Chapter 4

PUBLIC POLICY AND IMPACT OF THE BANKING REFORM ON ECONOMIC GROWTH AND DEVELOPMENT

This chapter examines the impact and significance of the Banking Reforms on State owned sectors, private sectors and overall development and growth.

The impact of banking reform is to promote State owned enterprises (SOEs) through mergers and liquidations and reduce the number of SOEs from more than 12,000 to about 6000. Most of SOEs that were liquidated and merged were administered by the local authorities in the past. SOEs received more than half of all credit through the formal banking system – while generating less than 10 percent of employment.

The SOEs sector in Vietnam could surprise even the most experienced observer of public enterprises. The contribution of SOEs to GDP was substantially lower than in other socialist economies. The reforms have brought qualitative changes. As a result, this Vietnam has experienced faster growth. Although while the number of SOEs and their share in employment and total domestic credit have declined sharply, it has contributed to the growth of GDP. It has registered a steady increase in its net remittances of taxes and transfers to the state budget, which amounted to about 12 percent of GDP or about 50 percent of total budgetary revenues in 1999-2000.

The performance of SOEs has been improving since 1991-1992, when a number of important measures to increase the autonomy of SOEs and a clear profit motive for the sector had been introduced. However, additional factors have contributed to the improvement of SOE performance, including overall economic growth following liberalization of agriculture, high levels of protection in numerous sectors where SOEs are active, and remaining privileges over private enterprises. These privileges – in particular preferential access to land and foreign trade quotas and licenses – have played a very

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1 Initial measures to harden the budget constraint and increase the autonomy of SOEs had been introduced in 1987
important role in the concentration of foreign direct investment in joint ventures with SOEs, which has in turn contributed significantly to SOEs performance by making capital, managerial skills and market contacts.

In spite of the critical performance of SOEs and the positive impact of a number of recent reforms introduced to date of which, financial and banking reform played a very important role, there is a wide dissatisfaction with SOE sector in the Vietnamese official as well as business circles. This dissatisfaction stems in part from the recognition that factors other than high level managerial capacity – including overall macroeconomic and external developments, and remaining privileges over the private sector – are contributing to the successful performance of the SOE sector, and that this performance is thus vulnerable. In part, this dissatisfaction stems also from the recognition that the size and composition of the SOE sector are the result of the historical evolution from a centrally planned system toward a market economy, and do not reflect the strategic vision of what SOEs could and should contribute to Vietnam’s overall economic development.

Further reform of SOE sector is thus necessary, even though it is not motivated by macroeconomic concerns over the short term stability of the sector. First without further reform the satisfactory performance of the SOE sector would not be sustainable as the economy becomes more open and integrated in international markets. Thus, the expansion of industrial SOEs branch network that remain protected by high import tariffs and quotas presents the danger that their future financial performance – if not their present one – will be critically dependent on trade policy and may thus become an impediment to trade reform. Second, the reliance of SOEs on retaining privileges over private business will become an impediment to the establishment of a level playing field and in general to the reform of the incentive framework that is necessary to sustain and accelerate private sector development. Third, the concentration of SOEs in productive, non-strategic sectors will encourage non-competitive behaviours and thus become an obstacle to the expansion of private businesses, discouraging entry in those sectors where SOEs are dominant. Finally, without a substantial reduction in the number of SOEs and transfer of those that are non strategic to the private sector, a substantial share of scarce public resources will continue to be tied up to achieve objectives that could be reached by using private resources and to stretch scarce administrative resources for SOE supervision.

Reform of the SOE sector had been focused on three broad issues:
a) Restructuring the policy environment, to ensure that there is a level playing field with the private sector;

b) Identifying and transferring to the private sector those SOEs that do not perform a strategic role while listing scarce state resources;

c) Improving the supervision of strategic enterprises remaining under state property.

A reform of entry regulations emphasizing decontrol and deregulation would in fact encourage more active competition between enterprises – both private and state owned – and thus promote efficiency. Similarly, the establishment of a regime conducive to the development of an efficient and transparent market in land use rights would eliminate an important advantage of SOEs and force them to use land allocations efficiently. Finally, the most important is the elimination of unnecessary administrative requirements and restrictions on foreign trade and the rationalization of the tariff system to reduce protection and increase neutrality would impose international standards for efficiency and quality on SOEs and private business alike.

*Divestiture of non strategic state enterprises* will be critical to encourage entry by private businesses in productive sectors that are currently dominated by SOEs - which include not only *capital intensive*, heavy industries but also textiles, electric and electronic products, paper, building materials – and to free resources that should be used to achieve strategic public objectives. Three criteria for state enterprises classification are as follows:

- First, SOEs producing public goods and services should remain in the public sector, as these goods and services would not be efficiently provided by the private sector. Private provision of public goods through contractual arrangements with the public sector (e.g. BOT) should however be considered and introduced whenever efficient.

- Second, SOEs producing goods and services that are efficiently provided by the private sector, either domestically or imported, in competitive markets should be transferred to the private sector and the revenues obtained in the process should be directed toward public objectives.

- Third, SOEs producing goods and services that are efficiently provided by the private sector but in non competitive markets should remain in the state sector at least partially, until regulations and institutions can be developed to
ensure that they would behave efficiently as they were in private hands. This can be done through "equitization process"

A strategy to implement the divestiture of non-strategic SOEs should be devised on the basis of their actual number, size, sectoral composition and financial performance, which are not known in detail, especially outside the industrial sector. However, the information available indicates that the vast majority of SOEs operating in productive sectors are relatively small and could easily be privatized through auctions or competitive bidding. Divestiture of medium and large SOEs could on the other hand be implemented in a phased manner, for instance by offering for sale block of shares, and by accelerating the implementation of the on-going pilot equitization program. Even a phased approach to divestiture of non-strategic SOEs should however be part of a consistent and comprehensive program to fully privatize non-strategic SOEs operating in competitive markets. Two additional concerns will need to shape the divestiture strategy: First, adequate consideration should be given to employees and management, second, the implementation of SOE divestiture needs to be carefully coordinated with tax and administration reform, in order to ensure that the former does not impact negatively the budget. In fact, as discussed above, SOEs currently provide about one-half of total budgetary revenues, while the contribution of the private sector remains significantly smaller in absolute term and in comparison to its value added.

The reduction of the size and scope of the SOE sector resulting from divestiture of non-strategic enterprises will allow the government to improve the supervision of strategic enterprises remaining under state control. While an effective supervision system is not sufficient to improve SOE performance, it is nevertheless critical that the government as owner ensure that the SOE sector achieves its public goals in a financially sustainable manner. The effectiveness of the existing system is in fact limited in particular by the choice of tax remittances to the budget as the only performance indicator used to evaluate individual SOEs and by inadequate incentive system, which rewards managers exclusively on the basis of enterprise profits and irrespective of whether profitability is due to external events or to managerial capacity.

It is often proposed that the government should introduce an effective supervision system to evaluate systematically the achievements of SOEs against their objectives and on the basis of fair criteria, to motivate managers to improve their performance, and to provide policy makers with timely and relevant information on the SOE sector. The large body of international
experience that is available to design such a supervision system suggests that—while the supervision system should cover all SOEs—it should be tailored to their operations; thus the supervision system should impose specific and detailed performance criteria on important, complex SOEs but smaller ones should have simple and easy to monitor arrangements. In addition, international experience indicates that institutional arrangements—and in particular the separation of the supervisory function of the government as owner of SOEs from its regulatory function—are also critical to the functioning of SOE supervision system. The divestiture or liquidation of non-strategic SOEs should allow the government to concentrate the limited—and currently overstretched—administrative resources on the needed improvements in SOE supervision.

Initial state owned sector reforms were introduced in the mid-1980s, when the demise of COMECON led to a sharp reduction in trade and financial flows to Vietnam and to a substantial deterioration of SOE performance. The subsequent adoption of the policy of “Doi moi” (Renewal) resulted not only in the re-introduction of private ownership, but also a number of measures to increase autonomy and efficiency of state enterprises. Most importantly, these introduced a profit-based accounting system, allowed enterprise managers greater flexibility in making decisions on production and financial plans, and reduced budgetary support. By 1990, the impact of these changes—combined with the adverse external environment—had resulted in serious economic difficulties for many SOEs. Consequently, policy makers came under increasing pressure to help those regions and sectors that were badly affected by unemployment and to halt declines in output of “strategic” enterprises.

A range of policy measures, including the provision of substantially increased levels of subsidized credit, were adopted to address these concerns, contributing to the resurgence of inflation in 1990-1991. The un-sustainability of these measures was quickly recognized, credit policies were tightened, and SOEs were required to borrow at market rates of interest. In addition, guidelines were issued to limit subsidies to strategic enterprises and to liquidate non-viable, non-strategic enterprises while protecting the interest of the workers.

These early reforms increased autonomy and imposed a hard budget constraints on SOEs, and therefore new measures were introduced to rationalize the sector. The limited objectives of these measures were to restrict the creation of new SOEs, to take stock of the structure and performance of the sector, and to consolidate the SOE sector through merger and liquidation. In order to continue operating legally, all state enterprises
were required to re-register by submitting a detailed application to the State Planning Committee (now, it is Ministry of planning and investment) through their supervisory institution (Ministry or People's Committee).

The process of re-registration was completed as of end 1995. The government listed approximate 7000 SOEs that were in operation, a reduction of approximately 5000 compared with 1990. Of these, approximately 2000 SOEs had been liquidated, while the other 3000 had been merged with other enterprises. Most of the liquidated enterprises were very small scale; their assets accounted for only 4 percent of total state enterprises assets and were generally sold to the highest bidder from either the private or the state sector. Most of the fund raised from liquidation of enterprises was used to pay the outstanding debts of the enterprise - majority were the bank loans. The number of SOEs would be gradually smaller from the liquidation and acquisition process.

In the current resource constrained environment, reform of the inefficient State owned enterprises has become more urgent. While budgetary subsidies are now very small, SOEs are still protected and receive preferential treatment from the banking system. A major problem is that they absorb a high share of available resources and generate too little in employment and productivity growth - again, it is emphasized that SOEs receive more than half of all credit through the formal banking system - while generating less than 10 percent of employment. Many SOEs have monopoly rights and they strangle the growth of the private sector. Recognizing the urgent need for change, the Authorities have recently announced accelerated programs of equitization - 1000 out of 6000 enterprises to be equitized by 2000 - and a reduction in direct subsidized credit. The government recognizes however that a great deal need to be done and a high level SOEs reform committee headed by one Deputy Prime Minister has just been established to take the agenda forward.

The 8th Congress of the Vietnam Communist Party has confirmed that

"Active and stable equitization of State owned enterprises is aimed at raising more capital, creating more motives for efficient operations of State owned enterprises and increasing State properties, but it is not as privatization. Besides 100% State owned enterprises, there will be many enterprises in

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2 Tran Ngoc Trang, Re-registration of State Enterprises, paper presented at the workshop on reform of State Enterprises in Hanoi (March 8-9, 1994)
which the State holds a majority of shares or controlling shares. Calling for additional shareholders or sale of shares to employees in enterprises and to organizations and individuals outside enterprises may be carried out on a case by case basis, and the raised capital must be used for investment in expansion of production and business.”

Box. 4.1. State Owned Enterprise Reform in 1999

The Government Took the following measures in 1999

- Completed classification of SOEs using financial and economic criteria and 1997 enterprise – by enterprise database of Ministry of Finance into worst-performing and poorly performing SOEs
- Registered 434 SOEs for equitation and completed 146 privatizations (where more than 65 percent shares were sold), 37 equitation (where 51 to 65 percent shares were sold) and 41 minor sales. Another 210 SOEs are at various stages of the equitation process (November).
- Issued regulations on liquidation, merger, transfer and lease of small SOEs and which permits liquidation through auctions without requiring conversion of SOEs into Joint stock companies (September).
- Issued the decision to establish Restructuring Fund for severance payments and other activities from equitization process.
- Selected 100 large troubled SOEs for independent analysis audit (September).
- Selected three General Corporations (i.e. Seaprodex, Vinatex and Vinacafe) for developing specific restructuring-action-plans (September).
- Issued resolution asking for amendment of Decree 44 to remove existing caps on the number of shares that can be bought by individuals and/or legal entities in equitised enterprises.

3 Share holding 100% is sole share holder – State and share holding is granted from state Budget. Majority is more than 33% of shares from the State, Minority is less than 25% of shares from the State and None are only individual and private share holders.
Equitization has picked up momentum relative to earlier years, even if it failed to reach the government's target. The cumulative total of equitized firms reached 224 by the end of August 1999. This total includes four firms that have foreign investors among their shareholders. Only a few were considered relatively large (i.e., valued about US$ 1 million).

### Table 4.1. SOEs Equitisation as of 31 August, 1999

<table>
<thead>
<tr>
<th>Registered and granted licenses</th>
<th>Over 65% share sold to non state sector</th>
<th>51-65% shares sold to non state sector</th>
<th>Total Enterprises with major private shares</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>81</td>
<td>28</td>
<td>109</td>
</tr>
<tr>
<td>Not registered/ granted licenses or no data</td>
<td>65</td>
<td>9</td>
<td>74</td>
</tr>
<tr>
<td>Total</td>
<td>146</td>
<td>37</td>
<td>183*</td>
</tr>
</tbody>
</table>

Minority privately owned SOEs = 41 not shown above

Source: *WB estimation based on data provided by Government*

From a macroeconomic perspective, the biggest short term impact of equitization is likely to be in signalling support for the non-state sector. The small number of equitized firms and their relatively small sizes means that fiscal and quasi-fiscal benefits, as well as impact on factor markets, will be limited. In terms of microeconomic improvements in productivity and efficiency, a survey of 14 of the first 17 firms to be equitized by end of 1997, found that these equitized firms showed strong growth in revenues and profits, particularly those first to be equitized (MPDF 1998). However, it was 4 An enterprise is said to be "equitized" when the share allocation and business plan are approved by the government or a local People's Committee. It does not imply that the improved amount of state shares have been sold. The state retains some ownership in all but 63 of these equitized firms ranging from 5% to 60%.

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Table 4.2. State Owned Enterprises under Equitisation.

<table>
<thead>
<tr>
<th>Ministry Corps Under Equitisation</th>
<th>No SOEs</th>
<th>Majority owned by outside Investors</th>
<th>Majority owned by employees</th>
<th>State is the largest shareholder or may have a Decisive vote</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>Ministry</td>
<td>43</td>
<td>33</td>
<td>40</td>
<td>27</td>
</tr>
<tr>
<td>Commerce</td>
<td>7</td>
<td>28</td>
<td>57</td>
<td>15</td>
</tr>
<tr>
<td>Industry</td>
<td>4</td>
<td>25</td>
<td>50</td>
<td>25</td>
</tr>
<tr>
<td>Construction</td>
<td>12</td>
<td>67</td>
<td>8</td>
<td>25</td>
</tr>
<tr>
<td>Agriculture</td>
<td>10</td>
<td>10</td>
<td>50</td>
<td>40</td>
</tr>
<tr>
<td>Tourism</td>
<td>3</td>
<td>0</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td>Transport</td>
<td>5</td>
<td>40</td>
<td>40</td>
<td>20</td>
</tr>
<tr>
<td>Marine products</td>
<td>2</td>
<td>0</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Corporations</td>
<td>22</td>
<td>19</td>
<td>43</td>
<td>38</td>
</tr>
<tr>
<td>Vietnam Coffee</td>
<td>3</td>
<td>0</td>
<td>66</td>
<td>34</td>
</tr>
<tr>
<td>Electricity</td>
<td>2</td>
<td>0</td>
<td>0</td>
<td>100</td>
</tr>
<tr>
<td>Water transport</td>
<td>5</td>
<td>20</td>
<td>60</td>
<td>20</td>
</tr>
<tr>
<td>Coal</td>
<td>2</td>
<td>50</td>
<td>0</td>
<td>50</td>
</tr>
<tr>
<td>Northern Food</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stuff</td>
<td>1</td>
<td>0</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td>Telecommunication</td>
<td>2</td>
<td>50</td>
<td>0</td>
<td>50</td>
</tr>
<tr>
<td>Chemicals</td>
<td>2</td>
<td>0</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Steel</td>
<td>1</td>
<td>0</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td>Cement</td>
<td>2</td>
<td>50</td>
<td>0</td>
<td>50</td>
</tr>
<tr>
<td>Garment, textiles</td>
<td>2</td>
<td>0</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Cities and provinces</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>159</td>
<td>9</td>
<td>63</td>
<td>38</td>
</tr>
<tr>
<td>Hanoi</td>
<td>38</td>
<td>12</td>
<td>79</td>
<td>9</td>
</tr>
<tr>
<td>Ho Chi Minhcity</td>
<td>20</td>
<td>10</td>
<td>40</td>
<td>50</td>
</tr>
<tr>
<td>Haiphong</td>
<td>7</td>
<td>0</td>
<td>86</td>
<td>14</td>
</tr>
<tr>
<td>Danang</td>
<td>4</td>
<td>0</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td>Tuyen Quang</td>
<td>6</td>
<td>0</td>
<td>83</td>
<td>17</td>
</tr>
<tr>
<td>Phu Tho</td>
<td>5</td>
<td>0</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td>Others</td>
<td>79</td>
<td>6</td>
<td>51</td>
<td>43</td>
</tr>
</tbody>
</table>

Source: WB estimates using Government’s data.
noted that the good performance was largely the result of favorable firm-specific conditions. Indeed, initial advantages of profitability, limited debt, and efficient workers were the reasons that these firms were selected for equitization.

However, there are concerns that statutory restrictions on individual and entity share holdings may be translated into dispersed ownership. Operational control of equitized firms and the incentive to manage efficiently may not go to those with the expertise. The table below shows different patterns of share ownership in equitizations. On the provincial level the insider orientation of equitization (i.e. share purchases by managers and workers) was most pronounced. Next 63 percent of SOEs equitized by the people committees, employees acquired majority shares (at least, 50 percent of the company's charter capital). The state was left with the largest or decisive vote in 38 percent of the SOEs.

Centrally-owned SOEs were more successful in the search for outside investors. It is not clear whether these were either due to more attractive assets for sale or whether there was easier access of private investors to these assets. The outsiders succeeded in acquiring operational control in seven of the 12 equitized SOEs under the Ministry of Construction, two out of five under Ministry of Transport and two out of seven under Ministry of Trade. General Corporations expressed stronger preference for retaining the controlling interest in equitized SOEs, and they were less successful, than ministries in attracting outside buyers for shares of their equitized SOEs.

This suggests the need to broaden the menu of options to access additional capital and better management for these enterprises. There is clearly a need to take three steps: first, remove the existing ownership caps on share purchases by individuals and legal entities to allow majority purchases. This will permit private entrepreneurs with management talent and capital to buy majority shares in these SOEs. Second, increase transparency of the process of equitization through announcement and advertisements of sales at least a month in advance of accepting offers, to solicit interest. Third, move the authority to issue and sell shares outside the management of each SOE. These two actions will enhance access to outsiders to SOEs being equitized.
Box. 4.2. Improving Efficiency of the State Enterprise Sector: A Three-year Agenda

- Adopt, announce and implement a three-year comprehensive SOE reform program with annual targets for equitization, divestitures, liquidations, mergers and other forms of restructuring to cover a significant fraction of SOEs.

- Amend Decree No 44 to remove caps on shareholding of individuals and legal entities in equitized enterprises, to enhance transparency by announcing sale of SOEs in newspaper 30 days before bids are invited and to improve effectiveness of sale by moving sale of shares of an SOE to an agency, outside the SOE.

- Implement system to monitor quarterly changes in bank credit and budgetary support for 200 large highly-indebted SOEs.

- Conduct operational reviews (i.e. diagnostics audits) for 50 large troubled SOEs.

- Develop and implement restructuring plans of the three selected general corporations (i.e. Seaprodex, Vinatex and Vinacafe) to enhance efficiency and competitiveness.

- Enforce ceilings on bank credit to the SOE sector, including a sub-ceiling on the 200 large highly-indebted SOEs.

Recently, the National Enterprise Reform Committee (NERC) working together with line with ministries and people's committee have been developing a comprehensive program of SOE reform based on classification of all SOEs using economic and financial criteria. This reform program consists of measures aimed at:

- Diversifying ownership (i.e. equitisations and divestitures)

- Restructuring and downsizing large SOEs that are zero remain in state hands.
- Reducing the number of SOEs that are non-viable (i.e. liquidations and mergers)

The main challenge for reforming state owned enterprises is to improve SOE efficiency. For this purpose, the SOE sector with around 6000 enterprises accounts for about 30 percent of GDP, 20 percent of total investment, 15 percent of non-agricultural employment, and around 50 percent of outstanding domestic bank credit. The 200 largest ones account for 60 percent of state capital and 40 percent of total debt. The group "worst-performing" SOEs, classified on the basis of profitability and debt-levels, includes small, medium and large enterprises.

The National Enterprise Restructuring Committee (NERC) has developed a comprehensive program of SOE reform, though it remains to be approved by the government. This program seeks to diversify ownership through equitization and divestiture, to consolidate the state enterprise sector through liquidations and mergers and to restructure larger troubled SOEs through downsizing and other measures to improve efficiency. There is no doubt that implementation of this program is now urgent as a large proportion of medium and large SOEs are generating losses and piling up additional debts, that the country cannot afford.

Another challenge is social safety net for SOE workers. Reform of SOEs will lead to redundancies. During the SOE reform of 1989-1992, nearly a third of SOE workers had to leave their jobs. It is therefore imperative that social safety nets are established for SOE workers before the reform program is implemented. These safety nets should aim to compensate workers for their loss of incomes and to ensure that they can fund themselves during a transitional period of unemployment. A special fund for the reorganization and equitization of SOEs would soon be created. The fund is aimed at providing severance payments to workers who loose their jobs from SOEs as well as training support. In addition, the Fund is also expected to invest in new SOEs as well as in helping workers buy shares in SOEs if over the next three years, the government is able to equitize 1,200 SOEs and divest 600 SOEs5

Banks in Vietnam do not have proper infrastructure for credit services. This is seen in onerous collateral regulations, the centrality of personal connections, distortions in lending incentives, lack of banking skills, and

5 Decree 103 of the PM, september 1999 permits divestitures of those SOEs with legal capital of less than VND 1 billion, or about US$ 70,000 and those with up to VND 5 billion, or US$ 350,000, if making losses
issues of confidentiality. Common alternative sources of formal finance (capital markets, leasing, foreign banks, foreign investment funds, venture capital and mortgage finance). The proposals for improving business environment for banks are the following:

- Private customers should be enabled to communicate with the highest authorities for growth of private companies, including equitized companies.

- Liberalize banking regulations to allow greater competitions of State-owned banks with local and private banks;

- Assist banks to make it easier for private firms to access credit services; rationalize asset registries, speed up titling procedures, and streamline overall process by "more open" of both monetary policy and getting the banks to operate commerically;

- Clean up the banks for a healthy financial statement, restructure them and, in time, privatize them; in the short run, find an effective means of imposing a bottom line to make their incentives to lend to the best borrowers;

- Rationalize regulations concerning debt collection and collateral: (i) improve those aspects of the legal framework that apply to property rights as land use rights and contract enforcement, (ii) strengthen enforcement, (iii) broaden acceptable collateral to include additional types of fixed and current assets; (iv) simplify procedures associated with registering collateral; and (v) reduce restrictions on foreign borrowing taking collateral;

- Assist the banks in developing codes of ethics, including regulations on confidentiality;

- The government needs to launch a broad and credible public campaign to improve the image of private enterprises, and to create policy environment for private enterprises development. This would help to ensure private sector in entering into businesses or expanding their operations – an effective way to build image through performance.

- Make the tax regime more rational and equitable between SOEs and private Enterprises, and eliminate discrimination against domestic private firms, including service firms

A central feature of “Doi moi” (renewal) – the broad reform program introduced by the government of Vietnam in 1989 to overhaul its centrally planned system to move the country in the direction of a market economy –
was to re-introduce private sector ownership and activity in the creation of a mixed market economy, after approximately 45 years of central planning in the North and a decade of central planning in the South. To this end, prices were liberalized, agriculture was de-collectivized, the cooperative sector – important in industry, trade, construction and transport – was allowed for disbandment, state owned enterprises were given more autonomy, and legislation was introduced to allow various forms of private ownership, including foreign direct investment. Since then, the private sector has been growing rapidly, largely through creation of small-scale household enterprises but also as the result of incorporate private enterprise. Because much of the private sector activity is carried out by households which do not file statistics or tax information, the exact scope and extent of growth are difficult to estimate, it is likely that available statistics underestimate the real growth of the private sector.

Official data on private sector activities are looked upon widely as inaccurate and incomplete for a variety of reasons. First, the corporate private sector is very small, and most private sector activity is organized through household enterprises, whose revenues and output are captured very imperfectly by the existing statistical system. Second, state enterprises are closely connected to private sector activity, especially in the south, where they operate more often in light industry. It is not clear that the statistics reflect a consistent split between private and public activities. Third, foreign invested joint ventures with state enterprises are not included in the private sector, irrespective of ownership shares. Lastly, there is a tradition in Vietnam – as in many countries with limited tax, collection capacity – of concealing incomes and activity in order to avoid taxation and appropriation of surpluses, and this probably affects both state and private enterprises. On balance, it is probable that the official statistics underestimate the importance of private activities.

Statistics on credit confirm the rapid growth of the private sector. From the beginning of 1992, the year of formal recognition of the private sector in the constitution, the share of private sector in total credit has been rapidly increasing. The share of the non-state sector in the stock of total non-government credit increased from 10 percent at end of 1991 to 37 percent at end 2000. The flow of new credit to the private sector is rising very fast. Indeed, private sector credit grew to a peak in the fourth quarter of 1997, with an annual growth rate of 460 percent. As a result, the share of private sector credit in the total flow of new credit also increased rapidly, from 20 percent in March 1997 to a peak of 65 percent in March 1999. However, in the second

6 Credit statistics for the non state sector comprise joint venture, credit cooperatives, companies and a category dubbed private sector, which mainly includes small business and sole proprietorships. The non state sector is called the "private sector"
half of 1999, the share of private sector in new credit declined again to about 50 percent. This was partly because of a large increase in directed credit at the end of 1999 channeled through Bank for investment and development of Vietnam – which mainly benefited specific State owned enterprises – and partly because credit demand by farmers and enterprises slowed down due to negative impact of regional financial crisis and world economic crisis (see below).

Table 4.3. Credit Classifications, by Commercial Banks

<table>
<thead>
<tr>
<th>Year</th>
<th>VN Dong billion, end of period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Credit</td>
<td>9,822</td>
</tr>
<tr>
<td>- Claims on SOEs</td>
<td>5,224</td>
</tr>
<tr>
<td>- Claims on cooperatives a/</td>
<td>417</td>
</tr>
<tr>
<td>- Claims on share holding And limited companies a/</td>
<td>26</td>
</tr>
<tr>
<td>- Claims on Joint venture a/</td>
<td>71</td>
</tr>
<tr>
<td>- Claims on private sector</td>
<td>598</td>
</tr>
<tr>
<td>Total Foreign Currency Credit</td>
<td>1,867</td>
</tr>
<tr>
<td>- Claims on SOEs</td>
<td>1,802</td>
</tr>
<tr>
<td>- Claims on cooperatives</td>
<td>12</td>
</tr>
<tr>
<td>- Claims on share holding And limited companies</td>
<td>388</td>
</tr>
<tr>
<td>- Claims on Joint venture</td>
<td>82</td>
</tr>
<tr>
<td>- Claims on private sector</td>
<td>163</td>
</tr>
<tr>
<td>Share in total credit</td>
<td>100.0</td>
</tr>
<tr>
<td>- Claims on SOEs</td>
<td>89.7</td>
</tr>
<tr>
<td>- Claims on cooperatives a/</td>
<td>4.1</td>
</tr>
<tr>
<td>- Claims on share holding And limited companies a/</td>
<td>0.3</td>
</tr>
<tr>
<td>- Claims on Joint venture a/</td>
<td>0.7</td>
</tr>
<tr>
<td>- Claims on private sector</td>
<td>10.3</td>
</tr>
</tbody>
</table>

Note: a/ Included in private sector

Source: The State Bank of Vietnam
Within the private sector, most of the credit is extended to sole proprietorships, individuals and households (mainly farmers). With prices for many farm products increasing in 1999, growth in credit demand from farmers slowed down and their share in total credit stabilized. On the other hand, credit to companies – the other main category of private sector credit – gained rapidly in 1999. Credit to joint ventures accounts only a very small share of new credit, while the share of cooperatives has been declining.

Data on credit growth discussed above indicate that credit to private businesses has been growing faster than their output, suggesting that access to finance is not aggregatedly constrained and private sector has been becoming the customers of the commercial banks and credit institutions, quite different in pre renewal period. And in turn, the commercial banks and credit institutions has been expanding their banking products and services to service private customers. This is one of prerequisites for banking system development. In order to match requirements of the new customers in the context of the globalization and liberalization and fair competition, there must be a great change in the banking system as the main challenge for the future is to restructure the commercial banks and credit institutions to get them to operate commercially. However, in interviews with private sector employers in Vietnam, a major constraint to development was said to be access to finance for investment. There is a huge demand for investment funds, and each enterprise visited by the mission had a list of projects with a project cost that usually exceeded the enterprises current revenues several times. However, it is probable that many of these projects are not bankable, and therefore reflect a desire for credit rather than effective demand. Indeed, interviews with commercial banks suggest that the vast majority of viable projects are funded in Vietnam.

In contrast to the demand for credit expressed by private enterprises, the supply of which is limited. Retained earnings are the main source of growth and expansion for private firms. There is also thriving informal capital market. In spite of the recent rapid growth of credit to private business, the formal capital market, which consists essentially of banks, remains a minor source of financing for the emerging private sector.
According to Vietnamese law, access to credit is equal for all domestic parties. This has not always been the case. It was not until 1997 that the private sector obtained a significant share of newly extended credit, and access to medium term and foreign currency credit is still *de facto* limited. Underlying the rapid increase in credit to the private sector has been the ability to use collateral in the form of land use rights. However, recent reforms and developments in Access to land (land use and transfer) are likely to substantially limit the mortgage potential for holders of urban land use rights which are not related to residential housing.

In addition to credit from the formal sector, private businesses rely heavily on informal credit. This credit takes such forms as loans from extended families, money lenders (such as those in the Cholon district adjacent to Ho Chi Minh city), rotating credit associations (Hui Societies), and other informal credit cooperatives. The amount of informal loans to rural households (mainly farmers) was recently estimated by the World Bank Financial Sector Review at four times the amount of loans extended through formal banks. Loans from the extended families carry interest rates that are reportedly more in line with the interest rates charged by the banks, while loans from money lenders can amount to 7-8 percent and in some urgent loans approximate to 10 percent a month - substantially higher than the rates charged by the formal banking system.

*Foreign Currency and term credit*

The share of the private sector in foreign currency credit is quite limited, compared to that of state owned enterprises. While 80 percent of additional credit to state owned enterprises now takes the form of foreign currency (mainly in US$), the comparable share for the private sector is just 25 percent. This share varies widely also within the private sector. While the share hovers about 90 percent of 25 percent for joint venture, and the share of shareholding and limited liability companies matches that of state owned enterprises, the share in foreign currency credit of the small scale private sector is only 3-4 percent.

Existing regulations limit foreign currency financing to the import of goods and services. This could in principle explain the skewed distribution of foreign

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7 These include also some foreign parties such as overseas Vietnamese and foreign citizens that reside for a prolonged period in Vietnam.
currency credit, as state owned enterprises account for a very high share of imports of goods and services. However, the fact that the expansion in foreign currency credit to the state owned enterprises sector is accompanied by rapidly declining domestic currency credit does indicate that state owned enterprises are deliberately substituting between the two sources of credit.

Foreign currency credit appears to many market credit participants attractive compared to domestic currency credit. The attractiveness stems from interest rates, which at their maximum level of 7 percent per annum in US Dollar appear quite moderate – compared to local currency interest rates of 7.5-8 percent – in context of stable exchange rate. Foreign currency credit is also attractive because it facilitates access to medium term loans. Commercial banks prefer to extend medium term lending in US$, both because medium term Dong lending is more risky, owing to greater inflation risks, and further less profitable, owing to the interest rate structure for Dong Loans. Not surprisingly, the share of medium term foreign currency loans has increased from virtually zero in early 1992 to over 30 percent at the end of 1994.

Access to medium term credit in Dong is quite limited, both for the state and the non state sectors. Apart from loans provided under the state plan through the bank for investment and development of Vietnam (BIDV) for specific purposes. such loans amount was less than 15-20 percent of credit extended for both these sectors. The main reason is a straightforward anomaly in the term structure of interest rates in Vietnam, interest rates for medium term loans are more or less equal to short term rates. This gap was somewhat reduced during banking renovation process.

A small bond market started operating in 1994; Auctions of treasury bonds and bills have been held at the head office of the SBV so far, and secondary market transactions are taking place through open market. Recently, a small number of state enterprises have been authorized to issue bonds domestically, although no issue has taken place yet. State Securities Commissions (SSC) was established in 1997 and Ho Chi Minh stock exchange centre entered operations in 1999 and Hanoi stock exchange centre is expected to open at the end of 2001. At present, the main instruments for financing new investments remain bank credit and withheld profits. There exists however potential for development of an equity market, and foreign investors have already been mobilizing capital in anticipation of its establishment.

Implementing guidelines of the law on Promotion of Domestic investment law, the Investment Support Fund was established in 1999 with relatively
small authorized capital of 2000 billion Dong. The purpose of the Fund would be to mobilize medium and long term resources to provide credits for priority projects eligible on concessional terms. It is unlikely that the Fund to be established as a non-profit institution could mobilize significant additional resources for medium and long term investment. The Fund could however play an important role in catalyzing investment in those areas where economic returns are high but market failures such as information asymmetries constrain access to credit.

In order to increase the availability of credit to priority investments in an economically sound and financially sustainable manner, the Fund has been operating on the basis of sound prudential implementing guidelines for the identification of priority projects and which enabled the Fund to operate efficiently and avoid the potential for corruption or arbitrary directing credit.

As part of the reform program, the young private sector requires the financial support and contribution from banking sector in term of credit and financing. While limited access and high interest rates are among the main constraints for private sector growth and development, attention should thus be focused on enhancing the pool of domestic savings through fund raising activities of commercial banks and credit institutions and efforts should focus on the creation of an efficient banking system, a stable business environment, and long term savings vehicles. Remaining distortions limiting the supply of medium and long-term funds such as appropriate interest rates like negotiable ones should also be applicable for potential customers of the commercial banks and credit institutions emerging private sector enterprises.

Vietnam had introduced over a period of a decade the basis of a proper tax system. Import and export duties were introduced in 1987, and turnover tax, excise duties, personal income tax, enterprise profit tax, land and housing taxes were introduced in 1990 and Value added tax (VAT) was introduced in the second half of 1988. The government is attempting to improve the system further, and has recently established a high-level tax reform Board under the chairmanship of the Deputy Prime Minister in charge of the economy to design future tax reform.

The existing tax system has a number of positive features: (a) the turnover tax has a comprehensive base, covering more than 60 percent of GDP, and generates almost 4 percent of GDP revenue; (b) the personal income tax is relatively simple, with few deductions; (c) the enterprise profit tax covers all enterprises and is based on a broad definition of profit, with few deductions,
exemption of privileges and (d) tax on land are applied to virtually all households and enterprises.

However, the current tax system has several weaknesses which has significant impact on the private sector, either because they raise the costs of doing business or because they put the private sector in a disadvantageous position related to the public sector.

(a) The turnover tax has too many rates, making administrative compliance difficult and expensive and thus encouraging evasion. In addition, the variation in rates distorts producer and consumer choices, and creates an uneven playing field for enterprises. Both are detrimental to development of an efficient market economy. Finally, the turn over tax acts as a disincentive to investment, exports and subcontracting, because of its relatively high rates on investment goods and its cascading effect.

(b) Import duties – instead of excise taxes – are used to tax luxury goods. As a result, rather than discouraging consumption, high tariffs applied to luxury goods are providing incentives for their production in Vietnam.

(c) The profit tax from various enterprises are levied that vary widely between different sectors of activity – between 25 and 45 percent for domestic businesses, between 10 and 25 percent for foreign invested enterprises and the profit tax may be too high in general for domestic enterprises. The disparity of rates distorts investment decisions, while the high levels of rates act as an incentive for entrepreneurs to register as unincorporated household enterprises and to remain in the informal sector. In the case of foreign enterprises and joint ventures, the enterprise profit tax – in addition to being lower than for domestic enterprises – fail to tax some forms of incomes generated in Vietnam, especially if it is remitted abroad – such as interest and lease rental payments.

(d) Recently approved tax incentives for domestic enterprises are insufficient as they apply not only to profit taxes but also to indirect taxes, that introduce excessive discretionally in the taxation system by
allowing substantial tax incentives in vaguely defined preferential sectors, and potentially lead to a significant reduction of the tax base by providing very generous tax exemptions and/or reductions.

(e) High transfer taxes on land make the transfer of land use rights expensive, and should be reduced to encourage compliance and accurate reporting of transactions.

(f) Though, in principle, domestic private and state enterprises face the same basic profit tax regime, in practice tax policy does discriminate between private and public sector through different rules for supplementary taxation (which appears to favor SOEs) and through the method of presumptive taxation (which appear to favor private micro enterprises).

The relatively small tax contribution of the private sector as compared to state sectors may stem the nature of the presumptive tax system that many small businesses use. In contrast to most countries, enterprise income of small households in Vietnam is subject to profit tax rather than income tax. Because households enterprises typically keep rather rudimentary books, profit tax is levied on a presumptive basis, at a rate of 1-3 percent of turnover, depending on the sector in which the enterprises operate. The implicit assumption in this level is that value added in these enterprises is quite small as a percentage of turnover. As an indication, imposing a presumptive tax rate of 1 percent to household enterprises in the productive sector – where the average profit tax rate is 30 percent – implies that value added is assumed to represent only 3 percent of turnover in the manufacturing sector and in service sector, the comparable figure for assumed value added is about 4 percent of turnover.

**Foreign Trade Expansion**

The openness of the economy to international trade is more a matter of administration of regulation than of the basic system of regulation. Despite significant liberalization over the last decade, Vietnam still has a more restrictive trade regime than its neighbor. On the import side, importing firms have limited trading rights and import licensing restrictions cover two fifths of
imports and nearly one third of domestic production. This implies a high degree of non-transparency, limited access of private firms and of course unlimited protection for a significant share of industrial production. In addition import tariffs are both high and dispersed. On the export side, there are administratively-allocated export quotas on garments and rice and export taxes on several items. Indeed, there remains in place an extensive system of controls that could be used, if the government chose to so apply them, to tightly control all goods and services exported and imported into Vietnam. The removal of these controls would provide a more dependable environment for small-scale investment, and would allow further exploitation by Vietnamese entrepreneurs of the opportunities that exist in the expanding Asian market.

In Vietnam as in other developing countries, development of export contacts and technical improvement of export products rely mostly on efforts by individual enterprises. Development of export markets and acquisition of technology to produce products of sufficient quality to do well on world markets have been in fact primarily a matter of taking advantage of the extensive market networks that exist in Asia, and not a matter of incoming collective support. As compared to countries at a simple level of development, the exchange rate system functions well, and export-oriented enterprises have access to imported inputs (merchandise and services) at international prices. The overall level of import protection is moderate and is expected to decline further as the commitments assumed in joining Asian Free Trade Area (AFTA) are gradually implemented. The fact that many changes of import protection are particularly tailored to the needs of particular investors, or represent a changed interpretation by the Vietnamese government. It makes a close relationship with the government an important element in establishing in Vietnam an enterprise that will compete in the international market. Until 1988, Vietnam followed an essentially state trading system: export and import targets were reached through interaction system between local and central government, and trade was executed by state trading companies. Trade with COMECON was better trade arranged by the government. With the collapse of COMECON, the government was forced to re-evaluate its trading relations with the rest of the world. The exchange rate was unified, and a system of auctioning foreign exchange was organized, in addition, measures were introduced to relax restrictions on trade. State owned enterprises and private businesses that produce exportable items or use imports are allowed to trade directly rather than through state trading companies. Second, most quantitative restrictions and permit requirements were eliminated. Third, a duty draw back scheme from materials used in the production of export goods was introduced.
The private sector has benefited greatly from the freeing-up trading rights, that resulted in nearly 3000 new private firms sought custom-codes within a year after freeing trading rights. This has raised the share of domestic private firms in the total number of trading firms from 35 percent in 1998 to 58 percent in 1999 respectively. Increased percentage of the private firms in the total import and export volume were respectively 14% and 15% in 1999. Thus, private sector (defined as foreign invested and domestic private enterprises) now cover nearly three quarters of all trading firms and nearly half of all import and export value. However, the policy framework remains a number of characteristics that benefit state enterprises and that are likely to contribute significantly to their excellent performance. First foreign trade certificates have been granted to a much larger number of SOEs than private businesses. While this does not appear to have restricted the access of private enterprises to imports and exports, it does increase their cost, as a result of fees charged by mostly state owned import-export enterprises. Second, the goods that are afforded the greatest protection from the foreign trade regime - whether through administrative restriction or high tariffs - are predominantly or fully produced by SOEs.

The highest priority in the coming months is to finalize a three year plan for the phasing-out of import licensing restrictions and to operationalize the Vietnam-U.S trade agreement. The latter is considered being an important step towards joining World trade Organization (WTO). This would increase Vietnam's access to a major market for exports. The three-year plan for trade reforms must include the phase-out of at least 17 of the 19 items on which there are import licensing restrictions, the freeing-up of trading rights for all importing firms, removal of foreign exchange surrender requirement and further expansion of private sector's access to garment and rice export quotas.

In a country where the government needs to move from controlling to promoting business activity, and where there is limited experiences in developing such an enabling environment, it is important that the government and the business community find ways of exchanging views. The government has made a start in creating this dialogue with business, and a clear message has been set to the business community that government is willing to listen and respond to business concerns. Meetings are now being held frequently between government officials and the business community, to debate issues of common concern.

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8 It appears that today any enterprises with export potential can readily obtain certification to export and to import inputs for own use. Certification to import generally seems however more difficult to obtain, although he government seems to be concerned not to allow any one enterprise to enjoy market power in the importation of any class of commodities.
Box 4.3. Opening up to Foreign Trade

**Measures adopted in 1999**

- Issued implementing regulations to free rights of all firms to export and import directly all products listed in firm's business license without requiring license. Exporters were also given rights to export products not listed in their business license (January).

- Issued implementing regulations to reduce the number of tariff rates to 12 (from 26) and the maximum tariff to 50 percent (from 60) except for six broad categories of goods, i.e. motorcars, motorbikes, petroleum products, alcohol, tobacco and used clothing (January).

- Permitted private firms to export rice (February)

- Began auctioning 20 percent of export quotas for garment-export (January)

- Reduced foreign exchange requirements from 80 percent to 50 percent of available balances (August)

**3 Year Plan.**

- Adopt, announce and implement the phase-out of quantitative import restrictions and replace with transitional tariffs.

- Continue to expand the auctioning of garment export quotas and improve the terms of auction, including transferability among firms.

- Increase the share of rice export quotas allocated to private firms.

- Cease granting of new discretionary exemptions on import-tariffs and of new import restrictions.

- Eliminate remaining restrictions on firms' importing rights, so that they can import directly all non-restricted products without restrictions, including those not listed in firm's business license.

- Remove the foreign exchange surrender requirement.

- Perform the Vietnam-US trade agreement to expand export markets and move towards WTO accession.
In order to take initiatives of this kind to bear fruit, the government and the business community need to develop efficient machinery for further consultation. Experience of reform efforts in other countries suggests that creation of high-level deliberation bodies may play an important role in demonstrating a commitment to dialogue, but that results are obtained through action-oriented government-business groups working on specific issues. Once the agenda of reforms has been established, specific groups can be created bringing together government agencies and private business interests. While there are several organizations with whom specific issues can be discussed, an obvious candidate for coordinating inputs from the business community is the Vietnam Chamber of Commerce and Industry (VCCI), which is the only national organization representing the business community.

Box. 4.4. Private Investment Measures in 1999

In 1999, the government took the following measures:

- Allowed Vietnamese private firms to contribute their land-use rights as equity in joint venture, as long as they have paid for land use rights in full (February)
- Formed private sector forum (PSF) to meet every quarter to discuss issues of interest to private sector, domestic and foreign (March).
- Established a steering committee for developing a five-year strategy for private sector development (April).
- Announced a set of new incentives for foreign investors (May).
- Approved the enterprise law, eliminating discretionary restrictions on the rights of any legal entities and individuals to establish private business, simplifying substantially registration procedures, creating a basis for a unified legislation covering all kinds of enterprises including equitized enterprises (June)
- Announced a detailed private sector action program
including both state and private enterprises. In addition, many organizations at the local level and for particular industries have developed affiliate status with VCCI.

There will also be a need for government to organize itself for more effective cooperation with the business community. This will generally require a bureaucracy that has been accustomed to issuing orders and directives to production units to learn how to listen to the business community. In particular, it is important that future reform efforts ensure that all ministries and agencies that are involved in any particular area of the business environment are involved in the development and implementation of reforms.

Key element for growth in the private sector is the access, use and transfer of land and land use as collateral. There were two considerable progresses in term of land use right. The first is related to land use right contribution as share holding in joint venture by Vietnam enterprises including private enterprises after land lease is fully paid. The second is the foreign enterprises invested in industrial and processing zones which can obtain land use rights.

The market supporting institutions are evolving. Courts, public information agencies, accounting services, trade promotion agents and universities are supporting private sector activities. However, the Vietnam association for private enterprises, foreign information channels and trade promotion centers are emerging. Such associations would help to ensure private enterprises in entering into business or expanding their operations.

Although Vietnam has recorded and maintained impressive growth with relatively low investment levels during the past few years, this accomplishment seems uncertain to be sustained, as the upward trend in investment confirms. Besides a number of important public infrastructure projects which are often very capital intensive and have long gestation periods are now critically needed. A great capital requirement for investment is wanted for state owned and private sector reform. As discussed earlier, while budgetary subsidies are now very small, the state owned enterprises are still protected and receive preferential treatment from banking system. The consequences of this policy is that the banking system in the renovation process needs at least 30 billion VND to cover SOE debt and non performing loans. The investment can consolidate the capital base of the banking sector and may result in private investment. This is the foundation for refreshing the balance sheet of the commercial banks and implementing the strategy of
diversification of banking products and services to maintain high levels of investment efficiency – central objective of the incentive framework to emerging private sector. Vietnam still receives abundant financial resources from abroad, mostly in the form of Official Development aid (ODA) and Foreign Direct Investment (FDI). On the one hand, these capital inflows represent an extraordinary opportunity for Vietnam to increase rapidly its investment levels and thus productive capacity for economic growth; on the other hand, capital inflows can have adverse consequences especially international competitiveness, through their effects on the exchange rate. Losses of international competitiveness can in turn depress investment efficiency, by using the allocation of investment toward non-traded sectors.

Negative effects of capital inflows, as observed in a number of developing countries, include:

a) Excessive increase in the resource volume flowing through the financial system, which can create problems in countries with a weak supervisory system;

b) Rising domestic inflation, which can negatively affect savings and investment;

c) Appreciation of the real exchange rate, which can jeopardize export competitiveness and;

d) General macroeconomic instability, if capital inflows are volatile as in the case of portfolio investment.

This last problem – volatile short-term capital inflows leading to macroeconomic instability – does not concern Vietnam at this stage of development. Most capital flows, now and in the foreseeable future, are in the form of ODA, which mostly finances specific projects, and FDI, which is typically of long-term nature and cannot be liquidated easily. Both ODA and FDI, being linked to the implementation of specific projects to a large extent, finance imports of equipment and intermediate goods and thus finance foreign suppliers. These capital inflows have limited effects on domestic monetary aggregates and thus a subject of macroeconomic management, while adding to productive capacity.
However, efforts to develop Vietnam securities market are underway, and a limited trading center is currently operating in Ho Chi Minh city. The State Securities Commission (SSC), established in late 1997, is responsible for developing market where access to funds is appropriate for both investors and issuers. Another effort is to establish Asset management Company (AMC). Those two actions aim at developing a capital market in Vietnam and creating a sound banking system. The Vietnamese banks are closely linked to their major clients—the State owned Enterprises (SOEs). The sequencing of banking reforms is more closely linked to the pace and sequencing of SOE reforms. This would be essential for either a medium to long term prospect or for an immediate future, a detailed road-map for this important nexus of financial sector/corporate sector restructuring has to be prepared by the Government.

Tight fiscal policy provides investors with a positive outlook for long term macroeconomic stability. Trade liberalization removes the bias toward non-traded goods, moderates the pressure toward real appreciation of the exchange rate, and thus ensures that international competitiveness is not jeopardized. Finally, it will be important that over the medium term appropriate instruments of monetary policy be developed, in order to allow the central bank sufficient flexibility in implementing domestic and foreign currency markets interventions that may be necessary for the management of capital inflows.

In order to sustain high and broad based growth, it will necessary for state owned and private sector reform to generate adequate employment opportunities in order to absorb productively new entrants in the labor force. The high growth rate of the economy and the emerging and expansion of the private sector have allowed significant job creation, which has however barely kept pace with the increase in new labor market entrants. During 1989-1993, about 3.8 million jobs were created, as a result of 4.7 million new jobs in the non state sector and a reduction of about 1 million jobs in the state sector. However, the labor force is estimated to have risen by over 1 million new entrants per year. Though labor market data are weak, unemployment is on the rise, especially in urban areas, and underemployment remains high in rural areas, where arable land per capita is one of the lowest in Southeast Asia. Migration from rural to urban areas is taking place both in the North and the South, adding further pressure on the already stressed urban centers.

In order to promote adequate and productive employment generation, the first policy priority should be encouraging the development of emerging
private sector. Private businesses have in fact generated the most jobs in recent years, absorbing new job entrants from state owned enterprises and armed forces personnel. Private business remain the most promising source of jobs also in the year to come. In addition, it is critical that the incentive framework do not distort private as well as public investment decisions toward high capital intensity, and that labor market policies encourage flexibility and skills development.

PUBLIC VIEWS ON CONTINUITY OF BANKING RENOVATION

We have examined the issues in terms of overall picture, opportunities and challenges to Vietnam's renewal process, especially in the banking sector. This has contributed to economic growth of the country. It is advantageous and difficult as the banking reform has to be reviewed before the public view, strategy and policy.

The great achievements that Vietnam gained in pursuing external and internal relations, the active and positive foreign policies have enabled Vietnam to gain advantages for its socio-economic developments. The most prominent achievement is that Vietnam has avoided serious balance of payments and super inflation besides coping with many serious difficulties. The subsidy system through re-capitalization process, policy lending activities and preferred pricing system to the state owned enterprises has been eliminated.

Regarding state budget, the revenue percentage as compared to GDP has been increasing through the years (from 1991 to 1995: 14.2%, 17.3%, 21%, 23%, and 24% respectively) The structure of state budget expenditure has been changed actively. Issuing bank notes to cover regular expenditures are now totally removed. Budget deficit has been reduced through years and covered either by loans from local people or from foreign borrowings.

Monetary and lending activities has got a turning point. The two tier banking system has been established. The SBV (the central bank) has controlled the monetary system and the credit institutions. The commercial banks have operated commercially and it is growing. The investment ratio for socio-economic development has increased considerably, of which, the share
was 43% from the state, 27% for foreign direct investment and more than 30% from local people. Owing to this, the state subsidy through policy lending is reduced considerably and moving towards commercial lending activities. This is enabling process of industrialization and modernization. The economic structure is moving towards the direction to increase the industrial and services rate and decrease the fishery, forestry and agriculture rate. The multi-economic components structure with many forms of ownership has stemmed and developed labor forces, promoting economic growth. The state owned sector still plays a key and leading role in the economy in both total quality and efficiency. Non state owned sector economy is encouraged for development. The industrial cooperatives and small-scale industry are under re-organization for a new start of development. Household economy develops rapidly in agriculture, fishery, forestry and civil services. Domestic private economy has a great pace for development, particularly, the small and medium scale enterprises. Regional structure is closely linked to regional economic development planning.

View on Development and Management of State Bank of Vietnam

"The strategic target for development of the banking system up to the year 2000 is to form a powerful banking system on both planning capacity and policy performance, management capacity, business management capability, adequate strength on modern technology in conformity with the market economy, becoming an effective instrument for economic development goal and soon joining international financial community" 9

The SBV is central bank, its featuring function is issuing bank and its functions are to make macro monetary policies and macro management of the banking system. Specifically, it controls both monetary system and commercial banking system. Equipped with issuing function, the SBV issues not only bank notes, but also other means of payments. The responsibility of the SBV is to maintain adequate supply of means of payments including cash balancing, the monetary supply and demand.

9 Dr. Cao Sy Kiem, Banking in Vietnam Renewal cause, Vietnam Banking Magazine series March, 1995
Cash is a part in the volume of the monetary supply. Cash management was the first priority task of the SBV in the past and now cash is only one means of payment. The business transactions are generally conducted on a cash basis. So central control over money supply and currency transactions needs to be strengthened.

Monetary policy is not operated through central plan, but by proper policies on credit of the economy, foreign exchange control and tax policy applicable to the state revenues. A series of macro economic instruments are being completed: Phase-re-capitalization, interest rate, exchange rate, compulsory reserve, and open market instruments.

The SBV is last lender in the process of phase-re-capitalization, discounting to commercial banks. In fact, this is a kind of short-term loan collateralized by valuable papers. By doing so, the SBV can control credit quantity and quality of the commercial banks. It is responsible for establishment and development of monetary market and long-term capital market for better performance of open market instruments.

Views on development of commercial bank system

The commercial banks and credit institutions are financial intermediaries between savings and investments. Being monetary trading enterprises for profit, they look for the funding sources and utilize effectively these capital bases. After a certain years of renovation, a commercial banking system and credit institutions have been formed and grown up. Due to economic renewal under market mechanism, the commercial bank system must be reformed continuously.

Regarding organizational model: the credit institutions must be fulfilled under the following directions:

Multi ownership: including state, collective, individual and foreign ownership. A particular emphasis is on mixed ownership and considered popular. In substance, this is a state capitalist model in the monetary operations under socialist oriented market economy. Partial or full Equitisation (partial privatization) of the state owned commercial banks are also the way to create the mixed ownership. For the time being, there are many kinds of banks to be established, including: deposit banks (credit
banks), commercial banks, financial companies, credit cooperatives, people's credit funds, sector and association banks. In near future, other banks could also be established such as: Trust foreign exchange companies; leasing companies, investment banks, real property and estate banks, financial companies of the groups and corporations; and other bank subsidiaries as safe keeping, transferring, buying and selling valuable papers, movable and fixed property trading etc could be established.

For the better performance of the monetary policy, a distinction must be made between two kinds of banks: either commercial banks and non-bank financial institutions; or credit banks (short term lending) and bank for investment and development (medium and long term lending) and management of these two kinds of credit institutions must be followed accordingly.

New banking products and facilities will be developed in addition to traditional banking services that requires a further strengthening such as: discounting, re-discounting, transferable valuable paper mortgages, installment payment, auctions of state treasury and company bonds, consultancy services, guarantee, insurance, leasing and information services. On securities market, the commercial banks could perform their functions as stock and bond trading, payment, safe keeping, while providing brokerage and consultancy services not only for themselves but also for their customers.

As banking service provider, the bank is not the banking service provider to state owned enterprises but it has to be a popular to provide banking service to all economic components from industry, agriculture, commerce, construction to services. It would buy stocks and shares or making joint ventures and business cooperation contracts with the firms. The commercial banks and credit institutions are independent in planning and implementing business strategy, financial self-reliance and responsible for their business operation by laws. On macro level, the commercial banking system is an effective instrument for industrialization and modernization, due largely to its functions as capital provider for the economy. The state helps them commercially in the area of fund raising, but the tasks and instructions would not be given by the state. It performs naturally as its monetary and banking operations in the market economy. With a View to "Borrowing for lending", the commercial banks must be close to the market, exploiting optimally the domestic and foreign capital sources in order to expand their lending activities. Funds are raised commercially in the market and commercial banks are not looking forward to the SBV issuing bank notes as their main borrowing sources.
The foreign banks operating in Vietnam contribute to the economic development of the country. They are equal with domestic banks as stipulated by laws. However, their banking operations - scale, domain and geographical locations or expansion that will be based on mutual benefits of the country, and could maintain competitive ability of the domestic commercial banks. The state regulates certain banking areas for foreign commercial banks operating in Vietnam. Monetary operations are very sensitive, collapse of one bank can easily draw collapse of a series of banks, it concerns mass psychology so regulations on undisclosed information and advertisements are very important and necessary.

**PUBLIC POLICIES ON BANKING RENOVATION**

Based on above developments, four fundamental issues were identified by the State bank of Vietnam to renovate systematically as the following:

- Create a sound and transparent market mechanism through policy making, resolution for restructuring JSBs and SOCBs, strengthening regulatory & supervisory legal framework and leveling the playing field for all banks, particularly, improving financial market efficiency.

- Modernize the banking system for both purposes: industrialization and modernization cause of the country and international integration. The modernization project under WB assistance program is being implemented at present to aim at improving many areas of banking system such as accounting, settlement, information, and management and strengthening short, medium and long term capital markets.

- Complete the organizational system, both structure and management, improving staff qualifications and banking operations, the use of foreign languages, and computer. The virtue and market oriented-credit culture to match the requirements of the renewal period are also required to have further consideration.

- Strengthen the supervision, inspection, and audit of the SBV, while strengthening management of the commercial banks to aim at creating a sound banking system for higher growth.

*Economic credit policy and Fund creation.*
Fund absorption through banking system is one of the main channels to fund raising strategy. Firstly, it is the domestic capital demanded for economic development. An estimate of the government shows that fund raising required for economic development is about of 250,000 to 300,000 billion VND. In order to achieve this target, the following measures were introduced:

- Expansion of traditional savings

- Diversification of fund raising instruments of the commercial banks in the shape of bonds and notes

- Expansion of banking services, particularly payment so as to be fast, safe with low fee rates, reasonable interest rates for gaining the confidence in term of fund raising. Besides the improvement of fund transfer, modern clearing, the banks promote to open personal bank accounts, issue personal checks, and use credit cards, ATM cards. As payment agents for foreign banks and use of non documents in accounting and payments, home banking services.

- Capital market development.

Expansion of the monetary market including traditional credit market, domestic currency and foreign exchange inter-bank markets, state treasury bond market and other short term valuable papers for exploiting the short term capital resources of other banks.

Promotion of development of securities markets both in Ho Chi Minh City and Hanoi. Vietnam's first stock exchange began in 1992 and limited trading floor was opened in Ho Chi Minh City in late 1999. Vietnam's first tradable government and corporate bonds were issued in late 1994 and certificates of deposit and treasury bills have been tradable since March 1995. Treasury bill auctions, first introduced in June 1995, tend to be small irregular and the bill is viewed as investment instruments, hence little secondary trade occurs. These actions are required for strengthening and for long-term foreign currency bonds; the government would soon launch a bond on the international market.

The donor community has been playing an important role in Vietnam for the past decade. Evidence to date has shown that official development aids
(ODA) either bilateral or multilateral has been largely effective in Vietnam, both because of rehabilitation of infrastructure yielding high returns and earlier reforms had created a policy environment conducive to the effective use of ODA. Since foreign investment flows have fallen precipitously in 1998 and then again in 1999, higher FDI flows are likely only if the governments acts to improve Government’s project implementation arrangements significantly.

Formulating the projects for absorbing direct foreign investment (FDI). The banking sector in conjunction with other sectors and enterprises formulate feasible projects either for joint venture, or 100% foreign direct investment. On their part, Vietnam banks would improve quickly administrative and banking procedures in order not to waste time of the foreign investors. The banks also develop the form of supporting fund to local enterprises so that more conditions for joint venture with foreign partners would be opened.

Developing foreign remittance and foreign exchange operations in order to increase foreign currency volume. The SBV would enable the development of foreign currency services and exchange easily to Vietnamese Dong (VND) in conformity with Vietnam foreign exchange control policy.

In order to absorb funds of foreign banks operating in Vietnam, it requires building up their strong confidence to Vietnamese enterprises. So the state policy on development of multi sector economy must be performed and Vietnam becomes a truly “multi-sector” economy, in which the private small, medium and large businesses are able to grow and compete in an undistorted environment with the same freedom as state enterprises.

*Foreign exchange control policy, exchange rate determination.*

For the time being, foreign currency still accounts for a high rate (from 20 to 30%) in the total payment facilities. Due largely to Vietnam ‘s current account deficits financed by an inflow of foreign direct investment so foreign currency to Vietnam is greater. Foreign exchange control policy is to limit the domain of foreign currency and enhance the role of domestic currency, and further control foreign currency channels into Vietnam, the exchange rate must be maintained “managed float” and stabilized reasonably for export promotion, economic development and for inflation control.
The foreign exchange control policy is directed to currency protection, gradually narrowing dollarisation and making prerequisites for convertible Vietnam currency. The SBV is now actively trying to restrict the use of US dollars in the domestic economy, but this “de-dollarization” process has, in the past proved difficult to enforce. However, there is a forcefulness about the SBV’s desire to enforce legislation generally at present, which suggests that this time it should be more successful in achieving its objectives.

Following new registration introduced in early 1999, the VND is fixed to the USD at a rate set by the SBV each morning based on the previous day’s inter-bank rate as determined by the SBV. In theory, the VND can devalue by a maximum of 0.1% per day, though this has rarely happened. In 1998 before banking laws promulgated, the VND was devaluated twice by the SBV, representing an aggregate devaluation of 13%.

Current regulations place restrictions on residents (which includes foreign invested entities doing Business in Vietnam) from:

i) Holding foreign currency proceeds of certain informal transactions remitted into the country (decision 173)

ii) Using foreign currency within Vietnam (circular 01 for implementing decree 63) and

iii) On purchasing foreign currency for remittance overseas.

Foreign exchange control policy has been performed with reasonable progress that resulted in absorbing a great volume of foreign currency to Vietnam banks, and the selling, buying, transferring and paying in foreign currency were removed totally among enterprise. SBV could gradually balance the foreign currency volume to the enterprises that got foreign investment; reducing considerably the selling and buying of foreign currency in cash among population. Foreign exchange counters were set up in major parts of the country, particularly in the urban areas. Through foreign currency transactions on the inter-bank market, the central bank can recognize market signals and control supply and demand of foreign currency on the market.
However, the implementation of these changes is beginning now, the following hurdles are yet to be overcome:

a. Due largely to increased foreign currency deposits from inward remittances, the SBV estimated that money supply (M2) grew by 39.1 percent in 19999 compared with 26 percent in 1988. These funds were re-deposited in overseas banks and did not translate into accelerated domestic growth. The SBV must have appropriate measures for balancing money supply and demand and for the purpose of inflation control and for economic growth, while generating greater national foreign currency reserve.

b. Lending in foreign currency must be gradually removed. Selling and buying foreign currency and other foreign currency transactions must perform through foreign currency inter-bank market. Further, the banks must reduce certain number of foreign currency deposit accounts opened by economic enterprises, and tax collection in foreign currency have to convert into Vietnamese Dong equivalent.

c. The SBV must perform macro adjustment instruments for balance of international payments and adjust balance of international payment for balance of international trade.

d. Foreign exchange rate is very sensitive element of the market economy. Its impact could be on many aspects such as inflation control and accelerated economic reform.

The SBV adjusts the exchange rates flexibly. The exchange rates adjustment is based on foreign currency demand and supply, inflation rate of Vietnamese Dong, fluctuation limit of certain hard foreign currencies, import–export pricing system. The adjustment also aims at export promotion, import control, balancing national current account and increasing national foreign currency reserve.

Vietnam policy is to stabilize the foreign exchange rate. Foreign exchange rate stability is for domestic pricing rate stability; the SBV follows the foreign currency supply and demand on the market and manage the exchange rate flexibly. The SBV announces daily official exchange rate and
the commercial banks can actively buy and sell foreign currency with 0.5% margin. The SBV only intervene in some necessary cases.

Vietnam import is greater than export. The SBV does not introduce the measure of Vietnamese Dong devaluation for export promotion that will cause a great impact to import and domestic pricing system. The SBV only buys foreign currency at a reasonable volume so as to control appreciation of Vietnamese Dong, influencing export and domestic production.

Exchange rate adjustment policy of the SBV is not performed through administrative measure, the rate is adjusted under market demand, and SBV gradually liberalize it from macro adjustment to foreign currency market.

Completion and development of instruments for performing monetary policy.

The instruments for performing monetary policy includes two types: Direct and indirect management instruments.

In the initial renewal period, the market was underdeveloped, direct management instruments were utilized, when the market is diversified for development, indirect management instruments has been gradually utilized.

Credit limit

Credit activities of the commercial banks make monetary supply volume higher so the total payment facilities are also grown. Due to unsteady inflation control, Vietnam monetary supply and total payment facilities increase quickly through channels: State budget collected in foreign currency, foreign loans and foreign borrowings that are converted into Vietnamese Dong to cover state budget deficit; Another channel is due largely to great inflow of foreign currency and the state has to buy this amount of foreign currency; while, the commercial banks increase the credit volume. In this regard, we must apply credit limit to control the credit expansion in the banking system and in the commercial bank respectively. The issue hereby is how to identify the credit limit so as to provide sufficient capital for economic growth and control inflation.
Recapitalisation limit to the commercial banks

This is also a direct instrument, it is included in additional total monetary supply, depending upon economic growth rate and controlled inflation rate. This limit is only at macro level control and refunding is by the market signal, of which, the SBV is the last lender featured as indirect instrument.

Indirect Management instruments

Including rediscounting interest rate, it is very flexible macro economic instrument. Rediscounting interest rate is applied to all commercial banks when commercial papers and promissory notes enter operation. The central bank applies the rediscounting interest rate to all commercial banks in order to tighten or loosen central monetary volume supplied to the economy. Through its tight management, Vietnam has settled many contradictions in term of interest rate relations.

Interest rates would be adjusted flexibly by the market fluctuations, capital demand and supply relations, controlled inflation rates, interest rate fluctuations on the international market and attached to the monetary policy targets. At the end of 2000 and at the beginning 2001, the dollarization process was increased. Reform should be directed to maintain VND interest rate higher than USD rate so as to aim at monetary stability and enhancing people’s confidence in VND. The fact has shown that at the end of 1980s, by maintaining high interest rate, then Vietnam could decrease inflation rate. Some economists provided the formula for computing VND interest rate:

\[ I_{VND} = I_{USD} + Z + Ae^2 \]

Whereas 
- \( I \) = Interest rate
- \( Z \) = USD Confidence index
- \( Ae \) = Local currency depreciation rate.

The computing results have shown that \( Z \) value is from 5% to 10%.

Compulsory reserve requirement is an important instrument to perform monetary policy. By doing so, the SBV is enabled to manage total payment
instruments through impact mechanism of credit volume and prices of the commercial banks. The compulsory reserve requirement rate are applicable to all commercial banks at 10-15%. While inflation is not under tight control, the SBV complete it under a flexible adjustment in the permitted framework.

Open market has been set up at the SBV and with various commercial banks in the areas of buying or selling valuable papers on the secondary market. State treasury bills were initial valuable papers in the market through auctions of state treasury bills, then the secondary market of repurchasing state treasury bills would be autonomously developed. The open market operations regulations have been promulgated by the SBV and the volume of money supply through market operation could be soon controlled.

Renovation of banking technology

In renovation of monetary policy, the banking technology has been highly appreciated during 1996-2001. Renovation of the banking technology have been focused on two aspects:

- A strong development of banking practices as the bases for fully operated services of the modern banks.

10 The policy is aimed at modern banking development:

At central bank: Develop new facilities as rediscounting, open market, guarantee, foreign exchange operation and electronic clearing payment system, this will enhance and underpin the central bank in macro monetary management in conformity with international formalities and Vietnam conditions.

At commercial banks: Central bank allows to develop all banking operations areas at the commercial banks. The following banking operations would be utilized largely in Vietnam commercial banking system:

- Credit and International settlement
- Guarantee, collateral, mortgage,
- Brokerage and investment,
- Leasing
- Foreign exchange operations
- Correspondent and trust banking,
- Whole sale banking and syndication,
- Securities brokerage.
- Other customers services as consultancy, foreign remittances, payment, fund transfer and saving etc.
- Development of a modern technical infrastructure base for international integration, firstly on settlement, accounting, information and management.

One of the standards that the banking system could integrate the international financial community is modern banking technology. Given the present conditions, banking technology can be modernized based on the achievements of information technology (IT), high configuration computers and international communication systems. The Vietnam banks have to solve this problem immediately by a banking modernization project. This is due to the fact that, in the absence of modern technologies, clearing and settlements in Vietnam is generally done manually. There are two clearing houses, one in Hanoi and one in Ho Chi Minh City, which service inter-bank clearing and payments inside each of the cities. Clearing house have two sessions a day (morning and afternoon) with complicated paperwork that requires the physical presence of bank officers.

The SBV is currently considering the future introduction of an electronic clearing system. Whilst the date has been set, at the start, the draft operating guidelines of the electronic inter-bank payment system are in limited circulation and indicate a network of clearing centers in the major cities of Vietnam linked to one national clearing centre in Hanoi or Ho Chi Minh City. No decision appears to have been taken yet on network, low and high clearing holds or value dating.

Due to constraints of financial contribution, the banking modernization project would focus on investment of the SBV and several other large commercial banks in the initial period. The project supports to develop the technical bases for uniform electronic payment system with security and punctuality. The project is also aiming at an open system so as to make other members to connect on an on-line system in the later stage and develop other banking products and services in an uniform system.

After completion of modern technical base, big banks of Vietnam can definitely perform domestic payments (internal and inter-bank payments). The timing for payment will be shortened and the payment quality will be maintained safe and accurate. The commercial banks can control and adjust sensitively their capital and funding sources and the SBV becomes clearing payment center and controls actual monetary transactions.
The process of modernization and computerization will enable expansion of other banking operations such as risky preventive information, monetary market management, data bank and payment transaction for securities market and management information.

Management of the banking system has the following institutional organs:

**Board of Directors**: It has different names and functions, as typical feature of the Vietnam banking system.

**Board of management**: the headquarter and various departments can be either expanded or reduced according to the completion process of macro economic performance and the perfect of the market economy. Generally management regulation and the commercial banking system development requires the division of the departments into four groups:

- Policy making and Economic Research;
- Banking operations for policy performance;
- Logistics (maintaining material facilities and human resources);
- Supervision and inspection.

The subsidiaries and non bank financial institutions of the commercial banks are set up so that the commercial banks emerge as general banking development trend. A particular attention is made to the development of the rural credit institutions including: State owned commercial bank for agriculture, rural joint stock commercial bank, bank for the rural poor, credit cooperatives and people's credit funds for rural market shares and promotion of rural capital market.

In the urban areas and processing zones, the commercial banking system is adequate to service large customers, but it requires to develop banking products and services based on existing banking operations and strengthening the existing banks.
A further step to complete satisfactorily the existing financial company system, there will be newly establishment of financial companies in the production, business groups and of non bank financial institutions as well particularly investment funds, and foreign investment funds for the purpose of increasing volume of foreign capital and financial services.

In order to create bridging links for investment absorption, modern banking services development, banking staff training promotion, in conformity with existing management of the SBV, more foreign bank representative offices, foreign bank branches, foreign financial companies and foreign investment funds are allowed to open in Vietnam. The licence is granted for the high prestige banks that belong to the countries having good relations with Vietnam, more direct investment potential and quick disbursing assistance to Vietnam. And further, for those who are equipped with high technology, and good customer relations with Vietnam banks.

Joint venture banks are not additionally expanded for the time being, their new branches setting up can be considered in priority areas for the purpose of socio-economic development of the country.

**Banking staff training**

With the requirement to enhance the strategic view, diversifying new banking products and services in the modernization direction, balanced competitive environment, the banking staff training is an urgent task. This training is endeavored to

a) Training new employees, and retraining banking staff for updating their knowledge and advanced studies.

b) Training for additional knowledge to new recruited staff

c) Various Degree education: graduate and post graduate education for all banking operations and technology pursuant to job description and requirement.

d) Regular seminars: to update the knowledgeable awareness to the bankers.

e) Social awareness programs: to promote awareness of the social labor force and prepare the human resources for the banking sector.
For the purpose of training bank staff, Vietnam has regular and part time courses, long term and short term courses, direct and distant studies at the banking academy of Vietnam and at training centers of the commercial banks; domestic and foreign training and sector and non sector training. The course contents are generally macro economics, public management, banking operations and technology, business administration, informatics and foreign languages so as to match the banking renovation requirement.

**Inspection system of the SBV and commercial banks**

General inspection system plays an important role, it is not only supervision of internal financial activities, ware houses, property, bank notes printing etc. Regular inspection is to appraise functional performance of the departments, divisions and individuals and their responsibilities. At the same time, regular inspection can discover shortcomings in the regulations, mechanisms and overlapping in management, and cover the gaps and overlaps in functions and tasks among departments and divisions in the SBV system.

Strengthening internal supervision system, both oversight and off-site. At present, its impact is being seen not great, but offsite inspection does not function well and it is required to be strengthened and expanded for a tight and effective internal inspection.

The commercial banks and credit institutions in Vietnam are generally newly established, after a certain probation period, there appear many worrying signals, particularly, credit quality and informal overdue loans. The banking activities of the branches of foreign banks are not under a tight observation. These alarm signals place the inspection and supervision system under great and serious tasks and obligations. This is one of the main functions of the SBV and part of management function of the commercial banks and credit institutions. For the growth and security of the banking system, the inspection and supervision must create pressures for regular inspections among credit institutions.

**MEDIUM TERM PROSPECTS AND EXTERNAL FINANCING REQUIREMENTS.**
Vietnam's medium term outlook prospects hinge not only on what happens in Asia and the world but more importantly, on decisions made in Vietnam and impressive results since the introduction of a comprehensive program of adjustment and reform in 1989 which Vietnam has recorded.

The external situation improved in 2000 and beyond, especially in East Asia. The five East Asian "crisis countries" (Indonesia, the Philippines, Korea, Malaysia, Thailand) stabilized in 1999 and grew quite strongly in 2000 and beyond. Korea shows an exceptional recovery and China continue to be a stable economic anchor in the region with relatively high growth rate. The high-income economies of Singapore and Taiwan have performed strongly. It is, however, important to recognize that the strength and speed of this East Asian recovery remain uncertain, it depend on whether reforms in the crisis countries are sustained, and growth in Europe, America and Japan remains robust.

Fundamental to the medium outlook is the extent to which Vietnam adopts an accelerated reform program. Though the pace has picked up recently and efforts to develop detailed reform plans are nearing completion that is unlikely to be adequate to prevent continued slow growth. It is certainly insufficient to reverse the worsening perceptions of investors about Vietnam, given their current difficulties. Agricultural growth may be buoyant. In any case, faster growth of non-farm activities is key to future rural growth, and that will be unlikely without a credit announcement of the accelerated three-year reform program in trade, state enterprises, banking and in private investment regulations, that has been performed by ministries and agencies over the past year.

Since introduction of reforms in the economic sector, Vietnam has adopted a cautious economic stance, giving priority to ensuring macroeconomic stability rather than taking risks for higher growth. However, growth has been strong since then, except in some recent years, economic growth was slow down due to negative impact of regional financial crisis. Vietnam succeeded in avoiding a serious balance-of-payment, fiscal or banking crisis. It also succeeded in implementing gradual reform of trade and private investment regulations, in initiating reform of state enterprises and banks and in doing a lot of preparatory work to develop a detailed program of reform in banking, state enterprises and trade.
Notwithstanding this record of success, which can compare only with China's among the transitional economies, complacency would be misplaced, as Vietnam is only at the beginning of its road to sustaining high, labor intensive and broad based growth in order to eliminate poverty.

While Vietnam moves to consolidate the economic gains brought about by economic reform, the concern of policy makers turns to the questions of how to sustain this economic performance in the future. For the medium term, the government plans a GDP growth rate of 8 to 9 percent per year. It will be a challenge for Vietnam to achieve this target, and prudent management of the economy as well as further deepening of policy reforms will be required.

Meeting this challenge will require achieving three main goals. First investment efficiency has to remain high. Second, domestic savings must grow. Third, sufficient foreign resources must be mobilized and used effectively. In the projections to 2003, total investment rises from about 24.2 percent of GDP in 1994 to about 28 percent, and during the same period domestic savings grows from 17 percent to 22 percent. Filling the remaining gap will require steady inflows of foreign direct Investment (FDI) and Official development Aid (ODA).

Private domestic and foreign investment is expected to represent the largest and most dynamic component of aggregate investment. The public investment program is projected to increase from about 7 percent of GDP to 9 percent, while this increase is not large; it is consistent with the likely availability of reliable and stable sources of ODA. The government is expected to contribute significantly to the increase in domestic savings. Since the scope for further increase in the shares of revenues in GDP is limited, public savings will need to come from expenditure restraint, which can only be implemented through careful setting of priorities in public spending.

While domestic saving is expected to be the primary source of financing for investment, a steady inflow of foreign savings will be necessary to sustain rapid growth. FDI inflows have already become an important source of financing, and their role is expected to increase in the near future. FDI inflows in 2001 are in fact estimated at 500 US$ million. ODA inflows are also accelerating, and projected at 500 US$ million in 2001 and in the coming years FDI and ODA are projected to increase higher and this is a
good opportunity for Vietnam to seek quick-disbursing funds from bilateral and multilateral sources to cover financing requirement.

The government should sustain the progress already achieved in FDI and ODA mobilization by focusing its efforts on accelerating the implementation of ODA financed projects that have already been approved, as well as improving the environment for FDI after amended foreign investment law. The government has signaled its keen interest in attracting FDI not only in industry, agriculture but also infrastructure and is also developing the regulatory framework for Build-Operate-Transfer arrangements.

Vietnam will continue to need financial resources for projects in economic and social infrastructure in the years to come. These projects require substantial gestation periods to translate in actual disbursement and implementation. Additional commitments for these projects will thus be needed soon, to provide funds for 2002 and beyond. A level of about 2.5 US$ has been committed by the donors to build up disbursements of about 1.5 US$ billion by 2003.

The projections do not envisage an increase in sovereign commercial borrowing over the next five years. Although some commercial loans have been obtained in the past few years, increasing commercial borrowing or issuing sovereign bonds would be premature, owing to the high costs that would be incurred and the resulting high debt service burden on fiscal balances. Borrowing costs would in fact be very high, since Vietnam’s creditworthiness remains to be established as shown by remaining commercial arrears as well as aggregate risks of lending to Vietnam are perceived internationally to be high, owing to the early stage of development, uncertainty associated with the regulatory framework and the need to establish a longer record in macroeconomic stability.

Prospects in the coming years are dependent not only on what happened in Southeast Asia but also in Vietnam. If the government is slow in approval of three-year reform program developed by ministries, and concern agencies then the reform cost will be greater and growth will continue to be slow. The perceptions of potential investors as well as current producers and exporters will not improve. Even foreign investment that in the pipeline may wait and watch. Moreover, SOEs will continue to get loss and make more aggregate non performing loans at banks, worsening banks’ asset quality and re-capitalization. This also increases the cost of reform. At least, there are two main reasons for support. First, the SOEs, trade and banking reforms would
stem the costs. These are the costs related to the debt restructure of the State Owned Enterprises, refunding to the banks and assistance to the unemployed labor as covered by the State budget. These costs would be increased and higher in the successive years of the reform. A considerable amount is spent for SOEs and banking reforms, although it is small as compared with the cost of other countries in the region. Total cost would be about 8-10 percent GDP and regular annual expenditure is about 1 percent GDP. Capital cost stemmed from buy back of problem loans of state owned enterprises and refunding to the banks, in which, mainly state owned commercial banks, would be covered periodically during 3 years upon liquidation, ownership transfer and equitization of the state owned enterprises and refunding of the commercial banks. Regular cost includes interest and fees associated with fund raising under the form of bond issuance and indeed, the subsidy for the quantity of annual surplus labor from state owned enterprises. Secondly, more foreign currency is required for import activities in the 3 coming years and for corresponding reflection of the suppliers to the reform program.

It is conceivable that Vietnam will adopt slow reform program and not announce a major shift in the pace of reform. There is, however, a serious risk that continuing a slow reform program that is not time bound, would lead to a more permanent low growth path. A slow reform strategy may also make it more difficult to sustain the reforms. Under the current pace of reform, public revenue as a share of GDP is likely to stay depressed, and possibly fall further, making it difficult for the government to finance the costs of banking and SOE reform.

In the absence of clear and firm direction in reform of banks and state enterprises, trade and private investment, Vietnam cannot benefit fully from the strong regional recovery that is underway. Vietnam could be beneficiary from the East Asian Recovery, provided Vietnam adopted accelerated reform. Nevertheless, Vietnam, at present, could be a country of slow growth in the region.

On this background, agricultural growth would be the main one for Vietnam economic growth in the medium term. Public industrial and service sectors, foreign investment and small and medium private sector would be slow. Slow reform alternative would result in GDP growth rate at the levels of 3.5 percent in 2001 and 3 percent beyond respectively. On the other hand, accelerated reform alternative would shift perceptions in favor of Vietnam. Existing investors and exporters will consider expansion to avail of new export markets and opportunities. This will permit relatively high annual export growth rates. But the strength and speed of East Asian
recovery remain uncertain so export growth rate is also somehow uncertain. However, the alternative would create a higher growth rate as compared with the slow reform one. Particularly, the growth rate would be 6 percent in 2001 and 7 percent in 2002 due to positive impact of the private sector in the accelerated reform process. Both investment and export would be recovered in these two years.

Table 4.4. Growth Projection under Accelerated Reform

<table>
<thead>
<tr>
<th>Items</th>
<th>1998</th>
<th>1999</th>
<th>2000 (estimate)</th>
<th>2001 (projected)</th>
<th>2002 (projected)</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP Growth (%)</td>
<td>4.0</td>
<td>4.2</td>
<td>4.8</td>
<td>5.5-6.5</td>
<td>6.0-7.0</td>
</tr>
<tr>
<td>Agriculture</td>
<td>2.8</td>
<td>4.9</td>
<td>3.5</td>
<td>3.5</td>
<td>3.5</td>
</tr>
<tr>
<td>Industry</td>
<td>7.0</td>
<td>5.8</td>
<td>6.6</td>
<td>9.0-9.8</td>
<td>8.8-10.0</td>
</tr>
<tr>
<td>Services</td>
<td>2.0</td>
<td>1.6</td>
<td>3.3</td>
<td>5.1-6.7</td>
<td>4.9-6.3</td>
</tr>
</tbody>
</table>

Source: WB Estimates

External Financing Under Accelerated Reform

In order to finance the inputs required to sustain the growth rates presented in table 4.4, there will a need for External Financing of around $2.5 billion per year under accelerated reform. This requirement will be met by a combination of foreign investment inflows, disbursements from previously committed ODA and from new commitments of quick-disbursing ODA.

Foreign Investment inflows and disbursements of committed ODA will together cover around four-fifths of the financing requirements. Since foreign investment flows have fallen precipitously in 1998, 1999 and then again in 2000, higher FDI flows are likely only if the government acts to improve the situation significantly. Announcing and implementing its three-year reform program, the implementing of the Vietnam-US trade agreement, together with approvals of energy FDI projects in the pipeline, would promote higher FDI
flows. However, it would not be judicious to assume that higher foreign investment flows would reach 1995-1997 levels, anytime soon. With the pipeline of committed but un-disbursed ODA standing at round $6 billion, growth in ODA disbursements of around 10 percent a year is not unrealistic. But this would still require significant improvements in Government's project implementation arrangements.

Table 4.5. External Financing Sources Under Accelerated Reform (US$ billion)

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total finance</td>
<td>2.20</td>
<td>2.53</td>
<td>2.92</td>
</tr>
<tr>
<td>Official Aids</td>
<td>0.18</td>
<td>0.18</td>
<td>0.18</td>
</tr>
<tr>
<td>ODA Disbursement</td>
<td>0.87</td>
<td>1.00</td>
<td>1.10</td>
</tr>
<tr>
<td>Direct Foreign investment</td>
<td>0.75</td>
<td>0.85</td>
<td>1.03</td>
</tr>
<tr>
<td>Capital Deficit</td>
<td>0.40</td>
<td>0.45</td>
<td>0.65</td>
</tr>
</tbody>
</table>

Source: WB Estimates

Quick Disbursing Assistance:

In 1999, donors committed quick-disbursing of $500 million but only $200 million has been committed under the Miyazawa initiative. If the government announces the adoption of the three-year accelerated reform program, additional quick-disbursing assistance to support those reforms will be warranted for at least two reasons. First, the reforms themselves - SOEs, trade and banking reform - will have significant fiscal costs. The costs of SOE-debt restructuring, bank re-capitalization and of labor redundancy will have to be funded through the budget. These costs are likely to rise with time, being higher in outer years as reform proceed. Second, additional foreign exchange will have to be made available for needed imports. If there is to be an adequate response to the reforms over the coming years. Both these reasons
argue for strong donor support in the provision of this type of assistance. The WB, the IMF, and the ADB have been in discussions with the government on the form of this financing package. Japan has already committed an initial amount of quick-disbursing assistance under the Miyazawa plan, and is considering additional financing packages. Other donors are considering such funding too.

The donor community has been playing an important role in Vietnam for the past one decade. Evidence to date has shown that ODA has been largely effective in Vietnam, both because rehabilitation of infrastructure and earlier reforms conducive to the effective use of ODA. It is expected that donors will continue this role over the coming years, in close partnership with the government of Vietnam, the NGO community and the private sectors.

Principally, Vietnam medium term growth is dependent on Vietnam’s multi-sector economy, where the small, medium and large private enterprises could develop and compete in a level playing field as State owned enterprises.