaults given the drop in prime property prices and the sharp readjustment in servicing costs.

The deteriorating quality of property loans is similar to the experience of the stock market crash in 2007. However, unlike the repo and margin contracts under which banks can quickly sell off shares, disposing of collateralized properties will prove to be extremely difficult. Under existing bankruptcy procedures, a creditor can only start litigation 270 days after the loan is first overdue. And once litigation starts, it normally takes one and a half years for the collateral to be auctioned at a court-designated auction center. The creditor has no control over this process, with the result that lenders prefer out of court settlements to repossessions.

Property prices in new urban areas in HCMC have fallen by 40-50% from their peak. The standard technique employed by Vietnamese banks is to assess collateralized properties at 70% of their market value and then lend 70% of the assessed value. Even given this prudent 70x70 rule, many borrowers are nearing or have already reached negative net worth. Many borrowers are likely to walk away from their “upside down” loans. Yet the banks have no legal rights to liquidate the properties left in their hands. It could therefore take several years to unwind the debt obligations assumed during the 2007-2008 credit boom.

B. Urgent Need for Reform

Bank executives are on record saying that they are willing to “share some of the difficulties faced by the corporate sector.” This suggests that the banks stand ready to restructure and roll-over loans that come due this year. Under existing SBV guidelines, a restructured loan is not considered an NPL and a provision of only five percent of the difference between the loan value and collateral needs to be made. Thus, the banks and their distressed borrowers will “ever-green” loans and at the same time put pressure on the government to loosen monetary policy. *This is an extremely risky situation that should be avoided, because it prolongs the weak state of many financial institutions.*

Monetary loosening (that is, credit growth over 2% a month – the growth rate so far in 2008) would fuel inflation and destabilize the VND but it would not resolve the credit crunch. In this environment, the government must insist that banks clean up bad loans instead of hiding them. An executive decree from the government is needed to amend the bankruptcy procedures to make them more creditor-friendly, and SBV should re-examine its guidelines for the accounting and reporting treatment of restructured loans. Some observers argue against this policy saying that making it easier for banks to foreclose would deprive the struggling corporate sector of assets and would benefit only cash-rich speculators. However, the cost of prolonging the NPL problems would be much greater. The government should therefore take over distressed banks in the form of a receivership or conservatorship, delegating day to day management of the bank to an SOCB. This would give SBV time to value the distressed banks' loan portfolios accurately, and to sell or write off non-performing loans. The guiding principle should be to protect depositors and good borrowers and *not* protect speculators, bank owners and managers. As part of the takeover process, the previous managers would be replaced and the banks' owners would lose their equity.

PART IV. **Looking Forward: Structural Challenges to Long-Term Growth**

What does Vietnam need to do in order to position itself for long-term growth? The analysis in Part One identified the principal contradiction in the structure of the Vietnamese economy. This section considers the contradiction in more detail, in the context of industrial policy and public investment.

A. The State Sector

The fundamental contradiction that underlies Vietnam's economic turbulence, and will surely impede the country's long term growth prospects if not addressed, is the dualist structure of the economy. The state sector's contribution to the economy, measured in terms of value added, job creation, and exports, is widely out of proportion to the benefits the sector receives, in terms of access to credit, land, and favorable policies, such as access to lucrative government contracts.

This year's economic difficulties have sparked renewed discussion in Vietnam of the role of the state sector in general, and the conglomerates and general corporations in particular. However, the measures that have been adopted to date are best characterized as stop-gap, austerity measures intended to restore stability in the short-term. The responses of the conglomerates to the government's call for belt-tightening are revealing. Many promptly announced decisions to scale back investment significantly in 2008. Vinashin led the way, announcing cutbacks equivalent to 60% of total investment it had planned in 2008. We share the concerns expressed by Vietnamese economists about the rapidity with which these enterprises were able to make such deep cuts. First, one cannot help but wonder if the projects that have been selected for elimination or rescheduling were actually going to be implemented in the first place or if they had been planned and announced simply for political reasons. (This cannot be known unless more information is made available.) Secondly, these decisions raise serious concerns about the quality of management. Profit-driven corporations make investment decisions only after careful study; it is unlikely that Vinashin (which is reported to be having trouble raising capital without government backing) would be so cavalier in abandoning its projects if the management were convinced of their profitability. Even more alarming is the rapidity with which Vinashin has reversed course. By July Vinashin had announced a new venture with a Malaysian group for a $3 billion steel mill in Ninh Thuan province. By August the price tag attached to this project had reached $10 billion. Old habits die hard.

A particularly worrying trend is the movement of large industrial conglomerates into financial activities. Vietnam's large state-owned groups like Petro Vietnam, EVN, Vinashin, FPT, Vinatex and Vinacomin have opened banks, finance companies, securities firms, leasing companies and insurers. These ventures enable state business groups to leverage state assets and their privileged position in domestic markets. Allowing this trend to continue poses several immediate risks for the government. First, SBV will not be able to regain control over the money supply if industrial firms are allowed to set up new vehicles to create credit for themselves. Second, intra-group lending is a notoriously risky practice that diverts credit away from sound businesses and towards less deserving projects. Bank insolvency at least partly related to intra-group lending has triggered financial crises in a number of developing countries in Asia and Latin America. Third, these financing vehicles create instruments that managers use to shift value from public companies to private entities, including joint stock companies that are child firms of SOEs.

The argument is often made that Vietnam's state conglomerates are simply following the path of the Japanese *keiretsu* or Korea's *chaebol*. These comparisons are invalid for a number of reasons. The *chaebol*, for example, were not allowed to open banks, which for most of the relevant period were kept under strict state control. While the *keiretsu* were formed around a main bank, they were not conglomerates in the Vietnamese sense but rather decentralized alliances of companies related by cross-shareholdings. In any case, the *keiretsu* model was discredited in the 1990s, when Japan suffered a profound and extended financial crisis largely caused by mountains of bad debt and weak bank management. The negative impact of the 1990's crisis is still felt today. The impact was long-lasting because banks only gradually wrote off and liquidated bad loans and assets.

The government remains committed to retaining a leading role for the state sector regardless of the objective performance of these companies. Ultimately, this is a political decision that must reflect national priorities and strategies. Indeed, there is no theoretical reason why state owned enterprises cannot be just as competitive as private firms. We certainly should not fall into the trap of some economists who assume that all private firms are efficient and all state firms are not.[11] Singapore and, increasingly, China, have demonstrated that state-owned companies can be globally competitive. A few Vietnamese SOE's are well run, given the constraints they face with "social" obligations and other interference. If they were allowed to compete with fewer of these obligations (unless paid for by the state) or regulated intelligently, they could play a productive role in Vietnam's future growth.

The fundamental contradiction in Vietnamese policy is *not* between globalization and state ownership but rather *the government's attempt to achieve international competitiveness while shielding the commanding heights of the economy from global competition*. Singapore and China have created competitive companies by imposing market discipline on their state and private enterprises and in particular using international competition as the most reliable yardstick against which the performance of these companies is measured. State firms cannot grow and compete without experienced, properly trained managers whose remuneration and tenure is linked to company performance.[12] They will not compete on global markets if they are applauded for recording paper profits generated by speculative property deals built on state land and financed by cheap capital. Market discipline cannot be established if companies are not compelled to subject themselves to independent audits and reviews, the results of which are available to Vietnamese citizens as the real owners of these national assets.

The core contradiction between the drive for competitiveness and the reluctance to compete comes out clearly in Table 4, which reports Vietnam's recent rankings in a prominent indices: the World Bank's "Doing Business" report. Vietnam is ranked near the bottom of the East Asia region, and the country's rankings showed the largest negative change in the region. Vietnam scores exceptionally poorly in terms of protecting investors (170th out of 181 countries in the "Doing Business" report and 121 out of 131 in the Global Competitiveness Index). In an environment characterized by opaque business practices and lack of accountability, serious investors have no way to monitor the performance of managers and companies and allocate their investments accordingly. Such an environment is most attractive to investors looking to make quick returns on the basis of some kind of special treatment.

While one may make legitimate criticisms of the ways in which these indices are calculated, it is surely no accident that Vietnam scores persistently poorly. These rankings are watched closely by international investors as an indicator of general trends, and as such must be taken seriously. These rankings suggest that greater efforts are needed to improve the environment for foreign investment. Simply restoring macroeconomic stability will not be enough to retain Vietnam's attractiveness as an investment destination.

Table 4. Competitiveness Rankings of Vietnam and Comparator Countries

[11] A famous example is the World Bank's decision to discourage the Korean government from investing in steel manufacturing. Yet by the 1980s, state-owned POSCO was one of the most efficient producers in the world.
[12] The differences between Singapore and Vietnam with regards to the performance of SOE managers are exceptionally large. It is reported that several major state owned enterprises in Vietnam's shipbuilding sector have been unable to pay their workers since the spring. In any other country, the senior management of such a firm would be terminated for such an unacceptable performance. SOE managers in Vietnam appear not to be held accountable for the performance of their enterprises.

	Doing Business		WEF Competitiveness	
	2009	Change	2008	Change
Vietnam	**92**	**-5**	**68**	**-4**
Korea	23	-1	11	12
Malaysia	20	+5	21	-2
Thailand	13	+6	28	0
Taiwan	61	-3	14	-1
China	83	+7	34	0
Indonesia	129	-2	54	0
Philippines	140	-4	71	4

Source: World Bank and WEF

B. Public investment

As argued above, Vietnam's growth over the past several years has been characterized by an over-reliance on investment. Indeed, one key cause of inflation has been wasteful public investment, by state owned companies and directly by the government in the form of infrastructure projects. The government has announced that it will make modest cuts in public investment. While this sentiment is admirable, it is inadequate. First, the government has not released the list of projects it plans to delay or cut. Second, recent government actions suggest that it has yet to abandon its current strategy of scattering investment projects across the country with little regard to their efficiency.

The decisions Vietnam makes now regarding public investment will reverberate far into the future. At present these decisions are not being made for economic reasons. Two illustrative cases are the development of seaports and oil refining. Economic logic dictates that a country of Vietnam's size needs at most two major international seaports.[13] Yet the government has plans to develop no fewer than one hundred ports along the coast. These ports are often proposed and developed by state owned enterprises and provincial governments. Figure 6 shows large-scale investments currently being undertaken.

[13] A major seaport is one where "mother ships" of over 100,000 tons come to discharge and pick up containers. Only the Hanoi-Haiphong and HCMC area zones have enough activity to support such ships. Good rail connections from central Vietnam to either Haiphong or Ba Ria-Vung Tau would connect them better than would enlarging their seaports.

Figure 6. Location of Deep Sea Ports Under Development

Source: Authors' compilation from government's development plans

The government's rush to develop two more oil refineries (in Thanh Hoa and Khanh Hoa), is similarly misguided. With the large rise in oil product prices worldwide, there will be a substantial though gradual adjustment to slower demand growth. This will put pressure on refining margins. The government is pouring billions into these refineries at exactly the wrong time. Major international producers have already shelved plans to build new refineries, and some are actively reducing capacity. If foreign commercial partners were really majority investors in these Vietnamese projects then it is likely that the plans would have been delayed or cancelled by now.

The long term costs of these projects cannot be overestimated. First, they represent a missed opportunity. Vietnam is not investing sufficiently in infrastructure where it is needed most, such as in rapidly urbanizing areas including the greater Hanoi and Ho Chi Minh City regions. Second, as the government is over investing in infrastructure it doesn't need, it is under-investing in critical areas like education and healthcare that will have a great impact on the country's long-term competitiveness.

CONCLUSION. **Policy Recommendations**

The main theme of this policy paper is that Vietnam must address the structural contradictions in the economy in order to position itself for long-term growth. We believe that the temporary and tactical actions the government has taken to date, while helpful in the short-term, have yet to address these structural problems. The following recommendations are intended to address these structural problems:

A. Industrial Policy

- Immediately appoint reputable, independent accounting firms to conduct forensic audits of conglomerates and general corporations and publish the results. All state owned companies required to publish annual reports on line including audited accounts.

- Restructure the boards of directors of these firms to ensure that boards provide independent and objective oversight of firm performance. Managers should be held accountable for the performance of their enterprises. Restructure the management of poorly performing state owned corporations, using external expertise as necessary.

- Accelerate the implementation of WTO requirements in order to increase competitive pressure on the state sector and remove lucrative monopoly and oligopoly privileges that discourage efficiency and innovation.

- Accelerate the equitization of large state enterprises, following the lead of China and Singapore.

- Create an effective policy to supply power all the time. Create incentives for thermal power investment. Price electricity, at least for industry and high-consumption households, at levels that cover all costs to remove hidden subsidies and disincentives to electricity generation.

B. Monetary Policy

- Monetary policy must remain tight in the short term (money growth of no more than 2% per month) to prevent a repeat of the dong runs that disrupted normal business activity several months ago and have contributed to high inflation and trade deficits.

- The State Bank of Vietnam (SBV) should announce a policy of targeting the real (rather than the nominal) exchange rate and pursue this policy consistently to ensure that Vietnam's exporters are not priced out of competitive international markets and that imports do not swamp domestic markets.

- SBV should also impose tighter supervision of banks and take immediate and decisive action to strengthen the banking sector, including taking over insolvent banks in the form of receivership or conservatorship, delegating day to day management of the bank to an SOCB. SBV would then sell or write off non-performing loans while protecting depositors and good borrowers. The borrowers speculating in real estate would lose their collateral; the incumbent bank managers would lose their jobs; and the banks' owners would lose their equity.

- The Ministry of Finance should impose a moratorium on new non-bank lending institutions and conduct a careful audit of existing firms to determine whether they create value for the economy commensurate with the increased systemic risk associated with their activities. If it is determined that these lenders have no comparative advantage relative to banks other than the absence of prudential regulation, then they should be closed down now before they accumulate too many non-performing assets.

C. Fiscal Policy

- Issue regulations requiring detailed and publicly available cost benefit analysis as a requirement for all public investment projects prior to approval. Publish a list of the largest 100 public investment projects together with corresponding cost benefit analysis evaluation studies. Projects for which no assessment is available should be postponed.

- Eliminate directed and subsidized credit to ensure that scarce capital is directed to high payoff projects in both the state and private sectors.

- Land must be valued at its market price in all government and corporate transactions, including transactions between state owned enterprises and between government agencies to reduce profiteering and land-based speculation.

- Increase genuine private sector participation in infrastructure development projects but carefully evaluate the technical and financial capacity of private firms involved in infrastructure development. Bring an end to projects which are disguised as BOT but are in fact developed by well-connected firms with minimal or even no equity contribution, complete government guarantee in debt financing and substantial subsidies in the form of land swaps. This type of project structure only encourages overborrowing, creates cartels, and gives project sponsors the ability to enjoy all the upside potential while bearing no downside risk.

D. Governance

- Empower the National Financial Supervisory Commission to collect, process and analyze information on the financial system, and provide the commission the resources that it needs to fulfill its responsibilities.

- Restructure the Ministry of Finance and the State Bank of Vietnam to enable these institutions to perform their assigned functions.

- Commit to a more open system of reporting financial and economic data.

Appendix I. **The World Financial Crisis and Implications for Vietnam**

The global credit crunch has now lasted for one year and is still far from over. This week the crisis claimed two more victims: Lehman Brothers went bankrupt and Merrill Lynch, the world's largest retail brokerage, was bought by Bank of America. The U.S. government, which recently took over the mortgage intermediaries Fannie Mae and Freddie Mac, provided an $85 billion rescue package to the insurance giant AIG. Other large financial institutions are struggling to raise capital, which suggests that the situation will probably get worse before it gets better. The IMF predicts that nearly $ 1 trillion in bad investments will be written off by the time this episode comes to a close. Falling share prices across the globe have wiped out another $11 trillion in assets.

The key to recovery is the US housing market. The cycle of bad debt, tight credit, slower economic growth and more bad debts will continue until US house prices find their bottom and begin to recover. With foreclosures up 27% year on year, we have yet to reach that point. Demand in the US housing market continues to slow as the lack of availability and high cost of credit discourages potential home buyers. In June, house prices in the major U.S. markets fell by a record 15.9% from last year's levels. House prices are also tumbling in Europe.

Eventually American and European house prices will fall to a point at which home owners can afford their monthly mortgage payments without squeezing expenditures on other things like consumer goods and holidays. More buyers will come into to the market and begin to acquire the massive stock of empty homes that is now dragging prices down. But this process will not happen quickly. Most analysts expect that it will be two or three years before the US housing market enjoys a sustained recovery.

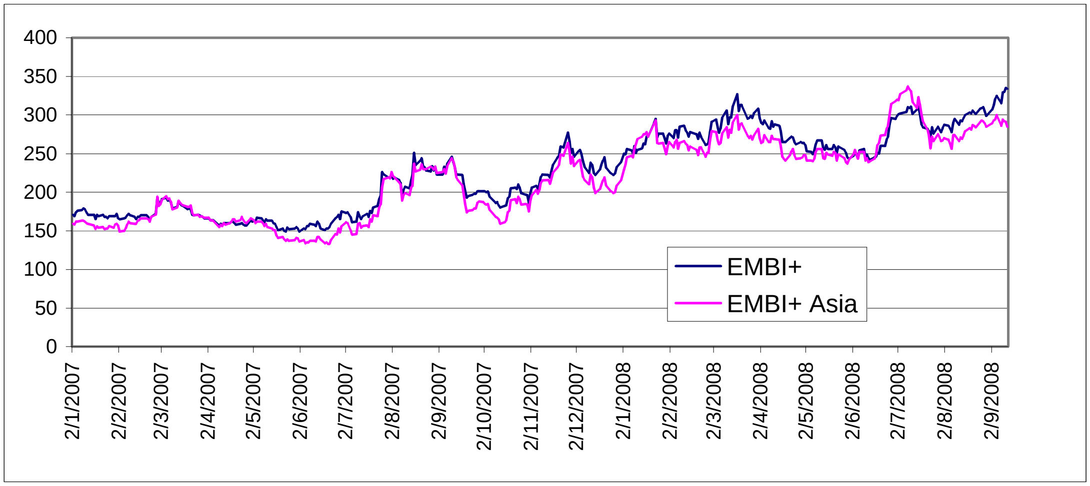
Vietnam will not be directly affected by these events. As far as we know, Vietnamese institutions have not lent money to Lehman Brothers or other distressed firms. Nor have they acquired mortgage backed securities or related instruments. Indeed, Asia as a whole is not in the front lines of the crisis. Mizhuo Financial suffered the largest write-offs in the region, but these were a fraction of the bad investments made by companies like Citigroup, Bear Stearns, UBS and Merrill Lynch. Temasek, Singapore's state investment group, has even used the crisis to make money, acquiring financial assets in the US at bargain prices. Some analysts estimate that Temasek made as much as $1.5 billion when Merrill Lynch was acquired by Bank of America.

The biggest concern in Asia is not the direct effect of the credit crunch but rather the impact on US and European consumers and ultimately Asian exporters. Asian manufacturers will also be hurt by the weakness of the US dollar, which is unlikely to rebound as long as the Federal Reserve is more worried about credit markets than price inflation. Demand weakness in Europe, the US and Japan could discourage new foreign direct investment projects in export-related industries in Vietnam and other countries in the region.

High inflation rates within Asia make it difficult for most of the region's economies to substitute domestic for foreign demand. Any attempt to stimulate the home economy is likely to spark another round of inflation. The Asian Development Bank recently revised its forecast of consumer price inflation in the region to 7.8%, up from 5.1% earlier in the year. While falling global prices for oil and food will help mitigate inflationary pressures, it is certainly not the case that inflation has been quelled in Vietnam or in the rest of the region. The main cause of inflation in Asia is loose monetary and fiscal policy leading to overheating. Any attempt to boost growth through domestic reflation would put pressure on the trade balance, exchange rates and consumer prices.

Another concern for Vietnam and other developing countries is that the global credit crunch has increased the cost of capital. As shown in the figure, emerging market and Asian bond spreads have increased steadily since the beginning of 2007. Borrowing from international capital markets, whether from banks or in the form of bonds, is likely to remain expensive for the rest of the year and most likely next year as well. This is not the time to finance large projects by issuing dollar-denominated bonds.

Figure 7: JP Morgan's EMBI+ Spreads 2007-2008



Source: JP Morgan

Indeed, it is not just that most developing countries will pay more for loans but that *risky borrowers* with big trade deficits and high inflation will be treated *much* more harshly than those with more conservative policies. While ODA and supplier loans will offset some of this credit tightening, these loans are subject to currency fluctuations that could make them much more expensive than they appear to be. For normal borrowing, risky clients will have to pay over 20% a year. This is a sign of crisis and should shock the borrower into more prudent behavior.

In sum, the main impact of the global credit crunch in Vietnam will emerge on the demand side, both from lower export demand and higher borrowing costs limiting investment. Commodity prices will give back some of their gains and demand for manufactured exports will weaken. A weak US dollar will make it even more difficult to export. Vietnam is not well placed to substitute domestic demand for export markets, since the country produces a lot of commodities for which demand at home is already saturated (rice, coffee, fish and shellfish) and does not produce many things that it needs to buy on external markets (intermediate and capital goods). Therefore, loosening fiscal and monetary policy would likely widen the country's large trade deficit and put additional pressure on exchange rates. This could reignite inflation and cause even more social tension. A more appropriate policy is to maintain fiscal and monetary discipline while taking steps to help Vietnam's exporters become more efficient and therefore more competitive producers.