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Unplugging Institutional Bottlenecks to Restore Growth

A Policy Discussion Paper Prepared for the

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This paper has been prepared for the fourth annual Vietnam Executive Leadership Program (VELP), to be held at the Harvard Kennedy School from August 26 to 30, 2013. The goal of this paper is to provide participants in the VELP forum, including Vietnamese government officials, international scholars, and corporate executives, with an assessment of some of the key public policy challenges confronting Vietnam today. This paper is by no means comprehensive; by necessity, it has not been possible to undertake an exhaustive study of every policy area. In selecting which issues to address, the authors¹ have been guided by the priorities of the Vietnamese government as they have been articulated in policy statements promulgated over the past year. By design, it is a work in progress, not a finished paper. Over the five days of VELP 2013 the authors hope that the analysis contained in this paper will be debated, challenged, and, strengthened. It is hoped that this paper will serve as a catalyst for informed discussion and debate both among VELP participants and among the larger policy community in Vietnam.

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“To place administrative procedure reform requirements right in the process of institutional development, learn from practical experiences and enhance discussions between the State and businesses and the people; increase democracy, foster the role of independent consulting organization and individuals in institutional development, develop national standards in administrative procedures; significantly reduce existing administrative requirements. To disclose standards and administrative regulations so that implementation can be supervised by the people. To increase transparency and accountability in public service.”

Communist Party of Vietnam,
Socio-economic Development Strategies 2011-2020
Resolution of the 11th Party National Congress²

“Institutions are the most important element to effectively distribute and utilize all resources, stabilize the macro-economy and achieve a sustainable growth. High-quality institutions, coupled with simple, open and transparent administrative procedures and a high sense of responsibility, will forge a favorable environment for investment and business activities, preventing corruption and prodigality and significantly contributing to the improvement of the economy’s aggregate competitiveness.”

Prime Minister Nguyen Tan Dung
*Resolutely Overcome Weaknesses, Face Challenges, Restrain Inflation,
and Continue Growth for Sustainable Development*
2013 New Year Message³

Part I. Introduction

A. Institutions as drivers of prosperity

Acemoglu and Robinson end one of the chapters in their famous book, *Why Nations Fail?* by the refrain, “*Institutions, institutions, institutions,*” with a clear message that growth, prosperity, harmonious society, democracy and progress can be explained by looking at each society’s institutions. Therefore, the key to achieving prosperity is through institutional reform.

While the emphasis has varied at different points in time, “institutional reform” has always been a concern of the Party and the Government for three decades since Doi moi began. Developing market economy institutions, perfecting state management, and improving the effectiveness of the rule of law are objectives that have been confirmed in political documents of the Party, and most recently were identified, collectively, as one of the three breakthroughs at the Party’s Eleventh National Congress. In the executive branch, the Government also prioritizes institutional development. In the Government’s agenda for the 2011-2016 term, the comprehensive administrative reform program for the period of 2011-

² Communist Party of Vietnam Online Newspaper
http://123.30.190.43:8080/tiengviet/tulieuvankien/vankiendang/details.asp?topic=191&subtopic=8&leader_topic=989&id=B T531160686

³ Online Newspaper of the Government, New Year Message 2013 <http://baodientu.chinhphu.vn/Home/Thong-diep-dau-nam-moi-cua-Thu-tuong-Nguyen-Tan-Dung/20131/158212.vgp>

2020, the above abstract from the 2013 New Year Message by the Prime Minister also emphasizes institutional development as a priority.⁴ This is compatible with the Legislative Agenda until 2016 of the Thirteenth National Congress, which clearly identifies institutional reform as a priority. The most important of these institutions are the 1992 Constitutional Amendment, and consequently the amendment of laws on state organization, including the Law on the Organization of the Government, Local Government Organization Law, People's Court Law, State Budget Law, Public Investment Law and other state management areas.

Vietnam's efforts and determination in institutional reform are completely in line with global trends, and therefore have received support from the international community, donors and investors. Vietnam's credibility and attractiveness to international investors depends on successfully developing the rule of law, consistent administration, transparency, reliability, and a legal system, that are compatible with international common practices and standards.

In order to maintain stability and achieve sustainable growth, there is a consensus among Vietnamese senior leadership and society that institutional reform must be prioritized. However, this is easier said than done. After three decades of reform, shortcomings in economic and social management, from macroeconomic stabilization, stagnation prevention, and public debt control, to daily concerns such as congestion, overcrowded hospitals, low quality schools, and traffic accidents, originate from poor quality institutions.

In short, the position of this report can be expressed as follows: poor quality institutions are the underlying cause of economic instability and stagnation. Current economic, political and social risks can be explained by the much delayed and often inadequate institutional reforms of the past. To restore high growth, this report advocates taking advantage of the opportunities in institutional reform to provide more economic and political power to the people.

B. About this paper

This document is intended to provide context for the policy discussions that will take place during the fourth annual Vietnam Executive Leadership Program (VELP). By design, it is a work in progress, not a finished paper. Over the five days of VELP 2013, it is hoped that the analysis contained in this paper will be debated, challenged, and strengthened. Following VELP, the authors will draw upon these discussions to produce a final draft that will be submitted to the government.

Vietnam's economy is going through a period of the lowest growth since *Doi moi*, almost as low as the period following the regional financial crisis in 1997-1998. Part of the reason certainly has to do with problems in the European and North American economies. But the main reason for Vietnam's slow growth lies in problems in three of the four engines for

⁴ Resolution No.30c/NQ-CP dated November 08, 2010 by the Government promulgating the Master Program on State Administration Reform in the 2011-2020 period, amended by Resolution No. 76/NQ-CP dated June 13, 2013.

Vietnam's growth. The four engines for growth are the state-owned enterprise sector (SOE), the domestic private sector, the agricultural sector, and the foreign direct investment sector (FDI). In the early years of the century, FDI and the domestic private sector started to rapidly grow and agriculture was also doing well. The SOE sector, though performing poorly, was compensated for by the others' success. However, since general companies were converted into economic corporations, fundamental weaknesses of the SOE sector have been exposed, especially as a consequence of domestic macroeconomic instability and the global economic crisis. This has resulted in the collapse of a number of economic corporations, fully revealing the SOE sector's inefficiency, and has also contributed to the already existing problems in the banking system. A weakened banking sector has in turn negatively affected the performance of two other domestic growth engines, the private and the agricultural sector. The banks have also lent heavily for real estate development that is suffering from a collapsing bubble and poorly conceived projects. The only engine that continues to perform well is the FDI sector, mostly because it is not entirely dependent on the domestic institutional system and has been able to reap the benefits from the fact that labor intensive industries have begun to leave China due to wage increases there.

This report consists of eight parts. Following the introduction, Part II discusses the state economic sector and identifies the causes of collapse, stagnation, and weakness from an institutional reform perspective. Part III looks at the private sector, especially in terms of the fragmentation and inefficiency of the market-supporting institutions. Part IV discusses achievements and difficulties in the agricultural sector. Part V assesses the foreign direct investment sector, including its achievements and weaknesses as seen from an institutional perspective. Part VI offers an evaluation of the commercial banking sector and discusses institutional solutions for a healthy system. Part VII provides three options for restructuring the economy and suggests necessary institutional reforms. Part VIII summarizes the institutional problems analyzed in the previous sections and recommends priorities to enhance institutional reform toward a modern and effective state management.

Part II. State Economic Sector

The State owned enterprise sector (SOE) plays a central role in Vietnam's economic development strategies. The Government expects the sector to be a pillar of the economy; to realize its leading role; to be the material force for the State to orient, regulate, and stabilize the macroeconomy; to improve competitiveness and business efficiency; and to accomplish social responsibilities and ensure social welfare.⁵ In fact, until the end of the 1990s, when the private sector was unleashed after years of being restrained, it made sense that the Government chose the SOE sector to play the central role in the economy and be the key driver of growth. However, over the past dozen years, with the continuous expansion and development of the private sector since the Enterprise Law 1999 was enacted and the US – Vietnam Bilateral Trade Agreement (2001) was signed, the role of the SOE sector has been reduced (Table 1).

Table 1. Ratio of State Sector with non-State and FDI sector 2000-2012 (%)

Comparison Criteria	State Sector			Non-State Sector			FDI Sector		
	2000	2005	2012	2000	2005	2012	2000	2005	2012
Investment Capital	59.1	47.1	37.8	22.9	38.0	38.9	18.0	14.9	23.3
GDP	38.5	38.4	32.6	48.2	45.6	49.3	13.3	16.0	18.1
Budget (excluding oil)	65.1	52.0	43.5	15.7	25.4	27.0	19.2	22.6	29.6
Jobs	59.1	32.7	14.7	29.4	47.8	61.8	11.5	19.6	23.6
Industrial Production Value	34.2	25.1	18.4	24.6	31.2	38.4	41.3	43.7	43.3

Note: 2012 numbers are estimated. Job statistics are from 2000, 2005, and 2011.

Source: Calculated from statistics by the General Statistics Office, Ministry of Finance, and the International Monetary Fund

Table 1 shows that among all expenditures, from investment capital and GDP to budget, jobs, and industrial production value, the contribution ratio of the state sector has dropped significantly over the past 12 years. The fundamental reason for such a decrease is that the performance of the state economic sector has been much lower than the private sector and continues to trend downward.⁶ In other words, the performance and the role of the SOE sector is decreasing in comparison to the private sector, and at the same time, the contribution of the SOE sector to the economy is completely disproportionate to the favors and resources that this sector enjoys.

Why is the SOE sector playing both a weakening role in the economy and as an engine of growth? As suggested in this report's thesis, the underlying cause of such a situation lies in the institutional system.

In Vietnam, to manifest the characteristics of "socialism," the state economy, whose pillar is the SOEs, is chosen by the Party and the Government to play the leading role. In order to

⁵ Decision No.929/QĐ-TTg dated 17/7/2012 adopting Project "Restructure of State-owned Enterprises, Focusing on State Economic Groups and Corporations in the Period of 2011 – 2015."

⁶ According to Bui Trinh's research, State owned sector's ICOR increased from 6.9 in the 2000-2005 period to 9.7 in 2006-2010, while the private sector's in these two periods were 2.9 and 4.0 respectively.

accomplish such a role, SOEs operate in key areas of the economy with on such a large scale that they crowd out other economic sectors. This results in the following serious consequences.

First, as the government's designated leaders, SOEs do not need to compete to be the "winners," at least within the domestic market.⁷ Furthermore, international experience has shown that government "picking the winners" policies often lead to failures.⁸

Second, sizable SOEs – state-owned groups and corporations – inherently enjoy a monopolistic status in key or requisite areas and operate as market commander-in-chief in any markets in which they participate. According to the Ministry of Industry and Trade's Economic Concentration Report (2012), state-owned groups are the market commander-in-chief in key areas and industries of the economy. Specifically, state-owned groups hold monopolistic or controlling positions in oil and gas, coal and minerals, transport infrastructure, airline, railroad, and electricity.

Third, state-owned groups and corporations also control business rights and opportunities through related mechanisms and institutions, especially through the drafting and implementation of industry development plans and strategies, which, in most cases, are directly appointed by the Government and ministries to state-owned groups and corporations. Though initially unintended with such a mechanism, groups and corporations have unified industry development plans and strategies with their own plans and strategies.

Fourth, by transforming SOEs into groups and eventually sizable corporations, the State has not only favored them with many resources (especially land, capital, credits, public purchase contracts),⁹ but has also created an unfair field of competition, notably a legal framework and policies that discriminate against the private sector, especially domestic private enterprises. As a result, the private sector, which is more dynamic and efficient, has been crowded out and unable to develop its potential by the SOE sector with its monopolistic operation, capital, access to economic resources, and ability to participate in policy making.

Fifth, it is this preferential treatment in terms of role, status, and resources mentioned above, that has encouraged SOEs' passiveness, and even dependence. This, along with the inherent bureaucratic characteristics of the state system, has gradually diminished the activeness, creativity, and accountability of SOEs, leading to stagnation and inefficiency.

Sixth, when stagnating and ineffective SOEs play the leading role, the State has to pump in even more resources, in some cases to save SOEs that have gone or are on the verge of going bankrupt – a syndrome called the "soft budget constraint," in economic terms. In other words, these SOEs neither have to face harsh market discipline of profit and loss, nor have to face

⁷ Vinashin is an exception because it was forced to compete in the international market, and it was the international competition pressure that exposed all the fatal weaknesses of this corporation, bringing it to collapse as soon as the global economic crisis broke out.

⁸ See "Boulevard of Broken Dreams" by Josh Lerner, Harvard University.

⁹ State-owned groups and corporations also benefit from access to and close connections with government officials and leaders, including senior leaders.

state discipline. Burdens caused by the stagnating and inefficient SOE sector have in turn become budget and public debt burdens, of which the last bearer are tax payers and future generations of the country.

From a management perspective, the weaknesses of SOEs originate from the vague definitions of ownership rights. Although SOEs have been converted into companies, especially those entirely owned by the State that have been transformed into one member limited liability companies according to Decree No.25/2010/NĐ-CP, these companies are owned by the people who are represented by the State. Depending on the size of each SOE, the State's representative ownership rights are implemented through the SOE's members' council or the company presidents. The multi-level representative ownership mechanism and the formalistic ownership at each level create a seemingly unreachable distance between the ultimate owners and the representative owner. In addition, other short-comings in management, such as opaque information, lack of accountability, and limited participation of the public, have turned SOEs into "black boxes" in the people's perception. As a result, the ultimate owners – 90 million Vietnamese citizens – are unable to implement their rights as owners, and the real ownership rights, the control rights and residual rights toward SOEs' assets, are entirely in the hands of state agencies and its representative institutions.

How are state representative ownership rights implemented at SOEs? In fact, these rights are not implemented in a consistent manner but only disparately, even localistically. According to Tran Tien Cuong,¹⁰ "the representative ownership function of a SOE is done by several agencies, creating a vertical system (from the central to local governments) and a horizontal system (including several ministries, ministry-level agencies and Government agencies)." Specifically, until 2011, of the 1,309 SOEs that were entirely owned by the State, there were 101 agencies that acted as state representative owners and at the same time functioned as regulators and supervisors.¹¹ Because no agency takes full responsibility for state representative ownership, and the coordination mechanism is inconsistent and ineffective, state management is very weak.

In the SOE sector, representative ownership rights, state management authority, and business management are merged together, a phenomenon often known as "three in one" in the SOE management system. At the same time, there is not a clear separation within the state's management authority regarding the role of managing ministries, policy making agencies, and regulating agencies – another "three in one" phenomenon in the SOE management system.¹² Obviously these agencies have different objectives, functions, roles,

¹⁰ Tran Tien Cuong (2012). "SOE Management Division and Decentralization: Situation, Problems, Causes and Reform Recommendations." Fall 2012 Economic Forum Proceedings published by the National Assembly's Committee of Economy.

¹¹ The 101 agencies include 17 ministries, ministry-level agencies or Government agencies managing 355 enterprises; 63 cities and provinces managing 701 enterprises; 11 state owned economic groups managing 147 enterprises; and 10 corporation managing 106 enterprises. There is an addition of 7 agencies whose leaders are in the Steering Committee for Reform and Development of SOEs.

¹² Typical examples include (i) the Ministry of Health is responsible for policy making and management of medicines and medical equipment import. It is also the managing agency of many important pharmaceutical and medical equipment companies; (ii) the Ministry of Transport is responsible for managing and regulating civil aviation while it also manages the largest domestic airlines; (iii) the Ministry of Industry and Trade is responsible for policy making and ensure a level playing field for industrial and trading enterprises but it also manages monopolistic companies in electricity and oil.

responsibilities, and tools. A “three in one” mixture will certainly lead to overlap and confusion in these aspects, causing inconsistency and conflicts of interests, diminishing the effectiveness and power of the entire SOE management system.¹³ The end result has been the failure of several groups and corporations, including Vinashin, Vinalines and Song Da Corporation.

Conflicts of interests in regulation – for example when a managing ministry which also acts as a regulatory agency tries to protect its enterprises – are already dangerous; however, the risk is magnified when the protected enterprises are both inefficient and monopolistic. In Vietnam, such protection is often disguised through use of market mechanisms – specifically monopolistic SOEs are allowed to “set the price according to market conditions.” It should be noted that this market price mechanism only exists in a competitive environment, not in a monopolistic one. In other words, that monopolistic SOEs are allowed to set the “price according to market mechanism” is a reflection of the abuse of state authority to protect the interests of a minority of enterprises with consequences that are borne by the whole economy.

When SOEs are not forced to compete, and at the same time are not regulated and supervised by the state, i.e. they are exposed to neither market nor state discipline, the very least that can help restore efficiency is society’s supervision. However, with the current lack of information about SOEs, the society’s ability to supervise is very limited.

Table 2. Information collected from SOEs’ current website content

Corporation	Overview	News and Strategy	Business Result	Annual report or Financial Statements or Auditor Report	Important Decision/ Resolution of Member’s Council
Housing and Urban Development Corporation	✓	✗	✗	✗	✗
Song Da Corporation	✓	✓	✗	✗	✓
Vietnam Northern Food Corporation	✓	✓	✗	✗	✗
Vietnam Southern Food Corporation	✓	✗	✗	✗	✗
Vietnam Paper Corporation	✓	✗	✗	✗	✗
Vietnam National Coffee Corporation	✓	✗	✗	✗	✗
Vietnam Airlines Corporation	✓	✗	✗	✗	✗
Vietnam National Tobacco Corporation	✓	✗	✗	✗	✗
Vinalines Corporation	✓	✓	✗	✗	✓
Vietnam Railways	✓	✓	✗	✗	✓
Vietnam Steel Corporation	✓	✓	✓	✓	✓
Vietnam National Cement Corporation	✓	✓	✗	✗	✗
Vietnam Posts and Telecommunications Group	✓	✓	✗	✗	✗
Vietnam National coal – Mineral Industries Holding Corporation Limited	✓	✓	✗	✗	✗
Vietnam Oil and Gas Group	✓	✓	✗	✓	✗
Vietnam Electricity	✓	✓	✗	✗	✗
Vietnam National Textile and Garment Group	✓	✓	✗	✗	✗
Vietnam Rubber Group	✓	✓	✗	✓	✗
Bao Viet Holdings	✓	✓	✓	✓	✓
Viettel Group	✓	✓	✗	✓	✗
Vietnam National Chemical Group	✓	✓	✗	✗	✗
Vietnam Shipbuilding Industry Group	✓	✓	✗	✗	✗
Vietnam National Petroleum Group	✓	✓	✗	✓	✓

Source: World Bank (2013). “State Owned Enterprise Efficiency in Vietnam: How can information disclosure help get there?”

Recent research on the transparency of the SOE sector by the World Bank shows that most of the information regarding SOEs is for internal use. Moreover, the quality of such information

¹³ See Nguyen Dinh Cung: “Imposing the competitive market discipline to promote restructuring of state-owned enterprises.”

is very low. Normally SOEs do not provide information for the public, and if they do, the information provided is often out of date, unclear, and even inconsistent. Even for the largest SOEs groups and corporations which typically have the highest level of information disclosure among SOEs – information transparency is very low (Table 2), creating serious obstacles to the Government's management and regulation as well as to the supervision ability of the public and the people – the ultimate owners of these enterprises.

In conclusion, collapses, stagnation, and inefficiency of the SOE sector originate from the vague ownership rights, the failure to impose competitive pressure and market discipline on the sector, and favorable treatment and lack of discipline in state management and regulation. The weaknesses of the SOE sector not only cause an ineffective allocation of resources, but more importantly, encourage opposition to the urgent needs of the economic restructuring program. Clearly if the role, incentives, management and regulatory system in this sector are not changed, it is unlikely that the restructuring program will be successful.

Part III. Private Enterprise Sector

The private enterprise sector has gained dynamism since *Doi moi* began, especially after the turn of the century. This sector has played a significant role in growth and job creation. However, the domestic private economic sector has recently been shrinking with an alarming number of enterprises closing. In addition, there is a clear differentiation between those with close connections with banking institutions and the authorities and those of a smaller size with little access to economic resources.

Since joining the WTO, Vietnam has not made the most use of the opportunities available and has becoming increasingly vulnerable. The domestic private enterprise sector is facing the following challenges: *first*, ownership rights, while theoretically recognized, are inadequately implemented and protected; *second*, private firms do not have equal access to resources; *third*, the bureaucratic hurdles imposed by the state management system to enterprises have not been reduced; and *fourth*, market supporting institutions are either not present or do not perform effectively.

Ownership rights are recognized but inadequately protected

Property rights of enterprises in particular and of the people in general are recognized in many of Vietnam's laws. However, in effect, ownership rights, especially properties related to land, are not secure. State protection is still ineffective, in some cases enterprises' property rights are easily encroached without proper or effective protection from the state. For example, land use rights of enterprises can still be revoked to serve loosely defined goals such as economic development. The vague definitions must be clarified to properly protect the rights of land users, avoid the abuse of economic development goals to improperly seize the assets and land of enterprises and people. According to the PCI 2012 survey, 61% of the enterprise participants think that the stability of their land use rights is only average, meaning that a large number of enterprises are facing the risk of being evicted from their existing land. It should be noted that, according to PCI 2012, only 36% of the surveyed enterprises believe that they will be adequately compensated if their land is seized.¹⁴

In a context of weak institutions, connections with authorities have become the key to opportunities and success in doing business. Creating and maintaining a close contact with the authorities helps private enterprises protect their property rights and open up the possibility of acquiring economic and natural resources when carrying out projects. The inevitable result is that many enterprises spend considerable time and resources on developing such connections instead of focusing on creativity, improving their competitiveness, or improving their products. We call private firms with close connections with the authorities or with banks and financial institutions 'closely tied enterprises'. In fact, as analyzed below, connections provide closely tied enterprises with considerable competitive advantages in comparison with private enterprises that are unable to develop such connections.

¹⁴ VCCI (2013), Vietnam's Provincial Competitiveness Index 2012

Unfair access to resources

Unfair access to resources in the private enterprise sector is reflected in two ways: (i) unfairness between SOEs and private enterprises, and (ii) unfairness between closely tied enterprises and the rest. Among economic resources, land and credit are the most important resources. In addition to the state's monopolistic and supporting policies, preferential treatment or favors for SOEs, as presented in Part II, also include accessibility to land and capital resources. However, it should be acknowledged that the situation has recently been improved. Many enterprises in the private sector have been able to access large areas of land and the credit ratio for the private economic sector has taken up about two thirds of the whole economy's debts. This is a notable improvement.

Nevertheless, there exists another problem in terms of unfair access to resources among private enterprises. The total outstanding credit of the private sector (including FDI enterprises) currently accounts for about 80% of Vietnam's GDP. According to the World Bank's statistics, the credit to GDP ratio of Vietnam's non-state sector alone is already at a very high level.¹⁵ This means that access to credit is not much of a concern for the private sector in general. However, results from several surveys, especially those by Vietnam's Chamber of Trade and Industries (VCCI), indicate that difficulties in access to credit and land are major obstacles to small and medium sized enterprises (SME) in Vietnam. For example, inaccessibility to credit accounts for 21% of the reasons for recent SMEs' closure or withdrawal from the market.¹⁶ This was caused by a bias in resources allocation within the private enterprises sector. Closely tied enterprises with connections to or holding majority share in a number of commercial banks have access to large amounts of land and credit while other SMEs are unable to acquire such resources.

The next problem is that many private enterprises in fact have shares in or close connections with shareholding commercial banks, resulting in the risk in which banks are manipulated to serve as a capital raising tool so that these enterprises can make use of people's idle cash for speculation purposes.¹⁷ The current problems in Vietnam's economy come in part from such a biased resource allocation. After the efforts to restructure the banking system and resolve non-performing loans (in the 1999-2004 period), close connections between a number of enterprises and commercial banks have become a common practice. As analyzed in more detail in the following sections of this report, the current cross ownership structure among commercial banks has become a risk difficult to control, reducing the effectiveness of state supervision of the financial market. With their connection advantage, closely tied enterprises are able to acquire land for their real estate projects. A large amount of capital has been used

¹⁵ According to World Bank's development index, there are very few developing countries with total domestic credit to GDP ratio over 80%.

¹⁶ VBIS 2012, VCCI.

¹⁷ Notable in this period is Ngoc Thao Company and Nam Do Bank case. Tran Thi Hieu, Ngoc Thao Company's director, was able to manipulate and use most of the mobilized capital of Nam Do Bank in her business, leading to losses so serious that the bank was forced to shut down, not to mention other serious consequences <http://vnexpress.net/tin-tuc/phap-luat/vu-an-cong-ty-ngoc-thao-y-an-tu-hinh-hieu-bac-bo-de-nghi-tu-hinh-phuoc-cua-vks-1953182.html>

to speculate in real estate thanks to enterprises' controlling power over and connections with banks. This has created a real estate bubble that has had a negative impact on the economy.

In the current environment, many enterprises have moved from value added activities for the economy to speculation and commercial activities, especially in real estate businesses with high rates of return during the market upswing. When the bubble burst and the real estate market froze, large enterprises were stuck in a difficult situation, leading to an increase in bad debts in commercial banks, which threatened the stability of the financial system and seriously impacted economic growth. In other words, the biased resource allocation within the private enterprise sector has changed their behavior. Creativity and entrepreneurship are not nurtured. In fact, the current resource allocation mechanism has encouraged speculation and connection establishment activities, reducing transparency and creating unpredictable consequences for the economy and the society at large.

As elsewhere in the world, while it is inevitable that there are influences from different interest groups in the policy making and implementation process, the most feasible solution for such a situation is to create a level field of competition among enterprises in different economic sectors. Expecting enterprises to voluntarily give up inappropriate promotion of their special interests is unrealistic. Therefore, the Government should focus on creating institutions in which all enterprises can compete transparently and fairly both in production and business activities and in influencing and lobbying the policy making process. When "barriers" to participation are removed, enterprises will have to depend on their own capacity to acquire resources and market share. This will make it possible for enterprises to discipline each other. Even in competition, enterprises will be able to sit down together to make recommendations or "help" the Government design fairer playing rules.

Bureaucratic obstacles in the state management system

After the Enterprise Law was enacted in 1999, Vietnam's business environment has been improved substantially with the elimination of informal licenses and promotion of administrative reform. However, it seems that bureaucratic obstacles have been making their way back.¹⁸ Although it is thought by some experts to not comprehensively reflect the level of difficulties in Vietnam's private sector, the World Bank's Doing Business Report 2013 ranks Vietnam at 99th among 185 economies surveyed, a position that is average at best and has not improved for several years.¹⁹ VCCI's Provincial Competitiveness Index 2012 also points out that, public administration reform in business licensing has not been adequately improved either²⁰ with enterprises having to spend a large amount of time and money on unclear and inconsistent administrative procedure requirements of state management agencies.

Lack of effective market supporting institutions

¹⁸ <http://doanhnhan.vneconomy.vn/20101130015756103P0C5/cuoc-chien-voi-giay-phep-con-cat-xong-lai-moc.htm>

¹⁹ <http://www.thesaigontimes.vn/Home/doanhnghiep/quantri/85664/>

²⁰ VCCI (2012), Provincial Competitiveness Index, http://www.pcivietnam.org/reports_home.php

Private enterprises can only operate stably when contract law, contract enforcement, the legal framework and a secured transaction system are clear, dispute settlement mechanisms are reliable and supported by an unbiased judicial system that is able to make fair judgments that are enforced with reasonable time and costs expended. Surveys on the business environment by the World Bank and VCCI's provincial competitiveness index (PCI) both show that these institutions are still performing ineffectively. Excerpts from domestic newspapers indicate enterprises' perception on the quality and effectiveness of Vietnam's legal institutions measured by VCCI in 2012 as follow:

“PCI is expressed in the form of a pie chart that looks like a cake with convex and concave shapes within each indicator. In PCI 2012, the pies in most provinces have a deep concave corner at the “Legal Institutions” indicator. In the analysis, the research team evaluates this indicator as follows: Enterprises have less trust in the legal system to protect their land, assets and contracts. Enterprises are increasingly losing confidence that they can file a complaint when a state official pursues a wrong endeavor. Enterprises have become less confident and do not rely on the court to settle contract disputes... In plain language, enterprises are increasingly losing trust in justice.”²¹

When the legal institutions are ineffective and not trusted by enterprises, there is a phenomenon which Douglass North predicted many decades ago. For Vietnam, it can be expressed as follow: “With insecure property rights, poorly enforced laws, barriers to entry, and monopolistic restrictions, the profit-maximizing firms [in Vietnam's private sector] will tend to have short time horizons [and even “grab and run” behaviors] and little fixed capital, and will tend to be small scale. The most profitable businesses may be in trade, redistributive activities, or the black market [which allow speculation and rent-seeking practices]. Large firms with substantial fixed capital will exist only under the umbrella of government protection with subsidies, tariff protection, and payoffs to the polity - a mixture hardly conducive to productive efficiency.”²²

Especially, when the economy is going through a difficult time, a bankruptcy mechanism, also known as “creative destruction,” should be established in order for the market to purge ailing firms. In economic terms, bankruptcy is the process of reallocating resources from less efficient users to more efficient ones. This process is not going well in Vietnam. Because the bankruptcy law is not enforced in practice, tens of thousands of enterprises have announced closure, but few have been able to declare bankruptcy. Instead, they turned into zombies. Specifically, according to official statistics, during the period of 2008 - 2011, the court received only 636 applications for bankruptcy and only 45 cases were granted bankruptcy approval.²³ This is disproportionate to the nearly 30% of 600,000 zombie enterprises believed to have defaulted and suspended operations due to defaults.²⁴

²¹ Ho Chi Minh City's Law Newspaper 15/03/2013, <http://phapluattp.vn/20130315121030800p0c1014/vet-hom-tren-chiec-banh-pci.htm>

²² See Douglass North's “Institutions, institutional change and economic performance” published in 1990.

²³ <http://dantri.com.vn/kinh-doanh/luat-pha-san-muon-chet-cung-khong-xong-754193.htm>

²⁴ <http://m.doanhnhansaigon.vn/online/dien-dan-doanh-nhan/thoi-su/2013/07/1075690/khong-the-pha-san-theo-luat-dn-thanh-zombie/>

With the Bankruptcy Law failing to be enforced, creditors and debtors lack an effective mechanism to restructure debts, carry out recovery commitments, and reorganize business in a humane and orderly manner. Overdue loans from enterprises that have defaulted are spread to other enterprises, spreading the default disease, eliminating contract discipline, and eroding trust in partners. When the judicial system to resolve business disputes is ineffective, the informal foreclosure mechanism will immediately come into play. The wave of defaults coupled with opaque procedures in the private sector's doubtful debt settlement are a serious threat that can sweep away the achievements made in the private sector since the enactment of the Enterprise Law more than a decade ago.

In short, institutional weaknesses explain the biased development and risks leading to a series of collapses in the private sector in Vietnam. Many private firms achieved a spike in their growth rates thanks to commercial or speculative activities, especially in real estate. On the other hand, without connections, SMEs, crowded out not only by the SOE sector but also by closely tied private enterprises, are unable to carry out long-term investment in order to scale up to sizable firms. This explains why there are few sizeable private enterprises that can create highly competitive products or unique products with higher added value for the society. Thirty years of reform in Vietnam has certainly helped many entrepreneurs accumulate wealth but it has not created a generation of industrialists whose names and careers are tied with the formation and development of the national industry clusters. While FDI can provide some part of the industrial effort needed, it is both inadequate and undesirable to rely on them completely. Vietnam needs competitive private firms owned and run by Vietnamese. It has largely failed to develop them.

Part IV. Agriculture

Since Vietnam began its reforms, the agriculture sector (including agriculture, forestry, and aquaculture) has always made an important contribution to the country's socio-economic development. Aiming to produce highly competitive products for export, agricultural production has grown significantly thanks to rapid increases in productivity. From 2001 to 2009, agricultural labor productivity in Vietnam has grown at an average annual rate of 4.6 per cent, the highest among Southeast Asian countries.²⁵ A calculation of the total factor productivity (TFP) contribution to agricultural output growth shows a similar picture. As shown in Table 3, until the middle of the 2000s, TFP contributed almost 60% to the agricultural growth rate.

Table 3. Contributions of factors of production and TFP to agricultural GDP growth (percent)

Period	Labor	Tractor	Water pump	Fertilizer	Land	TFP
1996-2000	8.9	7.0	11.4	10.9	31.4	30.3
2001-2005	8.5	5.1	6.5	5.3	15.1	59.5

Source: Calculations of the Institute of Policy and Strategy for Agriculture and Rural Development (IPSARD) based on official data of the General Statistics Office's data.

The positive development of Vietnam's agriculture sector is often analyzed with respect to three important claims: productivity will continue to grow rapidly; agriculture and the rural economy will absorb redundant labor from other sectors during times of economic recession and act as a buffer for the whole economy; and agricultural resources are still abundant for production expansion. However, the reality of agricultural production over the last three years (2010-2012) shows that these claims may no longer hold true.

First, the potential for productivity growth is becoming more and more limited. Previously, the contributing factors to agricultural productivity growth included market reforms, investments in infrastructure, a switch to high value-added products with larger markets, and rising world prices of agricultural products.²⁶ Recently, these sources of growth have been weakening. Meanwhile, there is a lack of new sources for growth coming from ensuring permanent land ownership for agricultural production, from the states' providing public goods in terms of research and development in agriculture, and because incentives are lacking for the private sector, including farmers and firms, to invest long-term in agriculture.

Second, the agricultural economy can no longer operate as a safety net to absorb the lost labor from other sectors. In Vietnam, the official figures for unemployment rates are always

²⁵ Vietnam Program at Harvard Kennedy School and Fulbright Economics Teaching Program (2012), Structural Reforms for Growth, Equality, and National Sovereignty, Policy Discussion Paper preparing for Vietnam Executive Leadership Program (February 2012).

²⁶ OECD (2007), Economic Importance of Agriculture for Sustainable Development and Poverty Reduction: The Case Study of Vietnam, Paris.

surprisingly low, even lower than the natural unemployment rate. This rate is often used to demonstrate the role of the agricultural sector as an effective buffer for the employment shocks that come with rapid expansion and contraction.²⁷ However, the labor force that could no longer find jobs in the urban areas and industrial zones due to the recent macroeconomic instability have not returned to their rural hometowns like in previous periods of economic contraction. In the long term, with more land seizures, changes in land use, and decreases in arable land, these laborers returning to rural areas will no longer have agricultural land to work with. Moreover, many rural migrants are still holding the rights to land use but not cultivating the land, which leads to a decrease in land efficiency.²⁸ Therefore, even if laborers eventually return to their hometowns, the land cannot be utilized due to desertion and under-cultivation. In the short term, the stagnation of agricultural world prices, the decrease of domestic purchasing power²⁹ and the limits to rural credit access have created a situation that the media have called “the rural indigestion of excessive labor”.³⁰

Third, agricultural resources have been exhausted due to pollution and excessive exploitation. According to the Institute of Policy and Strategy for Agriculture and Rural Development (IPSARD), the wasteful use of land (which includes: the excessive use of land for industrial purposes, the low rate of coverage, excessive speculation and desertion of land, and excessive use of fertilizer and pesticides) has lowered the future supply of agricultural production. The area and quality of forests continue to decline.³¹ Groundwater is being dried up in the Mekong Delta and in the Central Highlands, and is also being polluted with seawater and wastes. Some researchers say that groundwater will fall to a “deadly level” in the Mekong Delta within the next 5 years. In the Central Highlands, the decrease in groundwater is reducing the amount of irrigable water for coffee and rubber production. The rapid expansion of agricultural production, shrimp farming and the necessary irrigation creates further issues for health, water supply for human use and for other industries.³²

The inability to solve the above challenges for agricultural production is due to existing problematic policies and institutions, particularly ambiguous land use rights, misdirected agricultural support policies, and excessive and indiscriminate industrialization in agricultural provinces.

The 2003 Land Law allows farmers to have the rights to use, transfer, rent, inherit, collateralize, gift and contribute land as capital. However, the limited duration of the lease of

²⁷ According to Vietnam General Statistical Office, unemployment rate in 2012 is 1.99%, of which the urban rate is 3.25% and the rural rate is 1.42%. The corresponding rates in 2011 is 2.22%, 3.60% and 1.60%.

²⁸ Đặng Kim Sơn (2011), Solving to the roots of the land problem: one of the priorities for economic reforms, report at the Spring Economic Forum 2012, National Assembly Council of Economic.

²⁹ According the Vietnam General Statistical Office, the prices of short-term plants have decreased 1.46%, long-term fruit plants decreased 2.64%, husbandry decreased 9.09%, aquaculture decreased 0.39% in the first 6 months of 2013 compared to this time in 2012.

³⁰ Nhịp cầu Đầu tư Magazine, The rural indigestion of excessive labor, January 12, 2009.

³¹ Đặng Kim Sơn (2011), Solving to the roots of the land problem: one of the priorities for economic reforms, report at the Spring Economic Forum 2012, National Assembly Council of Economic.

³² David Dapice (2011), The role of the state: Asian models for Vietnam, Policy Paper for UNDP and the Institute of Development Strategy, Ministry of Planning and Investment.

land use for annual crops, for aquaculture, and forestry has created ambiguity about who has the rights to use the land after the lease has expired. This uncertainty has decreased the incentives for households and private firms to invest long term in agriculture, reducing the value of agricultural land to a level much lower than other types of land, and has led to a situation of excessive exploitation during the lease. Vague land property rights also create inequality in access to and guarantee of these rights. Large areas of land are still under the control of large state-owned agricultural and forestry plantations, despite their low efficiency. According to IPSARD, even after arrangements and reforms, the total area under the control of large agricultural and forestry companies is still 4 million hectares in 2010, down from 4.6 million hectares in 2003.

Agricultural support programs (credit access, input factor access, logistics, marketing, post-harvest and manufacturing, and even rural cash transfers), in many cases, have been misdirected and have not served farmers. Those who benefited the most from these programs are the middle organizations. Aside from the problems resulting from policy implementation, institutionally these programs were designed to transfer resources from the state to those who can provide input factors and/or consume outputs to help farmers. The default design of these policies is that resources are transferred to a few large organizations (to save on costs), and then re-distributed to households and individual farmers. However according to ground level reports, the benefits of these programs have not reached the farmers who directly work on the farms.

Policies supporting industrialization that are based on the criteria of raising the ratio of the industrial component to total GDP by building massive industrial and economic zones have led to a situation where agriculture has been sacrificed to serve the process of industrialization and urbanization. Commentators have often warned against the massive construction of industrial zones, especially economic zones of large sizes that are disconnected from the national infrastructure, that are not based on regional comparative advantages, and that do not have supporting backward and forward linkages. There has been no sign, especially from the regional governments, of reducing the sizes of the industrial and economic zones. Even if the current planning is feasible, there is no evidence of a determination to focus this investment on building industrial clusters and supporting agriculture.

Another problem is the tendency to massively develop new urban zones. In a favorable economic environment, developing urban areas ahead of economic activities is a reasonable idea. But it is not if capital is being invested in new urban areas with “too modern” criteria, while the more practical needs such as low cost housing and social infrastructure for the working class are not met, except in very large cosmopolitan areas. Even for many regions that attracted many large-sized industrial investments, they are often capital intensive investments in energy and heavy industries, so the population pressure in existing urban areas is not large. Therefore, public investment for technical and social infrastructure to

support agricultural and rural economic activities in these areas are still among the top priorities.

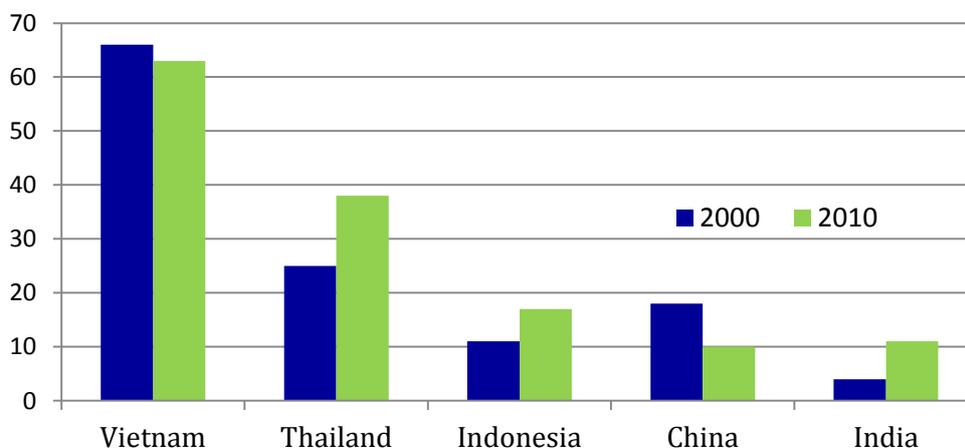
Part V. Foreign Direct Investment Sector

As a result of market oriented and international integration reforms, the private sector and the foreign-direct investment (FDI) sector experienced high growth rates up until 2008. The growth rate of the FDI sector reached a peak of 14 percent in 2006, while that of the private sector peaked at 9 percent in 2008.³³

However since macroeconomic instability began in 2008, the performances of these two sectors have diverged significantly. As analyzed in the previous sections, private enterprises are now facing their biggest challenge since the Enterprise Law came into effect, as illustrated by the contraction of production, reduction in investments, layoffs, and closures. Large private corporations currently are highly leveraged, while small and medium firms have limited access to credits and other necessary resources.

Meanwhile, the FDI sector is still growing rapidly. New FDI capital resources are still pouring into Vietnam and existing FDI firms are continuing to expand their businesses. Figure 1 shows that even though FDI disbursement is smaller than in the years following WTO accession, the ratio of FDI stock to GDP in Vietnam is still the highest among Asian economies.

Figure 1: Stock of FDI to GDP, Selected Asian Nations in 2000 & 2010 (percent)



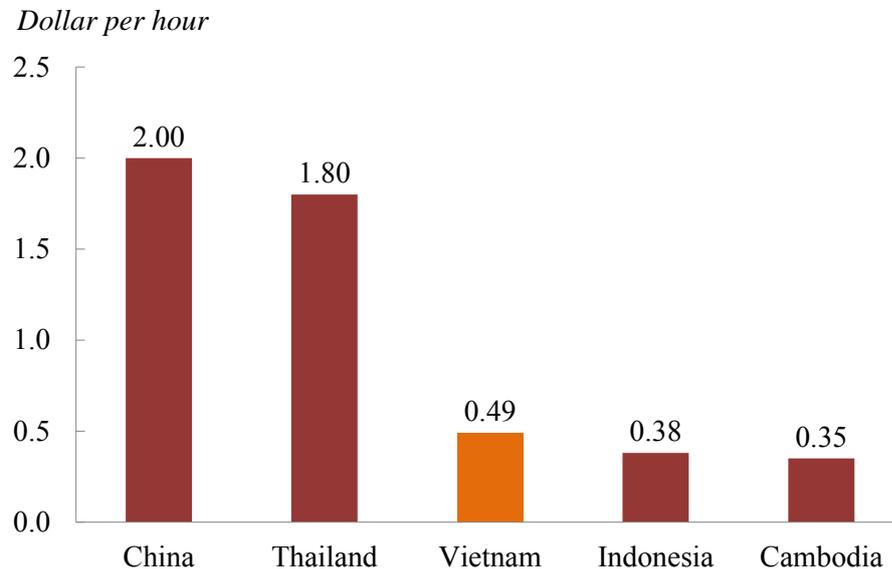
Source: UNCTAD (2011), World Investment Report for FDI and World Bank for GDP (nominal values).

With the current situation in Northeast and Southeast Asia, Vietnam is still an attractive destination for FDI. Labor intensive manufacturing activities have begun to leave China as China's wages increase. Wages in China have increased at an annual rate of 10% between 2000 and 2005, and 19% between 2005 and 2010, and are expected to increase rapidly, reaching 17% from 2010 to 2015. Firms with China-based manufacturing factories are now diversifying their production process by moving to countries with lower labor costs. While

³³ Vietnam General Statistical Office, Statistical Yearbooks, selected years.

the industrial wages in China are estimated to be about \$2/hour, that number in Vietnam, Indonesia and Cambodia, is \$0.49, \$0.38 and \$0.35 per hour, respectively (see Figure 2).³⁴

Figure 2. Fully loaded factory-worker wages



Source: Boston Consulting Group (2011).

The diversification strategies of foreign investors, known as “China Plus One,” have promoted the manufacturing industries throughout Southeast Asia. According to Boston Consulting Group (2011), “there has already been a significant transfer of work in apparel, footwear, sporting goods, and other labor-intensive products to South and Southeast Asia”³⁵. In this sense, Vietnam’s private-sector competitiveness looks relatively strong. According to Deloitte’s Global Manufacturing Competitiveness Report (2013), Vietnam will become the tenth most competitive economy in the world for manufactures within the next five years, ahead of neighbor countries such as Indonesia, Malaysia and Thailand (see Table 4).

Table 4. Manufacturing competitiveness ranking by Deloitte

Current		Five years	
Rank	Country	Rank	Country
1	China	1	China
5	Korea	6	Korea
6	Taiwan	7	Taiwan
9	Singapore	9	Singapore
11	Thailand	10	Vietnam
13	Malaysia	11	Indonesia
17	Indonesia	14	Malaysia
18	Vietnam	15	Thailand

Source: Deloitte (2013).

³⁴ “Made in America, Again: Why Manufacturing Will Return to the U.S.,” Boston Consulting Group, August 2011.

³⁵ *Ibid.*

The significant contribution of FDI firms are in export activities. The ratio of exports from FDI firms over total national exports has increased from 30% in 1996 to 47% in 2000, 57% in 2005 and 63,1% in 2012.³⁶ Table 5 shows that in 2012 and 2013, export performance of the FDI sector and the domestic sector in Vietnam shows a sharp difference. While domestic firms have had almost no export growth in 2012 and the first 7 months of 2013, FDI firms have had strong growth in exports, even higher than in the early 2000s.

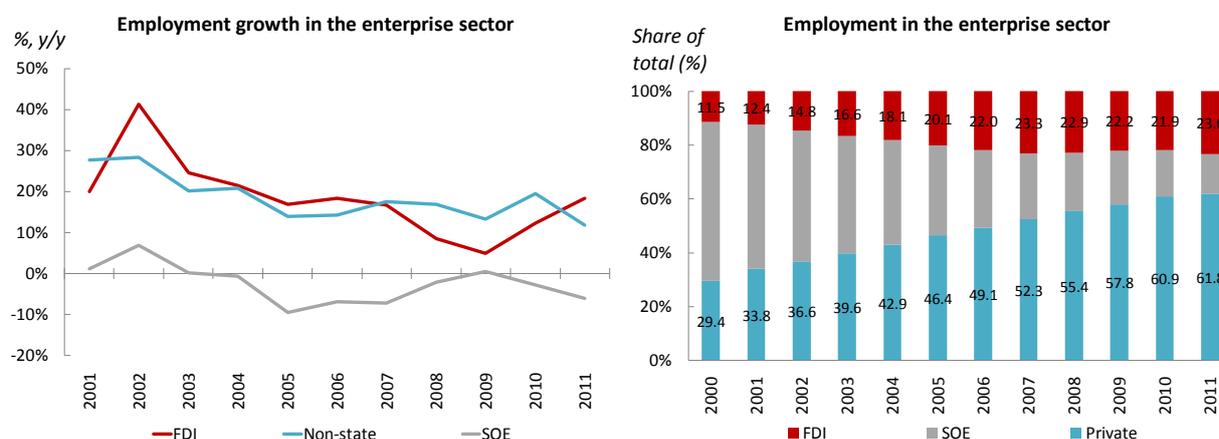
Table 5. Vietnam's Export Growth

	Total exports	Domestic sector	FDI sector including crude oil	FDI excluding crude oil
2012	18.3%	1.3%	31.2%	33.5%
7 months in 2013	14.3%	1.6%	22.0%	26.3%

Source: Vietnam General Statistical Office.

This divergence is repeated when we compare job creation between domestic firms and foreign firms.³⁷ Before the 2005 Enterprise Law, job creation in the foreign sector had increased faster than that of the domestic sector. After the law was passed, the domestic private sector increased its labor recruitment at a faster rate than the foreign sector (especially in 2007 and 2008). However, looking at the whole economy after the domestic macroeconomic instability, we see that the foreign sector currently has a higher rate of job creation while job creation in domestic firms is slowing down.

Figure 3. Employment in the Enterprise Sector



Source: Vietnam General Statistical Office, Statistical Yearbooks of various years.

In summary, facing a weak global economy and a structurally problematic domestic economy, domestic firms in Vietnam are still struggling while FDI firms are continuing to grow. From a policy perspective, macroeconomic instability, high interest rates, and limited access to resources have negatively impacted domestic firms, while FDI firms have somehow

³⁶ Vietnam General Statistical Office, Statistical Yearbooks of selected years.

³⁷ Data on employment from Figure 3 and Table 2 are different, because Figure 3 only include enterprise employment. Data in Table 2 include household employment and state employment, which is not included in the enterprise sector.

avoided these shocks. However, from an institutional perspective, the important factor here is that FDI firms, although established in Vietnam to make use of the cheap labor, resources, and some policy advantages, are still relying on external institutions to operate their businesses and production. The legal system that manages contractual relationships, the business administration, and linkages of production are all foreign based. Credit is provided mostly from international financial institutions, or Vietnam institutions with foreign capital. FDI firms have side stepped most of Vietnam's institutions, which are considered to have inhibited the business activities of domestic firms.

Therefore, together with the absence of domestic supporting industries, FDI firm's reliance on external institutions and avoidance of Vietnamese institutions explains why FDI firms in Vietnam are not deeply rooted in the national economy. In other words, they do not have strong incentives to develop linkages with domestic producers or help domestic supporting firms becoming part of their global supply chains. As long as Vietnam fails to develop effective market-supporting institutions which foreign investors can rely on to expand their business activities, the current manufacturing process of low value added products based on imported inputs and domestic assembly will continue.

Part VI. Commercial banks

One of the most stressful issues for commercial banks (CBs) are non-performing loans (NPLs) and the allocation of resources to efficient economic activities in a troubled economy. Some solutions are underway, but appear to not yet be effective. This section shows that cross ownership has neutralized safe banking regulations, creating problems for commercial banks and generating even more NPLs, and both market-based and state-based solutions to restructure the commercial bank sector and to resolve the NPLs are experiencing difficulties.

Cross ownership neutralizes safe banking regulations

Systematic NPLs often occur after a credit expansion when the economy is booming and safe regulations are absent or neutralized. Since 2006, Vietnam has experienced both problems. The year 2006 was the beginning of a second wave of new bank establishments (after the first wave in 1990). Ten rural CBs were transformed into urban CBs and 4 new CBs were set up. The scale of credit to GDP in Vietnam exhibited an even more impressive rise from 20 per cent in the late 1990s to 136 per cent by the end of 2010, reaching a level as high as China's and Thailand's, and much higher than other countries' in the region. This expansion of credit resulted from an excessive loosening of monetary policy. Even after a "strong" anti-inflationary monetary tightening in 2008, credit booms occurred again in 2009 and 2010. International experience has repeatedly shown that loose monetary policy together with weak banking management leads to a weak banking system.

Notably, the period between 2006-2011 was a time when both the legal framework and banking supervision processes were continuously reformed. Existing regulations on CBs' safe banking practices have covered all aspects of supervision of capital monitoring, credit limits, limits on equity investments and contributions, solvency ratios, loan classification and qualification, and risk provision.

However, banks, and investors can easily neutralize all regulations on banking safety, even if these regulations conform to international standards. Most notably, this policy neutralization in many cases, was technically legal, but went against the purpose of the regulations. The most pervasive method of neutralization is cross ownership, including state-owned enterprises (SOEs) owning joint-stock commercial banks (JSCBs), banks owning enterprises, banks owning banks, big investors owning banks, non-financial enterprises, joint-stock financial investment firms, and stock firms.³⁸ The following six issues are the consequences of cross ownership.

First, cross ownership neutralizes the regulations on CBs' charter capital. Decree 141 requires CBs to have a legal capital of VND3000 billion. Many banks met this

³⁸ VELP Policy Paper (2012) details this cross ownership structure.

requirement before the deadline, but there are still some banks, especially rural CBs, that lack the required capital. The simplest way for these banks to increase their capital is to make loans to their affiliated firms, so that these firms can buy shares from banks which are owned by the lending bank. Inadvertently, the debtor becomes a bank shareholder. A typical case is Saigon Commercial Bank (SCB) who loaned out to Van Thinh Phat and affiliated firms, then Van Thinh Phat and these other firms used the borrowed money to jointly invest in Tin Nghia Bank (TNB) and Ficombank (FCB). In terms of ownership structure, all three banks, SCB, FCB, TNB and Van Thinh Phat belonged to the same owner, therefore all regulations on pricing and supervision of lending and borrowing activities were avoided.

Second, cross ownership neutralizes the regulations on the capital adequacy ratio (CAR). Most banks have a CAR higher than the minimum 9% required by the State Bank of Vietnam (SBV), except Agribank between the years 2009-2011. In particular, some banks have an ideal but unrealistically high CAR, such as 54.92% in 2010 by Gia Dinh Bank, 37.3% in 2010 by Mekong Bank, or even SCB before the 2009 merger also reached a CAR of 50.2%. In reality, these were all weak banks. Cross ownership also helps banks to miscalculate their “risky assets”, and therefore artificially increase their CAR. According to current regulations, assets are grouped into various risk categories with the risk factor of up to 250%. In reality, many banks have loaned out a significant amount to invest in stocks and real estate through their subordinate and affiliated firms. However, cross ownership makes it hard to evaluate the end purposes of these loans, and therefore accurately classify them by risk. In the presence of cross ownership, CAR, a criteria strictly imposed by international banking standards, no longer reflects the real safety of bank capital.

Third, cross ownership neutralizes regulations on credit limits. Current law requires that the total loan balance to a particular customer must not exceed 15% of the bank equity, and the maximum loan balance to a connected customer group must not exceed 25% of the bank equity. This 25% figure is considered too large relative to banks' equity, and cannot guarantee diversification in lending activities. To avoid this regulation, an individual can set up multiple firms to borrow from a bank, and then legally increase its credit limit from 15% to 25%. Moreover, previously, the definition of credit did not include corporate bond investment, so instead of traditional lending activities, many banks extended credit to firms that operate in securities businesses which they controlled, and increased their loan balance to a very high level. For instance, in 2011, LienVietPostBank not only advanced VND1.961 billion in cash to Him Lam, but also bought VND250 billion in corporate bonds from Him Lam, increasing their loan balance from one single borrower to 33.54% of their bank equity, far exceeding the 15% requirement of the SBV.

Fourth, cross ownership neutralizes the regulations that separate the investment and commercial activities of a bank. The financial crisis in the United States in 1929 – 1933, and especially the 2007-2008 subprime mortgage crisis showed the danger of integrating investment and commercial activities within a bank. In Vietnam, the current law does not allow CBs to directly engage in stock investments, but it allows them to set up stock firms

for indirect investments. The law forbids banks to provide credit to their affiliated firms, and make non-guaranteed loans for stock investments. However, the law does not restrict banks from making loans for stock investments to other borrowers, and only limits the total loan balance of discounted stock to not exceed 20% of the bank's charter capital, except in some special cases.³⁹ An example of this situation is the case of ACB in 2010. ACB, with 19.52% shares in DaiABank, invested VND1,000 billion in DaiABank's bonds and thereby DaiABank was able to pour back VND700 billion into ACB Securities company (which was entirely owned by ACB) through holding the bonds issued by ACBS.

Fifth, cross ownership neutralizes the limits on equity investments and contributions. Current regulations do not allow banks to use capital from debt financing, only charter capital for equity investment and contributions. Moreover the ratio of equity investment and contributions cannot exceed 11% of the charter capital of the beneficiary. The law also specifies that the total maximum equity investments and contribution of a bank in all of its affiliated firms cannot exceed 25% of the bank's charter capital and reserves. However, through bond investments and direct or indirect investment trust activities with affiliated firms, the banks can still control other firms, projects, or even other banks. An example is MaritimeBank, which only has 10.2% share of capital at Mekong Development Bank (MDB), but through its affiliate the Tin Phat Fund, it holds 18.5% of the shares at MDB – and so MaritimeBank can still easily control MDB.

Sixth, cross ownership neutralizes the regulations on credit quality reporting and risk provision. Accurate calculations of NPLs, and more importantly, making NPLs more transparent, is a necessary requirement to improve the accountability of the bank's management board in front of supervising authorities and investors, especially minority shareholders. However, many banks have established Asset Management Companies (AMCs), but with very limited roles, mostly to help banks "polish" their balance sheets. Through these AMCs, the banks can manipulate the regulations through trust activities with AMCs to collect debts. These debt collection trust services help the banks to conceal their NPLs in the balance sheets, and replace them with a seemingly unrelated item, NPLs receivables. This situation of cross ownership also help banks to relax their regulations and evaluation criteria when monitoring their loans, which encourages debt rollovers, and inaccurate evaluations of credit quality. Banks can convert their NPLs into assets through a transfer of the NPLs to their subordinate or affiliated firms. Since the NPLs are hidden, risk provision becomes inaccurate, which in turn helps bank owners avoid profit and dividend losses. The risks, however, remain upon the shoulders of depositors.

In short, the situation of cross ownership has helped a small group of investors or firm owners to own one or many banks in particular, and financial organizations in general. These owners have turned the financial organizations under their control into private tools to

³⁹ See Item 10, Decree 13/2010/TT-NHNN, specifying the bank safety regulations for financial institutions.

mobilize capital and speculate in different assets, or create mergers and acquisition deals that contaminate markets. This increases overall risk and reduces transparency and accountability.

The problematic solutions to re-structure commercial banks

Although NPLs in a banking system may not lead to a systematic collapse, they are a burden for banks, and also a burden on firms forcing them to cut down on all business activities to pay back these loans, while at the same time new firms have no access to credit. As seen in the previous analysis of SOEs, domestic private firms and the agriculture sector, *in the short term*, the weakness of the banking system is the main factor leading to the slow growth of these sectors.

Decree 254 of the Prime Minister on restructuring the banking system proposed many solutions to solve the problems of NPLs. It is said that every international experience on solving NPLs has been included in this Decree. This is a foundation for the SBV to perform different strategies, but it did not make clear the order of priorities. In general, there are two main directions to resolve NPLs: market-based solution and state-based solution. However, both directions have shown inherent problems.

First, market-based solutions to re-structure weak banks increases the seriousness and complication of the cross ownership situation.

Until the asset management company was founded, efforts to re-structure the banking system focused on helping weak banks without using the state's budget. First, weak banks must re-structure if the existing shareholders can increase their capital. If this is not possible, the re-structuring process must involve outside investors through some transactions, mergers or acquisitions. Lastly, if both of the above solutions are not available, the state will dictate which outside organization would join the re-structuring process for weak banks.

Without employing state funds, this restructuring strategy would only be successful if money could be mobilized from the private sector (both domestically and internationally). If there is no money from the private sector, but the transactions, mergers and acquisitions must still take place, then some types of shadow money from the private sector must come into play. This means that re-structuring the weak banks will exacerbate the seriousness and complication of the current cross ownership situation. Essentially, in the absence of state and private funds, cross ownership is necessary for the restructuring of the banking system.

Since 2012, the SBV has identified 9 weak banks to focus on resolving their NPL problems. The main solutions are through transactions or mergers and acquisitions, while some banks are re-structuring on their own. Eight of these nine banks have been restructured, or listed to be re-structured, while one bank still remained with no restructure activity. This means that the restructuring process is taking place at a much slower pace than expected. This result not only reduces the effectiveness of the restructuring process of these banks, but also drags

down the entire banking system. More importantly, the way banks are being restructured currently has accidentally encouraged the use of cross ownership to handle weak banks. So, instead of re-structuring to solve the liquidity issues of weak banks, the current solutions are reinforcing cross ownership by letting new corporations invest in these banks. By letting some of the big investors with financial capacity participate in this investment, the short-term benefit might resolve some liquidity issues, but in the long term, problems from cross ownership will arise again.

New investors are expected to have strong financial capacity to pump more clean cash into the troubled banks, which would solve their liquidity problems at least temporarily. However, in this unfavorable economic condition and high NPLs, this so-called “clean cash” has to be reconsidered. If the financial capacity is not transparent, the risk of cross ownership will be reinforced and the connected groups will take this opportunity to make use of loosely designed re-structuring projects. In other words, by letting new investors take part in the re-structuring process without adherence to the principle of reducing dominant ownership or cross-ownership, it would be hard to have sustainable solutions to the current problems of the banking system. Changing current players with similar ones will not help solve the core problems of the game.

The situation is made clear by looking at the situation of weak banks that have been re-structured. First, consider the merger of three banks SCB, TNB and FCB. Because these three banks share the same owner, the merger would not solve their NPLs and other problems. In reality, the financial conditions of these banks have not improved, and there is no improvements created by this merger. Combining weak reeds does not create a steel beam.

Similarly, the liquidity problems of banks such as Tien Phong Bank (TPB) and Dai Tin Bank (TrustBank) are the opening for new investors such as DOJI or Thien Thanh to participate in the banking system and become strategic partners. According to DOJI, joining with TPB, DOJI and their potential shareholders has supported TPB financially, and provided charter capital for TBP to reach a level of VND5,550 billion in order to solve the short-term problems of TPB.⁴⁰ However, DOJI did not hide their intention to turn TPB into a financial gateway for DOJI affiliated firms.⁴¹ Additionally, while the SBV is trying to help the banks become less exposed to gold, the participation of DOJI – a gold and jewelry corporation – has the potential to increase TPB’s exposure to gold when DOJI brings in more gold transaction activities to TPB. A similar problem is seen in Thien Thanh’s case when the corporation, a strategic partner believed by many to possess strong financial and management capacity, became a strategic shareholder of TrustBank. However, while financial resources are a different story, one should be careful in assessing this corporation’s management capacity, particularly its banking management. Clearly this corporation also owns several firms in different sectors and therefore the risk for TrustBank to become Thien Thanh’s “financial gateway” is hard to avoid, as in the case of DOJI and TPB.

⁴⁰ See <http://doji.vn/he-thong-tap-doan/cong-ty-lien-ket-gop-von/ngan-hang-tmcp-tien-phong/>

⁴¹ See <http://thebusiness.vn/Home/Article/2036/Do-Minh-Phu---Ong-chu-Doji-va-ong-chu-moi-cua-Tienphong-Bank>

In the merger between HDBank and DaiABank, among the new members of the board of directors at DaiABank was Savico Holdings. Savico Holdings is also a founding member of Techcombank, VIB and Vietjet Air. Furthermore, the shareholders related to Savico are also holding many shares and important positions within HDBank. The merger between WesternBank and has PVFC recently created a different type of problem. While the law is trying to separate banking and non-banking activities, this merger has made their financial activities even more difficult to control.

These examples show that, the current methods of resolving the NPL problems are accidentally making cross ownership problems more serious. The mergers, reunification, or the participation of some new investors, even with financial capacity, but not much experience in banking management, will make it hard to improve the management capability of these banks. The model of one joint-stock commercial bank is a listed company. Therefore, the principle of using M&A is to ensure the post-M&A listing structure. The diversification characteristic of ownership must be expanded or narrowed down to the minimum, instead of just substituting one player for another, similar one.

Second, Vietnam Asset Management Company has no incentives to solve the NPLs quickly and transparently and will create incentives for the banks to conceal their debts and engage in more risky business activities.

With a charter capital of VND500 billion VAMC is an organization that focuses on solving the NPLs of established banks. This is much lower than the scale of the existing NPLs in financial organizations.⁴² However, this is just the buffer capital, the real capital to buy out the NPLs is created through issuing special bonds. The special character of these bonds is that they have no interest and a termination value of zero. Moreover, these bonds are not convertible in secondary markets. In other words, these bonds act as IOUs of VAMC, or more accurately, “bad debt receipts” issued by VAMC to keep track of the debts exchanged between banks. Therefore, instead of VAMC issuing normal bonds and using this source of money to buy out the banks’ debts, with these special bonds, there are absolutely no real financial resources being exchanged with the banks. This arrangement of special bonds is similar to what the State Bank of Malaysia applied after their financial crisis from 1998 until 2005.

The key problem is that VAMC does not have the capability (in finance or human capital), or the incentives to quickly resolve NPLs. According to their operation regulations, VAMC can buy the debts at the book values or market values, however, VAMC will first buy the debts at book values, but will not buy these debts completely. Instead, the banks continue to bear the burden of the NPLs by a risk provision of 20% applied continuously for 5 years. This

⁴² Official statistics by financial institutions show that bad debt rate by the end of 2012 was only at 4.08%, equivalent to VN150,000 billion while statistics from SBV’s supervisory agency as well as the SBV’s Governor show a rate of 9-10%, equivalent to VND310,000 billion. However, independent organizations estimate a rate of at least 15%.

regulation has discouraged many banks from selling their NPLs to VAMC, while the regulation requires that any bank with over 3% NPLs must sell to VAMC. The model of debt purchases according to the face value of VAMC is similar to Indonesia's model after the crisis in 1997, but is different from the successful KAMCO model of South Korea. KAMCO not only used real money to buy these debts, but also priced these debts according to a discount method using market principles. Because of this, KAMCO was pressured to sell off these debts quickly. VAMC does not have this incentive, nor the incentive to quickly resolve the NPLs effectively.

For the bonds issued by VAMC, the banks can use them to lend to the SBV at a discount rate, and so money can be indirectly pumped in from the state bank. This is different from the situation when VAMC directly issue bonds to the market, and then this source of capital is re-distributed among the players in the economy. However, the SBV's discount bonds can create concerns about the pressures on the money supply, and inflation. While the government is making efforts to stabilize the macroeconomy, increasing the money supply without adequate control can hamper the government's efforts. Another important aspect is that with these discounted bonds the SBV hopes to thaw the credit flows that have been recently frozen. The SBV also expects that these re-financed capital resources will make the banks more careful in their lending activities. However, although the NPLs have been sold, the banks still have to bear the costs, because they still have to pay for risk provision, and do not know whether or not their loans will be serviced because that now depend on the incentives of VAMC. Therefore, banks are left in a situation where they have nothing to lose. Moral hazard and adverse selection become apparent when the banks have to make decisions on how to use the re-financed capital, contrary to the expectations of the SBV. The banks will have the tendency to make even riskier loans in order to compensate for the aforementioned cost of managing their debts. By not putting real money into VAMC, the problems of bad loans are only put off, not solved.

The above analysis shows that the possibility of VAMC's debt management strategy to succeed is very limited. VAMC's function is designed mainly to serve as a "storage" temporarily holding the NPLs (for 5 years), without many incentives to rapidly resolve these debts, and even fewer incentives for VAMC to act for the benefits of these banks. This was also made clear in the recent speech by VAMC's leader, that after 5 years, even if VAMC cannot resolve all NPLs, the banks would have enough time to solve their basic financial problems, gathering resources for growth.⁴³ Besides, there is no criteria to evaluate the success of VAMC, and there is no time constraint for VAMC to commit to. From a banking perspective, because debts are not sold completely, the banks still have to pay for risk provision but do not have any active role in the management of these debts by VAMC, so they have no incentives to sell their NPLs to VAMC. The banks' incentives are to continue to conceal their NPLs and find ways to solve the problems internally. Meanwhile, the expectation of the SBV when VAMC was established was not only to resolve the NPLs, but

⁴³ Interview with the General Director of VAMC by reporter Hong Dung, *Đầu tư Chứng khoán Magazine*, accessed from <http://tinhanhchungkhoan.vn/GL/N/DJGDGA/dieu-kien-mua-ban-no-cua-vamc-khong-he-khat-khe.html>

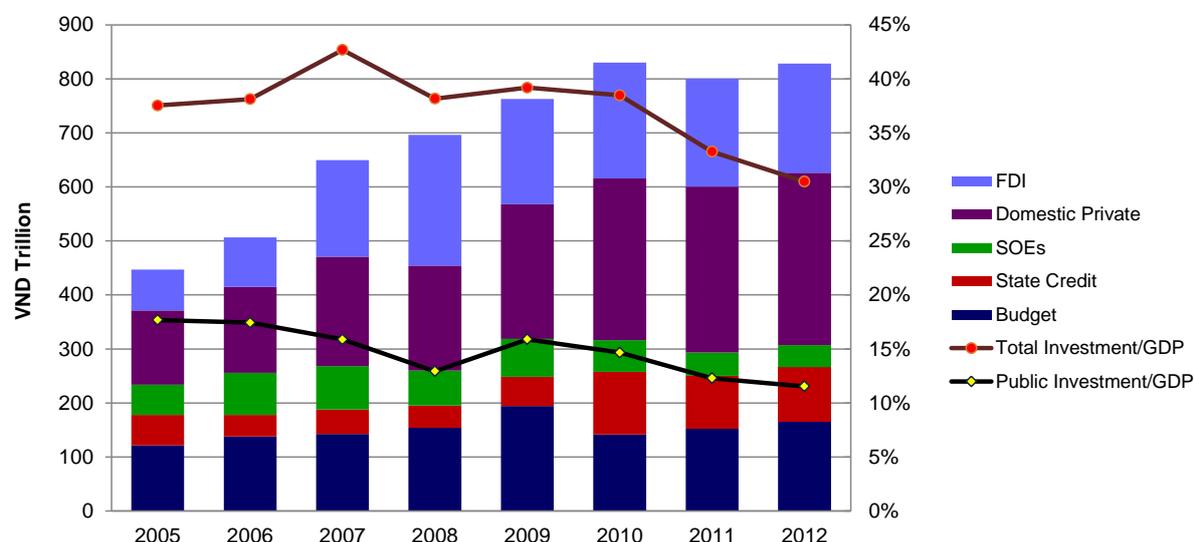
also to foster credit growth, restore and revitalize the entire economy. However, when the other problems of the banking system have not been solved, in particular the problem of cross ownership, together with the risks arising from an unstable macroeconomy, the above expectations can hardly be met. Even when credit flows smoothly, it is inevitable that the fear of newly formed NPLs will arise.

Part VII. Three Choices for Restructuring the Economy

A. Of four engines of growth, only one is at full strength

As analyzed in preceding sections, there are a number of reasons why Vietnam's economy has slowed to 5 percent a year or less recently and certainly the problems in the economies of the European Union and North America are a part of the explanation. But the core reason Vietnam has been slowing down is that the economy depends on four separate engines of growth, most of which at present are doing poorly. The four engines of growth are the state-owned enterprise sector, the domestic private sector, the small-holder agricultural sector, and the foreign direct investment sector. In the early years of this century, the FDI and domestic private sector were beginning to boom and agriculture was doing well. The state owned enterprises were not doing well but they were only one of the four growth engines. What has happened since, however, is that the performance of many of the state owned enterprises has worsened substantially and this has contributed in a major way to the problems of the banking system, and those banking problems have now dragged down the performance of both the domestic private sector and agriculture. Only the FDI sector continues to do well in large part because labor intensive FDI industries have begun moving out of China as wages there accelerate upward and because these enterprises are largely not affected by either the economic difficulties facing the Vietnamese economy or the weaknesses of Vietnamese institutions.

Figure 4. Investment: Sources of Financing and Relative Size to GDP (in 2010 constant prices)

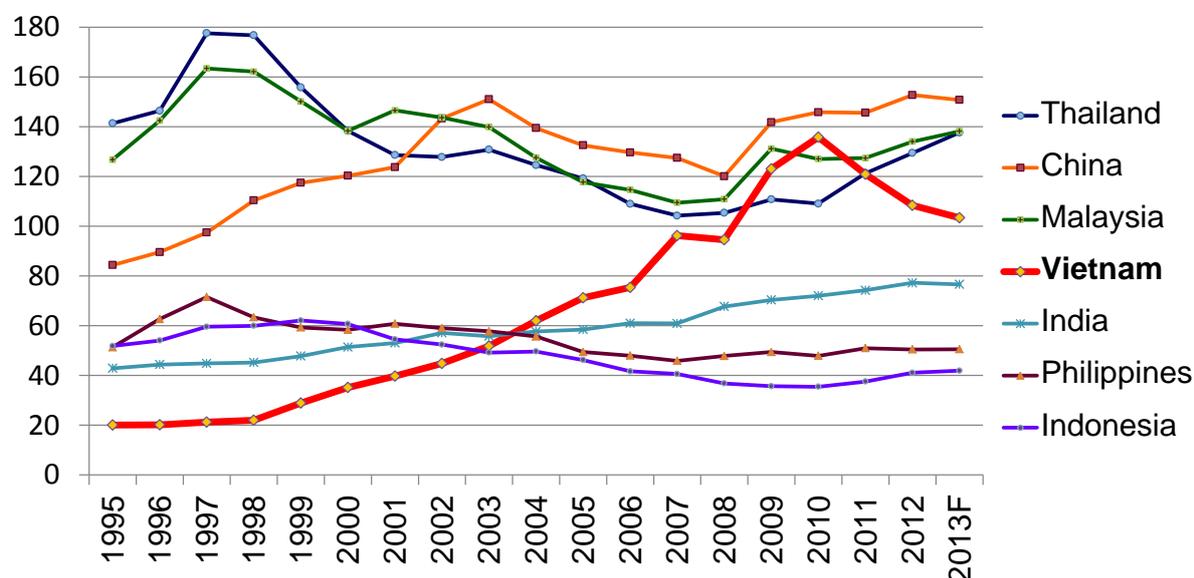


Source: General Statistics Office, Vietnam Statistical Yearbook, various years.

An important feature of the old growth model was that growth was investment led and investment was financed primarily by bank credit, but increasing inefficiency led to macroeconomic imbalance and a vicious circle of monetary and fiscal easing to spur growth. From a macroeconomic perspective, one of the government's efforts to restructure investment, enterprises, and banks has been the reduction in investment as a percentage of GDP from 30% during 2005-2010 to 33.3 percent in 2011 and 30.5 percent in 2012 (see

Figure 4). This change is in fact in accordance with the government's restructuring policy, which sets the target of maintaining macroeconomic balances so that total investment in the economy remains at 30-35 percent of GDP.⁴⁴

Figure 5. Bank Credit-to-GDP Ratio (%)



Source: Economist Intelligence Unit.

Along with this relative decline in investment is the reduction in credit in the economy. The percentage of bank credit to GDP has declined from a peak of 136 percent in 2010 to 121 percent in 2011 and 108 percent in 2012 (see Figure 5). International experience demonstrates that after a credit boom, all economies, whether they experienced a financial crisis or financial distress, must go through a process of deleveraging. From the macroeconomic perspective, deleveraging helped strengthen corporate balance sheets and improve financial ratios. In the context of restructuring, this is the road for companies to return to their core business in which they have competitive advantages. But from the macroeconomic perspective, deleveraging forces the corporate sector to reduce investment, therefore negatively impacting economic growth. Moreover, deleveraging can also increase the corporate financial distress, potentially leading to collapse and bankruptcy. As a result, in its efforts to restructure the economy, the government is confronted with a number of policy options.

B. Option One

Because of the macroeconomic concerns that stem from a slowing of economic growth, the first policy response by governments when economies enter a period of financial deleveraging and corporate distress is to attempt to reverse this trend. However, instead of urgently relaxing monetary and fiscal policy to increase credit and stimulate investment, the

⁴⁴ Prime Minister, "Decision approving the project to fundamentally restructure the economy while transitioning to a new growth model in order to enhance quality, efficiency, and competitiveness during the period 2013-2020."

top policy priority still remains reducing inflation and maintaining macroeconomic stability. For this reason, the first policy option is to maintain the status quo with respect to major economic policies involving the banks, the state enterprises, the private sector and agriculture. To the extent possible, the government will implement specific policy packages addressing the difficulties of enterprises, and stimulating growth.

From the monetary perspective, the government's intervention is limited to special credit packages with the objective of restoring credit lines to specific groups of firms.⁴⁵ The total supply of money and credit will not increase significantly in order to keep inflation in the single digits. This is a prerequisite for reducing interest rates according to market signals rather than by administrative measures—the most important issue in the effort to address the difficulties of firms.

From the fiscal perspective, reducing the taxation burden, including the corporate income tax, the VAT, and land use fees is the preferred choice as a rescue for firms and a stimulus. However, to avoid returning to a large budget imbalance at a time when revenues are down due to a slowdown in growth, these policies can only be temporary measures, postponing tax obligations, with the exception of reducing the corporate income tax rate. The most effective tool for stimulating consumer demand and reducing firm stocks is to reduce the VAT but this tax is the biggest source of revenue for the government budget and is working effectively. Reducing the corporate income tax will help those firms that are profitable, but will not impact those operating at a loss.

With respect to investment, this option envisions using administrative interventions to accelerate the implementation of hard and soft infrastructure projects funded by the budget, government bonds, and ODA. The hope here is that an increase in state spending will make up for the decline of enterprise investment.

The first option thus would simply continue the current situation which at best will maintain the present level of growth but there will be the real possibility that the situation will steadily get worse. The biggest single problem is the state owned enterprises, but the problem of these enterprises goes beyond their own well publicized problems of which Vinashin and Vinalines are the most extreme examples. These enterprises are also using their political power to squeeze out the private sector in a variety of fields that have not historically involved state enterprises. The bad loans accumulated by the many poorly performing state enterprises have also made a major contribution to the current weakness (insolvency would not be too strong a word) of most of the banking system. That weakness in turn has effectively made it nearly impossible for the domestic private sector and agriculture to get credit from the banking system, credit needed both to grow and to start new businesses.

To maintain the status quo with respect to major economic policies involving the banks, the state enterprises, the private sector and agriculture are likely to produce a GDP growth rate in Vietnam of 3 or 4 percent a year and there is a real danger that the rate could go even lower.

⁴⁵ The 30 trillion VND credit for social housing falls in this category.

One factor influencing the success of this option, in particular the GDP growth rate in the near term, is the rapid recovery of the global economy. But even with this outcome, policy option one will amount to a return of the economy to the old growth model of investment led growth financed by credit. The evidence presented in Figure 4 shows the investment from state credit grew the most and was at its relative and actual peak during the period 2010-12.

Option Two

The second option focuses the restructuring effort on the banking sector. This option rests on the assumption that the high rate of nonperforming loans and other weaknesses in the banking sector are the primary factors leading to slow growth in the corporate sectors (both SOEs and private firms) and the agricultural sector. This option envisions an incremental approach, and during the restructuring process, the state intervenes by increasing public sector debt to compensate for declining private sector debt. With a principle of not using real government resources, over the long term, financial institutions and nonfinancial enterprises will have to use their profits over many years to gradually pay down their debt instead of immediately selling assets.

The VAMC model is a part of option two. As has been analyzed, banks can use the VAMC to assume their non-performing loans (NPLs) in exchange for government-backed special bonds for five years. Even if the NPLs transferred to the VAMC are not addressed the banks can immediately reduce their NPLS ratio on their book to under 3 percent and use the special bonds to borrow from the State Bank of Vietnam (SBV). The policy objective is to relieve the banks of the NPL burden and encourage them to make fresh loans. While public debt will certainly increase, the government hopes that this mechanism will not cost the state any real resources as the banks are expected to make full loan loss provisions using their retained earnings and/or new capital contributions within five years.⁴⁶

Given the true size of the NPLs in the banks (most independent estimates are at least 15 percent of the total of outstanding loans), there is no question that the government will have to play a much larger role in correcting the problem. There are a great many ways of doing this without using real resources and many can seem quite technical and complex, but in essence all of them can be reduced to the government simply bailing out the banks through money printing.

One approach is for the government to use bank reserves or foreign currency reserves to make long-term recapitalizing loans or special loans to credit institutions. The fact that

⁴⁶ When China created four asset management companies to handle the bad debts of the banking system in the 1990s, one asset company for each of the big banks, it basically chose the first option of simply printing money and giving to the banks. The bad loans were taken off the banks' books at face value and placed in the asset management companies creating some very weak asset management companies but solving temporarily at least the banks non-performing loan problem. Now more than a decade later many financial institutions, notably those that have lent to local governments that now have RMB20 trillion in outstanding debt, are again accumulating bad debt.

reserves in the banking system at present exceed the required reserve level and foreign exchange reserves are high is the basis on which to proceed with this solution. The risk is a return to inflationary pressure and macroeconomic instability.

In order to create an incentive to address bad loans, banks would only be permitted to borrow special funds on the condition that they gradually reduce bad loans and use the borrowed funds to compensate for capital losses in the short term. Within three years the banks must mobilize new capital and any retained earnings to repay the special debt. Any joint-stock banks that lack the capacity to reduce bad loans through retained profits and cannot mobilize new capital (from existing or new shareholders) will immediately be taken over by the government in order to protect depositors.

In short, the second option mainly involves fixing some of the most obvious problems facing the Vietnamese economy today, notably the high level of non-performing loans in the banking system and the resulting near stagnation in the growth of the domestic private sector of the economy. This option could lead to a sustained growth rate of perhaps 5 to 6 percent a year. However, in the long term, these individual reforms will certainly not be sufficient to prevent a return of the current problems. This is because the banks learn that they can make overly risky or otherwise inappropriate (connected lending) loans in the future without paying a price for their mistakes. The result is in the future they are likely to take even bigger and more inappropriate risks. This creates what economists call “moral hazard”

Option Three

The third option involves a thoroughgoing structural and institutional reform of the major problems holding back Vietnam’s economy. These structural reforms would involve reforming the banking system and creating a favorable climate for the domestic private sector but they would also involve a major restructuring of the state owned enterprise sector, a restructuring that would end the current policies where the state owned sector threatens to drag down the rest of the economy as is to a degree happening today. The third option would also involve a major effort to reduce corruption or rent seeking and robust strengthening of institutions as will be described below. This thoroughgoing reform could produce a GDP growth rate of perhaps 8 to 9 percent a year.

In the banking sector, in contrast with option two, this option would require the state to use real resources to resolve non-performing loans. Real money, if not in the form of foreign borrowing, would have to come from the equitization and sale of some SOEs and the sale of stakes of equitized SOEs that are currently profitable. Assets associated with bad loans would be rapidly sold/liquidated in order to generate income. This can be considered the price to be paid for economic losses incurred in the recent past.⁴⁷

⁴⁷ Korea is an example of a country that undertook economic restructuring and resolved bad debt in this way and saw the dramatic resurgence of its enterprise sector in the years after 1997-98.

Using real money to restructure the banks must be accompanied by an effort to reduce cross ownership in the banking sector, which option two does not address. Liquidating bad loans that large shareholders borrowed from their own banks against their shareholdings as has been undertaken in a few recent instances is an effective approach to reduce cross shareholding and should be implemented more aggressively. After being permitted to borrow special funds to resolve bad loans, the banks will have to repay the loans to the state using real money derived from increases in their capital in a manner that maintains the ownership diversity of a publicly-traded joint-stock bank. Joint-stock banks with high levels of bad debt that cannot raise new capital within three years will be taken over by the state. Taken over means that the state assumes the role of bank owner but does not buy ownership from the existing shareholders. Existing shareholders have the option of contributing additional capital or losing their equity. After stepping in, the state will use budget resources to directly resolve bad debts. Using the bridge bank mechanism, the state will sell the cleaned-up banks to new investors, eliminating any cross shareholding.

In option three, restructuring the banking sector will be accompanied by restructuring of the state owned enterprise sector. First off, it will be necessary to undertake *a fundamental reassessment of the role of the state* in relation to the economy and the SOE sector in relation to the other sectors of the economy. Clearly, after a quarter century since the launch of *Doi moi*, the Vietnamese economy has completely changed; perhaps most importantly the economy has become very open and the ownership structure has changed fundamentally. Driven by the explosive growth of the domestic private sector and the strong participation of the FDI sector, the private sector now accounts for nearly 70 percent of GDP. This means it is no longer possible to use the “old operating system” in which the SOE sector plays the leading role, in a new economy. Therefore, the state must redefine its role, and must strictly adhere to the principle that the state should only do what the private sector does not want or cannot do. At the same time, it must be understood that the market is an institution independent of and parallel to the state and is not subservient to and subject to the dictate of the state, though subject to some regulation. Only on the basis of a clear “division of labor” between state and market can the state decide what it can and cannot do.

Reassess the role of the state-owned enterprise sector. The government frequently claims that SOEs are a tool by which the government can manage the macroeconomy, maintain economic stability, and ensure social protection. However, from theoretical and practical perspectives, this justification is groundless. From the theoretical perspective, in a market economy, macroeconomic management and economic stability are achieved through monetary, fiscal, and structural policy. SOEs are market actors like all other firms; they are affected by, but are not tools of, macroeconomic management policies. Naturally some will argue that as an important part of the economy, SOEs have an important role in curbing inflation. However, actual data provides no evidence to support this assertion.⁴⁸ Moreover, the use of SOEs as a tool to manage prices comes with a high price. First, SOEs occupy a

⁴⁸ See discussions of rice and gasoline prices in Vietnam in the policy discussion paper series of the Vietnam Program and the Fulbright Economics Teaching Program.

monopolistic or near monopolistic position, without competitive pressure and therefore are inefficient. Second, prices are distorted, leading to inefficient distribution of resources. Moreover, in many cases, following a period of price restraint, prices frequently spike, creating shocks for the economy. Third, to anchor prices in order to curb inflation, SOEs will either require subsidies from the Government, resulting in massive deficits, or will transfer the burden to other enterprises or consumers through repeated price increases, as in the cases of electricity and gasoline.⁴⁹

Similarly, SOEs do not contribute to social welfare in line with the government's expectations. In one respect, the rapid but inefficient increase in investment by SOEs is one important factor behind the 72 percent increase in the CPI during the period 2008-2011, seriously affecting the lives of a majority of people, especially the poor. In another respect, employment in the SOE sector has in fact fallen, when job creation is the most important condition for ensuring social welfare.

Not only do SOEs not fulfill the government's expectations, SOEs crowd out other, more efficient and productive firms. However, when SOEs increase the scale and scope of their activities they have failed to create jobs, exports, tax revenue or GDP growth in relation to the scale of subsidies and investment from the government. Moreover, in some case—such as the collapse of Vinashin—moribund results leave the national budget having to assume a heavy burden.

Force SOEs to compete on a level playing field with other firms. International experience (for instance in South Korea and China) and Vietnam (for example the case of Viettel and VNPT) demonstrates that in the face of competition (from domestic or international forces) and when unconditional government support is denied, SOEs must become more efficient in order to survive.

Therefore, it is necessary to reduce or eliminate monopolies, except in certain special cases in those sectors with natural monopolies (such as water and electricity distribution or national railways).⁵⁰ Monopolies, when allowed to exist, destroy market mechanisms, therefore market discipline is ineffective. In these cases, monopoly firms must be regulated by independent regulatory agencies that are accountable to the public that do not derive political or economic benefits from the success or failure of the regulated firm. State competition regulators in Vietnam must be designed in order to protect competition and the public interest, and most importantly to protect consumers who benefit from competition.

Force SOEs to pay market prices. At present almost all of the most important prices in the economy, such as land, interest rates, exchange rates, electricity, and gasoline...are manipulated. The first consequence is that national resources are distributed in a highly inefficient manner, while at the same time creating lucrative opportunities for special

⁴⁹ The ability not to raise prices or only to raise prices a little should not be understood as a contribution by SOEs because in essence, this is a subsidy from the state to the beneficiaries of the policy, not a public good provided by the SOEs. Moreover, subsidies distort price signals, turning Vietnam into a dumping ground of backward, wasteful technologies subsidized by low energy costs. In any case, using private companies or direct payments to the subsidized would be alternatives.

⁵⁰ It should be noted that electricity production is not have the characteristic of a natural monopoly.

interests to compete to enrich themselves. Naturally, in this competition the SOEs, and especially the conglomerates and general corporations always have the advantage. A related consequence is that highly inefficient investment and rent-seeking behavior distorts the structure of the economy in a way that damages the economy's medium and long term prospects. In the SOE sector, a prominent example is that of Vinashin and the other conglomerates and general corporations that raced to divert their investment from core businesses into real estate and finance. An example at the local government level is the race to open economic and industrial zones, and build airports and deep sea ports. In the private sector, an easily observable example is the race to invest in sectors that are natural resource and energy intensive and polluting.

Rationalization of subsidies and trade protection must be a focus of the SOE restructuring program. SOEs not only enjoy preferential treatment in access to credit, land, and markets. They are also shielded from international competitive pressures thanks to protective barriers that restrict the participation of foreign firms in the domestic market, a readily observable trend in the sectors dominated by the state's economic conglomerates.

An important lesson from developed countries is the subsidies and protections must be accompanied by clear standards of efficiency in order to ensure that favorable treatment is temporary and conditional. If subsidies are unconditional and can be extended indefinitely, firms will be incentivized to engage in speculative and rent-seeking behavior while losing the incentive to increase its efficiency and competitiveness. For example, South Korea used subsidies and protections to help its large private companies achieve economies of scale and develop technological capacity. However, this assistance typically was limited in time (usually less than five years) and was closely tied to the achievement of ambitious export targets. High SOE prices mean firms using their products find it hard to compete or export.

Limit as much as possible the extent to which SOEs are required to pursue social policy and political objectives. At present, whenever they are criticized for being inefficient, SOEs immediately point to the many political and social responsibilities which they have been assigned as if these tasks are the primary factors behind their poor economic performance. For this reason, with the exception of a few special, necessary cases, it is necessary to limit to the maximum extent possible the political and social responsibilities of the SOEs while reassigning these objectives to fiscal and social welfare policies in order to ensure transparency and accountability.

Reform the corporate governance of SOEs. At the system level, it is necessary to clearly separate the functions of state management, regulation, and direct business activities. At the company level, the business operations of the SOEs must be made as transparent as possible. With the exception of special cases related to national defense, security, or foreign policy, SOEs, especially conglomerates and general corporations must make its accounting reports public as a publicly listed company would, in order to strengthen the ability of external experts and society at large to monitor their activities. The people, as the ultimate owners of the SOEs, should at least have the right to know the actual conditions of the enterprises.

The government should objectively and comprehensively assess the pilot program to create economic conglomerates. On the basis of such an assessment it will be possible to introduce appropriate policies in order to avoid the today's "too big to fail" scenario. An essential precondition for accurately evaluating the economic conglomerate model is to compile a comprehensive and up-to-date information database regarding the conglomerates' finances, management, and business activities. Comparing these results, as possible, with private ASEAN firms in similar lines of business would help to create performance benchmarks.

Continue the equitization process. In fact, large conglomerates and general corporations which the state need not control should also be equitized, with the clear objective of attracting strategic investors from the ranks of leading multinational corporations. However, equitization should only be considered one method for restructuring SOEs; it should not be regarded as the most important approach or a panacea.

The three options described above are not mutually exclusive. One can basically do some of three while mainly focusing on two or one can do option two but only halfheartedly. One can also overly focus on the short-term pressing issues rather than long-term structural problems. The further one goes toward option three and, at the same time, not allowing short-term policy measures to jeopardize long-term reforms, the more likely is Vietnam to get its engines of growth functioning at a high level resulting in an East Asian level of catch up GDP growth. The barriers to moving toward option three are not economic or technical. They are mostly political and it is more interest group politics than ideologies about the state retaining control of the commanding heights.

Part VIII. Conclusion and identifying institutional reform priorities

In the preceding sections, this report sought to advance a number of policy recommendations. This section seeks to situate institutional reform trends in a broader framework and identify a set of priorities to guide the development a vision for institutional reform in Vietnam.

A. From Public Administration Reform to Building Quality Institutions

In all contexts, administration is regarded as the core of state institutions, therefore public administration reform is an important part of institutional reform. This is an area in which Vietnam has realized many achievements. However, beyond public administration reform, institutional reform is usually defined more broadly by economists, encompassing both economic and political institutions. It frequently involves changes in laws and institutions.

From the perspective of economic institutions, a clear property rights regime is the foundational institution for any market economy. The innovations and relentless competition of all market actors are guided by incentives that originate from well-defined property rights. Property rights are said to be well-defined when a person's exclusive rights over an asset is recognized, the state protects those rights against all encroachments from any third parties, and all disputes can be fairly adjudicated in independent courts.

From the perspective of political institutions and public governance, the level of citizen participation in exercising public power and in delegating power to the state is the foundation of the political legitimacy of any democratic regime. This participation is made possible by political institutions through which citizens realize their rights to have access to information, to participate in political life, to express their opinions, to establish their civil associations, and to impose accountability on all levels of government when necessary.

Depending on the level of participation of all social strata in society, Acemoglu and Robinson in *Why Nations Fail* divide political and economic institutions into two categories: extractive institutions (exploitative and exclusive in character) and inclusive institutions (democratic, representative, and equitable in nature). Inclusive institutions ensure the ability of individuals to exercise their rights and derive benefits from society. Beginning with the protection of private property rights, an independent judiciary to ensure justice, and a free press to help defend the peoples' right to know and right to express opinions. Once they have been established, these inclusive institutions steadily spread, gradually increasing the democratic rights of the people, and eventually emerging as representative democracies capable of exercising oversight of and ensuring the accountability of the executive branch. Also from these origins, the administrative apparatus (the core of state institutions) are subject to ever greater pressure to become more transparent and professional, rapidly learning from the experiences of the private sector in order to improve the provision of public goods to the people. Inclusive institutions such as these ensure that values such as democracy and rule of law are steadily strengthened and unassailable.

Acemoglu and Robinson's concept of inclusive institutions is related to the concepts of good institutions and good governance that has been distilled from the experience of developed countries. The United Nations Development Programme (UNDP), the Organization for Economic Cooperation and Development (OECD), and the World Bank have for several decades identified and defined standards for measuring good governance.

Some of these standards can be summarized as follows. *First*, good institutions and good governance must encourage popular participation and listen to their voices and must create opportunities for people to express their ideas and opinions. As popular participation and people's voice increase, the threat of potential conflict may decrease. On the other hand, if the process of designing and implementing policies restricts people's participation, the threat of inequality and social conflict increases. *Second*, good governance must make clear the accountability of each level of government and of public managers and officials. All policy decisions of the government must be explained and justified. If policies are wrong or implemented poorly, resulting in negative consequences, the specific person responsible must be identified. When the trusteeship and confidence of the people is lost, the legitimacy of the government is also lost. Therefore, strict accountability must lead to resignations, and the replacement with more capable people. *Third*, good governance is measured by the capacity of the executive apparatus and its ability to grasp the policy environment, recognize solutions and make decisions that benefit society and promote equity and implement these decisions effectively. *Fourth*, good public governance requires that a transparent government and one that wields power in accordance with the law. Power must be legitimate, and legitimacy is usually determined by ballots cast by voters in free and democratic election. Policy design and implementation must be overseen by elected bodies, the press, the electorate, and operate in strict accordance with the law, according to the principle that "state agencies can only do what the law allows."

The criteria for building good institutions, and good governance, or in the words of Acemoglu and Robinson, for building inclusive institutions, are universal, and in reality are the same objectives that the Vietnamese government has set for itself.⁵¹

Summary of institutional bottlenecks in Vietnam

After almost three decades of *Doi moi*, the fundamental reform issues in Vietnam – ownership, property regime on land and on SOEs – seem to remain unchanged; their sizes, complexity, and severity are even higher than they were before *Doi moi*. The inefficient and unmotivated SOE sector is increasingly becoming a burden of the economy, blocking

⁵¹ The speech delivered by Prime Minister Nguyen Tan Dung on the occasion of the commencement of the 2011-2016 government term made this clear: "National public administration must be aggressively reformed to improve the quality of public governance. Increasing the participation of the people and of businesses in the process of making policies and institutions; elevating the role of social criticism and the accountability of managing agencies in policymaking and assessing the effectiveness of implementation." Prime Minister Nguyen Tan Dung (2011), Duties of the Government, 2011-2016. Government website, 31/7/2011.

<http://thutuong.chinhphu.vn/Home/Thu-tuong-neu-nhiem-vu-cua-Chinh-phu-nhiem-ky-moi/20117/12561.vgp>

fundamental reforms which would bring Vietnam back to the rapid and sustainable growth path. Land ownership policy is heavily debated causing potential discontents or even chaos in the society. The nonpublic sector – a major achievement of *Doi moi* – is struggling to stay above water. Waning institutional reform efforts, delayed implementations, and missed opportunities all make the fundamental institutional problems difficult to resolve. As a result, Vietnam seems to be back at the starting point before *Doi moi* began.

In this report we have discussed some challenges and barriers facing Vietnam during the institutional reform process. In short, the institutional bottlenecks can be summarized as follows:

With regard to economic institutions, well-defined ownership rights still represent a large challenge for Vietnam. The current ownership regime is dispersed and vague about who are the actual owners of land, public resources, the capital invested by the state in SOEs, and public investments. The deep-rooted reason for this ambiguity derives from the hesitant and piecemeal ownership reforms that have been implemented over the last three decades. The dispersed and uncertain ownership rights can be illustrated in the land rights or in the management of the government capital invested in thousands of SOEs and affiliated companies, or in the management of public resources and public investments. During the last three decades, the design of institutions aimed at defining who is the actual owner and responsible for the efficient management of public capital invested in SOEs is still unsuccessful.

In this context, the special interest groups and firms with close relationships with government officials who possess the power to allocate economic resources receive the benefits. In reality, economic institutions are established to persistently protect their interests. The possibility of setting up inclusive economic institutions is becoming more remote.

With regard to political institutions and governance, in spite of many achievements in administrative reforms and improvements in quality of public service delivery such as the one stop shop reform, administrative ISO, and assessment by citizens, there still exists enormous gaps in building accountable public institutions, empowerment and public participation enhancement in making policies, policy debates, supervision and enforcement of regulations, the local government accountability, and confidence in officials to ensure the legitimacy of the authority. The World Governance Indicators by the World Bank indicate that among 6 dimensions of governance, the voice and accountability have been assessed to be very low for the last decade. In addition, regulatory quality and the rule of law in Vietnam are also assessed to be low (only higher than those of Laos and Myanmar), see details in Figure 6.⁵²

The Prime Minister Nguyen Tan Dung has emphasized enhancing the citizens and firms' participation in policy formation, social debates, and full accountability of government agencies. This priority suggests that, just as the WB governance indicators suggest, the

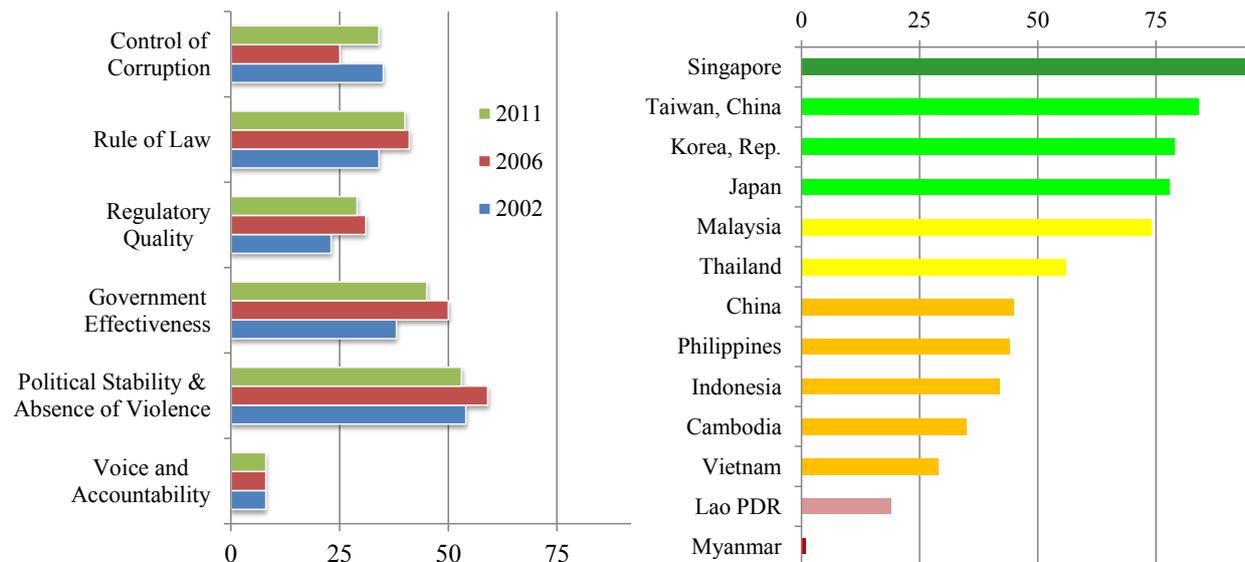
⁵² See details on <http://info.worldbank.org/governance/wgi/>

Vietnamese government understands that the political institutions and governance are not inclusive and do not empower citizens.

Figure 6. Quality of Public Governance: Vietnam and other Asian Countries

Vietnam: Comparison between 2011, 2006 and 2002

Regulatory Quality (2011)



Source: World Governance Indicators Database, World Bank

Numerous examples of wasted resources and missed opportunities relating to tens of thousands of public investment projects (with the SOEs capital or the state budget) share a deep-rooted reason, that is, Vietnam lacks institutions that force the decision makers to listen to the people's opinions, counterarguments, press reflection, and even the recommendations of experts. They are not politically and legally responsible for their wrong decisions which causes serious socioeconomic costs and waste.

With regard to the institutions of accountability, cadres and leaders in the government are only indirectly held responsible via the supervision of the elective system, the National Homeland Front, and the political system, as well as the press. Vietnam has a dense elective system including over 300,000 representatives in commune/ward/district/province people's councils and National Assembly. On average, every 300 citizens have a representative, though, most of them serve on a pluralism basis where they are also officials in the government apparatus. Such a representative system certainly reflects and protects the interests of government authorities. When interest conflicts between resident groups and government agencies exist, such a pluralist representative system cannot define political accountability.

The reasons for deficiencies in both economic and political institutions are legion, but from the point of view of economic research and public policy analysis, the following factors may mire Vietnam with backward institutions that block development:

First, in terms of economic benefits, current institutions channel economic resources to the privileged elite in Vietnam who now control land resources, minerals, public investments and assets in SOEs. This privileged elite enjoys benefits from the current institutions and thus has no incentives to reform them. However, empowering citizens poses a direct challenge to the elites and they explicitly and implicitly resist all ideas of building inclusive institutions.

Second, current economic and political institutions were primarily designed with regard to the old benchmark which emphasized the role of people's ownership (collective ownership) and the leading role of the state economy. This benchmark initially included the political conceptions that were gradually embodied in legal documents and institutionalized in government policies, and finally became unquestioned habits. It is hard to overcome the notions, conceptions, habits and thoughts that have been imprinted upon many generations of Vietnamese. This can be illustrated in the recent process of constitutional or land law amendments. The objectives of empowering people in building a constitution, participating, creating well-defined land ownership, limiting state power, decentralization, limiting land acquisition by the state, or in short, all institutional reforms toward inclusive institutions, have encountered many obstacles from old conceptions and thoughts.

Third, many policy reports have clearly focused on and analyzed the congestion in economic and political institutions in Vietnam. For example: the de facto power is dispersed among ministries, disciplines, and localities; there is a lack of concentrated control and accountability; an unclear relationship between the Party and the governmental system; the press is not independent; social debates are weak. However, all reforms contain risks. In other words, the risks and costs of transition, fears of instability and chaos in governance reduces and undermines the leaderships determination for reform and also reduces the people's confidence and support. The irony is that a lack of reform will ensure national weakness and disorder, so the paralysis from fear of excessive reform may create exactly what is feared.

Establishing priorities for institutional reforms

Opportunities to push institutional reform often come from two scenarios: the legitimacy of the privileged elite is threatened by either domestic residents' voice or outside pressures. With regard to domestic pressure, the socioeconomic situation in Vietnam seems to be opportune for enacting policies to build inclusive institutions, empower ownership, encourage participation in establishing and monitoring policy enforcement, and push accountability.

With regard to external pressures, after the WTO accession in late 2006, the negotiation of Trans-Pacific Partnership (TPP) is a new opportunity for Vietnam to push domestic institutional reforms. Not a usual free trade agreement, TPP also creates new pressures to build transparent and consistent governance with reliable standards. To exploit advantages

brought about by TPP, Vietnam needs to actively embrace values and standards analogous with those respected and carried out by other country members of TPP. TPP is an opportunity and an external pressure to promote reforms.

In that context, from now till 2016, there will be many opportunities for institutional reforms with the amendment of the constitution and amendment, supplement, or new promulgation of 85 laws regarding economic institutions, governance, and social management. Inclusive institutions that basically empower the people with economic and political rights need to be founded on constitutional commitments. Accordingly, creating an extensive social support for the design of inclusive economic and political institutions and empowering the people via the amended Constitution are among the most important contents of institutional reforms.

With regard to economic institutions, among the inclusive institutions, establishing well-defined property rights that are effectively protected from violations by third parties, even from unreasonable interventions by government agencies, is of the highest priority. National resources, land, coast, and islands are the assets accumulated by the efforts of many Vietnamese generations and their uses should be in the nation and people's interests: that is an absolutely just political principle. However, the property right to dispose of a particular land lot should be clearly and well defined. Legally, articulated legal institutions should be established based on political declaration of the people's interests.⁵³ Hence, from constitutional requirements to fundamental laws such as Civil Code and Land Law, it is necessary to get rid of legally unclear concepts (for example, the people's ownership) and lay a solid foundation for the property rights of the people, firms, and subnational and national governments.

In addition, the ownership of SOEs should not be dispersed; it is necessary to discuss the establishment of trust agencies, which are delegated by the local or central government to carry out the concentrated state ownership of firms. The model of the State Capital Investment Corporation (SCIC) in Vietnam in recent years is simply a conservative and unsuccessful step toward the concentrated governance of the local and central government ownership of SOEs. Vietnam needs to consult experiences from OECD countries and China recently in the establishment of public asset management commissions that have the authority to enforce the local and central government ownership in key SOEs.

Coupled with empowerment toward concentrated governance, it is necessary to discipline and disclose SOE governance, at least as strictly as the disclosure requirements for listing companies. After all, the owners of SOEs are the people; hence, the trust agencies that are delegated by the government or the provincial people's committees to govern SOEs should

⁵³ According to experiences of the Law on Property Right 2007 in China, it is necessary to clearly define land ownership, including land owned by the central, provincial, town and village governments (public entities) and private institutions/individuals. The Chinese Property Right Law makes the concept of "people's ownership" fade out successfully as a note of "the state ownership". Then, "the state ownership" is clearly defined as being owned by government levels. Thus, the Chinese Property Right Law is defined as well as any similar law in the West.

be responsible for transparent information disclosure to all people, especially the elective agencies on behalf of their constituencies.

With regard to political institutions and governance, many valuable recommendations have flourished during the debate on the Constitutional amendments: in general, it is necessary to carry out the people's will, starting with empowered institutions that facilitate the people's understanding, participation, discussion, and provide a method to legally express their opinions about government policies. This empowerment should be institutionalized in laws, such as a law on having access to information, a law on referendums, a law on free establishment of associations, and a law on demonstrations.

Institutionalization is just the first step, the empowerment process also needs to be supported by the liberty of the press and media to give people access to information and create connections. In addition, when government agencies do not carry out their obligations to provide information or they create unreasonable obstacles, the people's rights need to be enforced by the impersonal and independent justice system that is able to enforce its decisions over the government agencies.

The accountability of political leaders needs to be articulated in relevant institutions. Direct elections, as proposed for pilot elections of commune/ward people's committees or direct elections of mayors in the model of municipal government are the right steps toward establishing accountability of the authorities to voters and locals. Vietnam is building a democratic representative regime, the accountability of the authority should be defined by elective agencies that are in the voters' interests, operating professionally and permanently. Thus, instead of proposing to buy Ipads for almost 300,000 elected representatives, it is necessary to liberalize the election process, maintaining a significant numbers of specialized representatives with proper compensation and authority so that they can devote themselves to their only task, that is, supervision of the government in the voters' interests. Then, those assigned and appointed to control the regulatory, executive, and judicial branches will gradually become accountable to the Vietnamese people.

Finally, in previous sections, we have emphasized the dispersed management of economic resources in 63 provinces and the economic groups that block the ability of the government to make plans and regulate activities, as the cause of wasted resources and missed development opportunities. Like the WTO accession, the TPP accession requires a government that is capable of regulating the economy in a concentrated and effective manner. To do so, we contend that, amending the Constitution and developing the Law on Local Authorities are good opportunities to discuss the local authority structures and the relationship between the local and central governments in Vietnam. It is also necessary to discuss the establishment of regional economic institutions that are authorized to govern and regulate economic resources more efficiently, such as water in the Mekong Delta or traffic in and around large cities. The actual authority has been gradually decentralized to provinces, but provincial authority is confined to a narrow scope, which is not sufficient for concentrated planning and the governing of economic resources. Hence, the government should consider setting up a

regional or inter-provincial authority level. The discussions on planning economic regions⁵⁴ should be expanded to include how to organize the regional authority with broadened management of economic resources. In addition, at the regional level, urban areas and villages and communes need to have the right of self-government on the principle of self-governance stipulated in the Constitution with well-defined authority and budget.

⁵⁴ To consult experiences in East Asia countries, with a population of 1.3 billion, China has 33 provinces; Korea has 9 provinces, so their resources do not too much spread out, especially from economic decentralization point of view. For Southeast Asia, similar to Vietnam, Thailand has 75 provinces, the Philippines have 80, and these countries have their resources less efficiently dispersed. For economic regions in Vietnam, see <http://chinhphu.vn/portal/page/portal/chinhphu/noidungvungkinhtetrongdiemquocgia?articleId=10000721>