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POLICY DISCUSSION PAPER NO. 2[1]

Surviving a Crisis, Returning to Reform

*****EMBARGOED FOR 45 DAYS******

I. Introduction

The Vietnamese economy is facing its most serious challenges since the mid-1980s. Over the past several months the government has stated its determination to curb inflation and restore macroeconomic stability. These are indeed critical priorities, but the government's actions to date to achieve this end have been largely ineffectual. This Policy Discussion Paper argues that a restoration of the situation prior to the onset of the current instability is neither possible nor desirable. This is because the current situation is due largely to structural weaknesses in the Vietnamese economy; the international conditions that have been offered as explanations are, at best, secondary factors. In previous papers, we have argued that the development trajectory Vietnam follows between now and 2020 and beyond will be determined by the *choices* that the government makes.[2] The fundamental choice facing the government is between maintaining a dualist economy, in which the state sector, although extremely inefficient, continues to receive the majority of credit and investment, and an internationally competitive economy, in which capital is allocated to those firms that can use it most efficiently. This paper will demonstrate that, over the last several months, the choice between these two systems has grown even starker. The state sector, led by the conglomerates and fed by a profligate public investment mechanism, often destroys value. Social and economic returns in the sheltered sectors are exceedingly low and do not justify the privileges that are lavished upon them. Efforts can be made to extend the life of this system, but in the end this endeavor would fail, with tragic consequences for the Vietnamese people. Vietnam must instead adopt a modern, globally integrated economic system that operates according to the rules that apply in every successful country. One thing is for certain: Vietnam cannot do both.

Vietnamese policymakers are understandably keen to avoid a "crisis." But what constitutes a crisis in the present circumstances? Certainly, the collapse of one or more vulnerable joint stock banks could trigger a chain reaction, inflicting enormous damage on the financial system. Such a "nightmare scenario" would indeed qualify as a crisis. *However, we argue that if the government's objective is to build a prosperous, modern economy and avoid the traps that have ensnared so many middle income countries, then the current situation is already a crisis.* Without urgent and resolute action the achievements of the recent past will be undone (especially poverty alleviation and economic growth) and the country's economic future put in jeopardy. The reasons for the dire economic situation are simple and not contested by serious Vietnamese and international economists:

- Price inflation is now over 20 percent according to official statistic and is accelerating. The official statistics probably underestimate inflation (Figure 1).[3]

[1] This discussion paper was written in response to a request from the Vietnamese government in the context of a policy dialogue initiative, to analyze the challenges confronting the Vietnamese economy. We are supported in this endeavor by our policy dialogue partners, the United Nations in Vietnam and the Ministry of Foreign Affairs. *During the period of embargo, this paper cannot be quoted or cited without permission of the Harvard Kennedy School Vietnam Program.*
[2] These choices are analyzed in our January 2008 policy report to the Vietnamese government*, Choosing Success: The Lessons of East and Southeast Asia for Vietnam's Future*, in which we concluded that Vietnam is replicating many of mistakes made by the region's less successful countries and that Vietnam's strategy for the development of diversified state-owned conglomerates is unlikely to produce the desired results.
[3] This issue is discussed in *Choosing Success.*

- The trade deficit during the first four months of 2008 was more than $11 billion, almost equal to the total trade deficit in 2007. The trade deficit is on track to reach the astonishing and dangerous level of 40 percent of GDP (Figure 2).
- The IMF estimates the fiscal deficit at 7 percent of GDP, although others think it is as high as 14-15 percent of GDP if government backed SOE debt-financed spending is included.
- As a result, bond traders are offering deep discounts on government treasuries, suggesting that they expect a sharp fall in the value of the Vietnam dong over the coming months.
- Inflows of indirect foreign investment have slowed. At the same time, foreign investment, and much SOE investment as well, is moving mostly into over-priced real estate, adding little to long term employment, exports or technical transfer, but a lot to their debt load and domestic credit growth, creating an overheated economy with many potential risks.
- Although information on public debt is difficult to obtain, the Ministry of Finance says that total debt of 70 public corporations was $28 billion (or 40 percent of GDP) as of December 2007.[4] If this figure is accurate, the debt-GDP ratio is now 100 percent.
- Banks have poor risk management capabilities and many are overexposed to the inflated property market. Many smaller banks have no fixed income assets (such as government bonds) and have essentially bet their businesses on high property prices. At least a dozen of these banks are currently under considerable financial stress.
- Interest rates on the inter-bank lending market are about 20 percent and smaller banks must pay a premium of 5 percent to borrow.[5]

Restoring economic stability must now be the primary concern of government. A crucial factor will be the government's ability to attain credibility in the markets. It is essential that consumers and investors at home and abroad come to believe that the government has identified a consistent and realistic set of policies and that it is able to implement these policies in a single-minded and coherent manner.[6] Macroeconomic stability will not be restored if the government fails to communicate its policy priorities to the public, or if it appears willing to compromise its stabilization program to appease special interests. The markets (including Vietnamese consumers) would view capitulation to narrow political and financial interests as a signal that the government lacks the determination needed to avert a crisis, and would react by disposing of Vietnam dong assets (including the currency) in favor of commodities, land and properties, gold, and foreign currency. This is the pattern established in many slowly growing developing economies.

This Policy Discussion Paper has two key messages. First, the government's response to the worsening economic situation has been, to date, insufficient and even counterproductive.[7] We are well aware that in making this assertion we may be accused of impatience, of not giving policies time to take effect. Our response is that time is a luxury Vietnam cannot afford and the government must take vigorous action to translate its recent policy pronouncements into action. Second, reestablishing economic stability will require the Vietnamese government to address core structural flaws in the Vietnamese economy. Vietnam cannot both integrate into the global economy and continue to make policy as if the hard-learned lessons of other economies, that the "laws of gravity" do not apply. We conclude with a ten point plan for stabilization and recovery. These recommendations include both short-term measures to restore equilibrium and longer term, structural reforms needed to improve the economy's competitiveness and make possible the attainment of the government's long-term development goals.

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[4] Calculation based on report presented by the Ministry of Finance at the conference "Rearranging and Reforming SOEs" held in Hanoi on April 22, 2008.

[5] See http://www.tuoitre.com.vn/Tianyon/Index.aspx?ArticleID=257789&ChannelID=11

[6] In *Policy Discussion Paper No. 1* (February 20, 2008) we analyzed the ineffectiveness of the current fragmented structure of Vietnam's economic policy apparatus, according to which responsibility is spread across several ministries without a single, apex decision-making unit. This structure can be particularly damaging in times of crisis, when decisions must be taken and implemented swiftly and comprehensively.

[7] Such as the decision to require credit institutions to purchase 20.3 trillion VND worth of treasury bills or permitting conglomerates including Vinashin and Vinatex to borrow large amounts of money from Deutsche Bank.

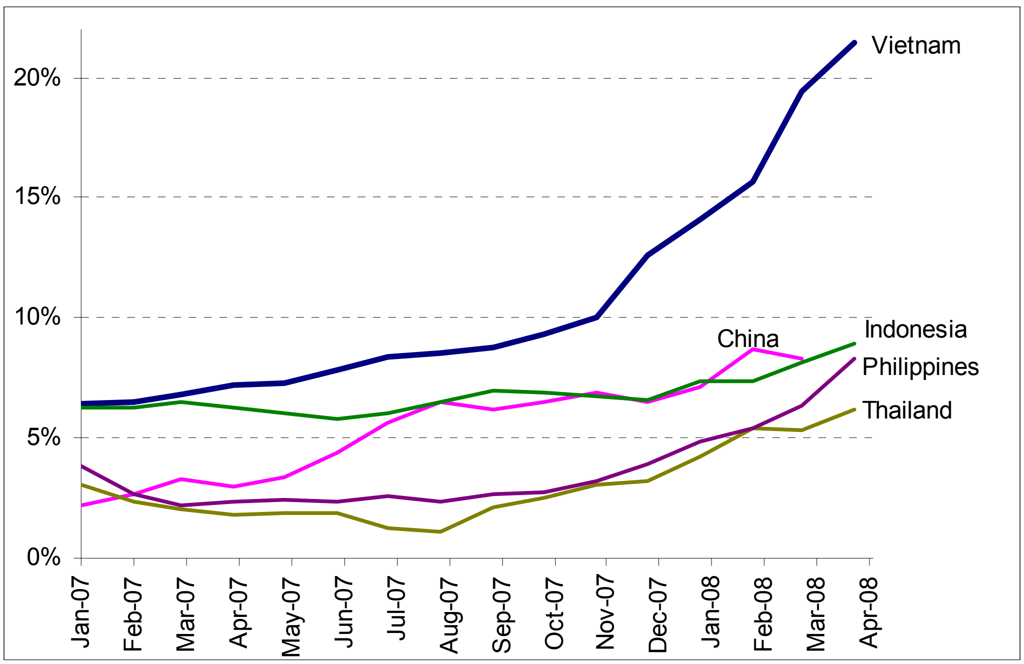
II. The first five months of 2008: The economic situation worsens

This section begins by considering a few "headline" macroeconomic indicators. It then considers fiscal and monetary policy and the ongoing turmoil in the banking system, concluding with an examination of two essential components of macroeconomic stability: credibility and information.

A. Key indicators

The economic situation has continued to worsen during the first five months of 2008. The rate of inflation has continued to accelerate (see Figure 1). Inflation has been blamed more on world commodity inflation than on monetary or fiscal policy. This is likely to be wrong. Neighboring countries, even food importers, have much lower inflation than Vietnam. Taking food out of the price index does little to break the close relationship between money or credit growth and the remaining inflation.[8]

Figure 1. Consumer Price Inflation, % Change on a Year Earlier



Source: General Statistical Office and Global Financial Data

At the same time, Vietnam's trade deficit has ballooned to an alarming level (see Figure 2, below). Imports are now nearly double exports. If this trend continues, the trade deficit in 2008 could reach $30 billion. The trade deficit would be dangerous even if it were half of its current rate of 40 percent of GDP.[9] By comparison, over the past thirty years South Korea's trade deficit has never reached even the 10 percent level. Vietnam's current situation is significantly worse than Thailand's in the period leading up to the 1997 crisis. In 1995-96, Thailand's trade deficit to GDP ratio was 6%, up from about 4% in 1993-94. In 1997 they had either a small surplus or a zero balance, depending on the data set used. This means that, even if the trade deficit in Vietnam is $20 billion in 2008 (which is a conservative estimate given the rate through April), the trade deficit would

[8] International comparisons provide a sense of the extent to which inflation can be attributed to international influences. The inflation rate in China during the first months of 2008 is measured at 8.5 percent. The consensus of Chinese and international experts is that 6 percent of this rise is due to higher food and petroleum prices. Assuming that China and Vietnam are subject to similar international influences, this suggests that most of the inflation in Vietnam is due to domestic factors.

[9] Estimation is based on the first four month number

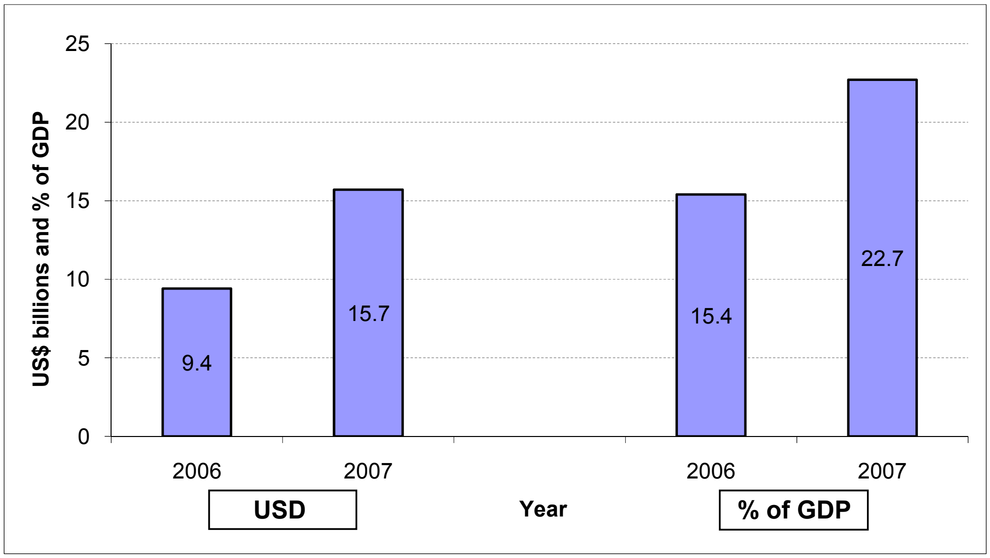
still be *four times higher* in relative terms than the situation that helped cause Thailand's crisis. It is true that large trade deficits can be sustainable if they are incurred to import machinery and other inputs as a result of large FDI disbursements. However, the trade data recently released by the General Statistical Office show that while imports made by FDI firms increased by 44 percent during the first four months of 2008 compared to the same period of 2007, those made by domestic entities jumped up by 86 percent. Thus, there is an urgent need to determine the precise nature of these imports. The VND will be subject to enormous depreciation pressure in the latter half of the year if it turns out that the surge in imports is mainly for private consumption and/or investment and production of firms that have neither foreign exchange financing nor foreign exchange earnings. Since some of the increased investment is in real estate, which does not earn foreign exchange, the indications are not good.

Figure 2. Trade Deficit, USD billions

Source: Asian Development Bank; General Statistics Office

Vietnam is financing this trade deficit largely through capital inflows, which have increased dramatically over the past year and a half, as Figure 3 illustrates. Analysts agree that the indirect investments which flowed into Vietnam through February 2008 were attracted by a booming stock market, an attractive rate on government bonds, and the expectation that the VND would appreciate. These attractions no longer exist and, predictably, inflows are falling. There is now a possibility of short-term capital outflows and a shortage of foreign exchange at the current exchange rate. This possibility is reflected in the low price of government bonds.

Figure 3. Capital Inflows, USD billions and % GDP



Source: International Monetary Fund

B. Monetary and Fiscal Policy

At present Vietnam's monetary and fiscal policies are flawed. On the monetary side, efforts to curb liquidity while capping deposit rates has produced a serious liquidity crunch which is disrupting the smooth functioning of the financial system. The decision on Monday, May 19 by the State Bank to remove the cap on deposit interest rates and increase the base rate will help address the liquidity crunch and ease pressure on the exchange rate. However, the State Bank will need to continue to closely monitor the commercial banks, especially small joint stock banks in order to ensure that their credit activities remain responsible.

Even if Vietnam were to implement a better coordinated set of monetary policies, it is unlikely that they would have the desired effect on inflation. This is because the key drivers of inflation are public investment and activities of the state owned sector. We have noted in previous papers that Vietnam's public spending is enormously inefficient, far more so than other countries in the region while at equivalent GDP per capita levels. The government has repeatedly announced its determination to reduce public spending, but, as recent examples in the news suggest, these pronouncements have not been translated into action.[10]

The government has announced plans to cut regular government spending by 10 percent. However achieving this in practice will be extremely difficult because salaries account for a large share of regular spending, and the government will not want to cut salaries in a time of rising inflation. Moreover, the official budget is also the principle source of spending on crucial public services like health and education. Reducing spending in there areas is not advisable and would hurt the poor disproportionately. Moreover, we estimate that a 10 percent cut in regular expenditures would only reduce the deficit by one percent or less. By far the most problematic element of fiscal policy is off-budget expenditures and is the reason why creating a unified budget is a critical component of the recovery plan outlined below.

C. Calming the banking system

[10] The government's approach amounts to a reversal of the "asking and giving" phenomenon that has led to the current situation, only now it is the central government's turn to "ask" the provinces to submit a list of projects to be delayed or cancelled. Examples of counter-productive recent moves include a quarter-billion dollar resort development by EVN; a new international terminal at Noi Bai airport; Vietnam Airlines being licensed to open an insurance company and a new joint stock bank controlled by a troika of conglomerates.

Decision 16, issued by the State Bank on May 16, 2008 regarding VND interest rates removed the cap on deposit rates and raised the base interest rate, bringing it closer to market reality is an essential (if belated) step to reduce negative interest rates and address the liquidity crunch. However, it can be anticipated with a fair degree of certainty that when this policy takes effect commercial banks—especially small join stock banks—will raise interest rates in response to their liquidity difficulties. This could lead to an undesirable interest rate race, and could also squeeze banks' margins, creating an incentive for them to expand credit. The State Bank should be prepared to respond to these scenarios.

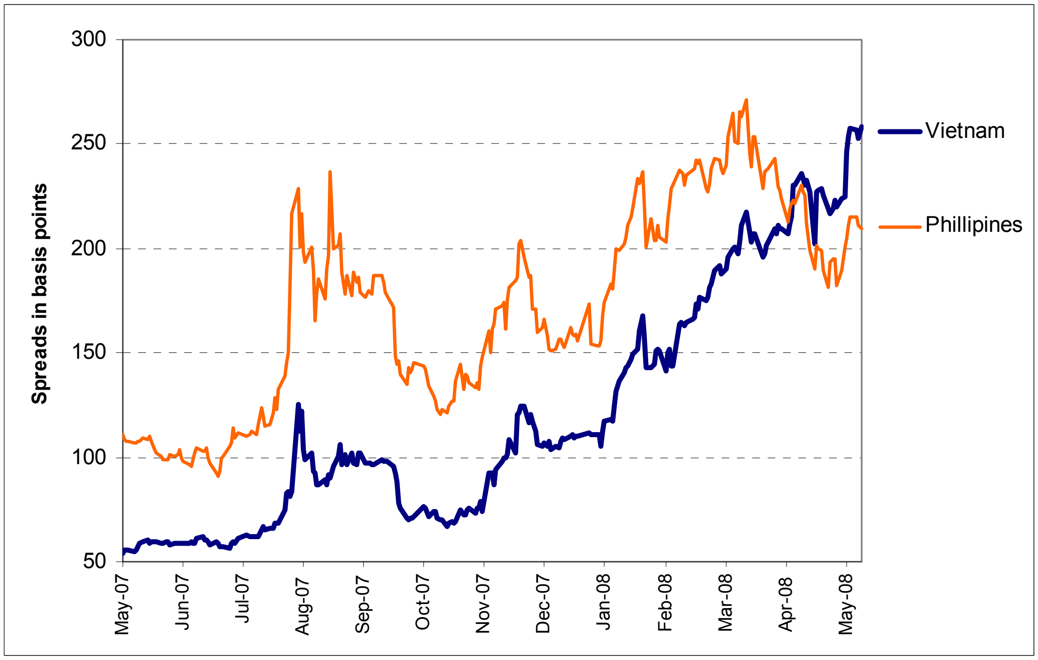
The banking system is deeply troubled. It is said that a number of small joint stock banks are in facing sever difficulties. An artificially low cap on deposit interest rates has created a critical shortage of funds in credit markets. Because the refinancing rate is unchanged at 7.5 percent, which is much lower than the market rate, banks are queuing to borrow from the SBV, making SBV the lender of the first as much as the last resort, but in a way that rewards opaque management and hurts efficient firms. Moreover, the current cap on deposit interest rates is driving liquidity out of the banking system, and at the same time, taking liquidity away from small banks, putting these banks in a severe liquidity situation. Consequently, the interbank lending rate has risen to more than 20 percent, and small banks have to pay 5 percent premium to borrow.[11] Needless to say, the advantage in this game belongs to SOCBs and SOEs at the costs of small joint-stock banks and efficient private firms. As long as the interest cap is maintained and the liquidity shortage in the banking system is not improved, exporters and private SMEs will encounter difficulty accessing credit while bad credits are extended to SOEs. Credit is being allocated to those who generate no net new jobs and who use capital poorly.

D. Restoring Credibility: Actions and Information

In order for Vietnam to avert a more serious economic crisis, it is essential to restore the market's and the public's faith in the government's ability to manage the economy. Vietnam has achieved such credibility thanks to the macroeconomic stability it has maintained since the early 1990s. This credibility is now in jeopardy. Consider the following statements from leading international financial institutions. In its monthly update on the Vietnamese economy, issued on May 8, 2008, Deutsche Bank described the economy as "in distress" with "rising risks to the banking system."[12] S&P, one of the most influential ratings agencies, put Vietnam's credit rating on a "negative watch" list. CLSA (Hong Kong) described the Vietnamese government as "absent without leave."[13] Morgan Stanley (US) warned in mid-April that Vietnam's "fundamentals were turning negative."[14] We often disagree with the analysis provided by these institutions, and they can hardly be considered disinterested. However, they have significant impact on the behavior of international investors. One of the best indicators of how international markets evaluate a country is the price they are willing to pay for its bonds. The spreads on Vietnamese bonds are now wider than those of the Philippines, a country with a history of macroeconomic instability, meaning that bond traders now regard investments in Vietnamese bonds to be riskier. Investors' concern with Vietnamese bonds is reflected in the price which they are willing to pay to insure themselves against the risk of default (called credit default swaps). Figure 4, below, shows that the insurance price on Vietnamese bonds, which is measured in terms of the interest rate spread, has virtually doubled since the start of the year, while those for Indonesian and Philippines bonds have fallen. Patterns like this are oftentimes an early warning sign of credit problems and suggests that, at present, international investors have are losing confidence in the Vietnamese government's ability to manage the policy environment.

[11] See http://www.tuoitre.com.vn/Tianyon/Index.aspx?ArticleID=257789&ChannelID=11
[12] Deutsche Bank, Vietnam Monthly Update, May 8, 2008.
[13] CLSA, Infofax, March 26, 2008.
[14] Morgan Stanley Research, "VND: Risk/Reward Deteriorates," April 18, 2008.

Figure 4. Bond risk, as assessed by international investors



Source: Bloomberg Finance, L.P.

Clearly, Vietnam must restore credibility before it is too late. However, achieving credibility is not as simple as making tough policy statements. Credibility is determined by actions and information. Vietnam must demonstrate its determination to restore macroeconomic stability through concrete actions and it must provide the market with information to make informed decisions. Words must be backed up by action. Moreover, the markets must have complete, timely and reliable information on economic trends and policy decisions. In the absence of reliable information, rumors begin to spread, and market participants engage in socially counterproductive behavior such as speculation and hoarding. As famous British economist John Maynard Keynes wrote in 1936, "in an unstable economy, speculation dominates enterprise." Market participants must be convinced that unproductive speculative activity is risky, and that profits can only be obtained through creating value.

Until now Vietnam's policy actions have been inconsistent, and the government has refused to provide essential information to the market and its statements and actions often conflict. The gap between words and action and the absence of reliable information reflects a deeper problem of macroeconomic management. The government's policy making apparatus is weak and fragmented, and too susceptible to political interference. It is difficult to implement a tight monetary policy or cut off funding for low-return public investment projects when macroeconomic policies require consensus building across a wide range of institutions and interest groups. On the other hand, many project decisions are made "behind the curtain" and lack any serious attention to the economic rate of return – an essential to any serious investor.

The need to restructure Vietnam's macroeconomic policy apparatus is becoming ever more urgent. SBV certainly needs more autonomy, with accountability guaranteed by a small monetary policy committee that includes experts from outside government. Similarly, the Ministry of Finance's forecasting, analysis, and policymaking must be enhanced. For its part, the government must prioritize the formation of an elite policy analysis unit to support the policymaking efforts of the Prime Minister and the government, including individuals with expertise in a range of economic areas (including experts from outside the state system and international experts). An essential condition for ensuring that this group can function effectively will be access to information and data needed to conduct policy analysis; at the same time they must be permitted to express constructively critical perspectives.

III. Root Causes: The Dualist Economy

Vietnam's current economic difficulties are due to structural inefficiencies in the economy. The state owned sector continues to receive a most of the credit in the economy (70 percent)[15] and executes the lion's share of major public investment projects, despite the fact that, by all objective measures, it is grossly inefficient. At the same time, the private sector, which is doing a far better job than the state of creating jobs and exports, is in danger of being strangled by current economic conditions. This is the fundamental contradiction in the dualist economy. The Vietnamese government must decide to discard this dualist structure and allocate capital on a competitive basis if it wants to achieve its ambitious development goals. Put another way, a subsidized and protected state sector is incompatible with global integration and economic success.

A. The Role of the Conglomerates

The huge jump in inflation, fiscal and trade deficits and capital flows is not an accident. Vietnam does not have a good way to use a lot of the extra funds coming in. Most SOE's and much government investment destroy value – the final investments are worth less than the debt created.[16] The debt of 70 conglomerates and general corporations had built up to an astonishing $28 billion (40 percent of GDP) by the end of 2007.[17] In addition, SOE's investment increased abruptly by nearly 60 percent, resulting in a surge of fiscal deficit in 2007. This problem lies at the heart of the current troubles, and is a crucial impediment to continued growth. Vietnam wants it both ways – an open trade and capital account but a political allocation system that does not pay much heed to efficiency. The negative outlook placed by the ratings agency Standard and Poor's on Vietnamese government bonds is a signal that the game cannot be played the way it has been and the Vietnamese government must choose which road to take.

The situation of Vietnam's conglomerates appears to be even more perilous than that of South Korean *chaebols* in 1997. The *chaebol* in South Korea that survived the Asian Crisis were accurately criticized in 1997-98 when their debt to equity ratios rose to three, four, or five. A comparison of these debt levels with those of Vietnamese conglemarest is alarming. According to a recent report of the Ministry of Finance, the debt to equity ratios of conglomerates are very high: 42 times equity in the case of Cienco 5, 22.5 times in the case for Cienco 1, 22 times equity in the case of Vinashin, and 21.5 times in the case of Lilama. This numbers indicate an inability to raise funds from profits or by issuing stock. They were forced to cut these ratios in half. A lack of equity makes it very difficult to avoid a crisis, and the collective corporate debts were so large that the entire nation had a crisis in 1997. When Hanbo Steel went bankrupt in 1997 it had a debt to equity ratio of twenty, and it was regarded as a major scandal that they had been able to acquire such an extreme amount of debt relative to assets. If a company has good prospects and governance, it can sell stock and reduce its over-reliance on debt and soft loans.

The *chaebol* also "diversified" with excessive debt into real estate, finance and unrelated activities in which they had no real knowledge or ability. Because they were confident that the state would not let them fail, they took one-sided risks. If things went well, they made money. They believed that, if these investments went poorly, the Korean tax payers or the central bank would bail them out.[18] These skewed payoff incentives led

[15] See http://www.laodong.com.vn/Home/ldcuoituan/2008/4/84090.laodong
[16] There are many examples of this phenomenon ranging from the "million ton sugar project" to the offshore fishing project to the empty or nearly empty industrial zones found in provinces around the country.
[17] Calculation based on report presented by the Ministry of Finance at the conference "Rearranging and Reforming SOEs" held in Hanoi on April 22, 2008.
[18] The subprime mortgage debacle in the United States had several of the same elements: high leverage, unfamiliar activities, and a confidence that the Federal Reserve (the US central bank) would not let large players fail.

the *chaebols* to take on absurd risks and waste a huge amount of resources.[19] When Vietnamese conglomerates argue that they need to make highly profitable short term investments to fund their "real" long-term activities,[20] the answer must be that unless they are severely punished for losing money, they are unlikely to make many profits, at least not without undue influence or government favors. Vietnam should learn from Korea's mistakes, not replicate them.

There are several reasons why this "short for long" argument is unconvincing. First, it ignores the critical question of capacity and comparative advantage. Does an oil company possess the skills needed to develop office towers, run banks and insurance companies, and distribute mobile phones?[21] Second, diversification risks distracting conglomerates from focusing on the core businesses, over which they enjoy effective monopolies. This concern is particularly urgent in light of the mounting evidence that conglomerates are performing poorly on their "home fields." Examples of incompetence include: reports that a dozen power generation projects being undertaken by EVN are behind schedule while blackouts threaten to cripple the national economy;[22] Vinacomin's inability to prevent rampant smuggling of valuable anthracite coal; and the fact that Vinashin appears to be building no fewer than 17 ports, shipyards, and steel plants, in contravention of sound business practices. Third, to the extent that these forays into speculative businesses are being financed by borrowed capital, there is the real risk that a sudden downturn could put them at considerable risk as it did to the South Korean *chaebols* and Indonesian conglomerates. Finally, the argument that speculative investments are needed to finance strategic projects fails to account for the efficiency of modern capital markets. Vietnam would have no trouble tapping domestic and international markets to finance sound projects such as power plants and rational transport infrastructure.

The policy response thus far has been to insist that SOEs invest only 30 percent of their capital outside of their core businesses. This is a weak criterion by any standard. It is also difficult to measure the extent to which the conglomerates are complying with this rule. Is a real estate project carried out by a computer company part of its "core business" if the company calls it a "high tech park"? Is a construction company owned by an oil company part of its core business if it builds petroleum storage facilities? While government officials debate the meaning of this policy, as the examples cited above make clear, the conglomerates do not appear to have changed and they continue to expand into speculative sectors like finance, banking and real estate. Indeed, the rate of expansion may have speeded up lately as conditions threaten to shut the window of opportunity. The 30 percent cap also doesn't address the banks, financial companies, and real estate development vehicles that conglomerates have already established.

In short, it is impossible to monitor the behavior of the large conglomerates and micro-manage each of their investment decisions. The only way to make sure that these companies are not investing in bad projects is to force them to pay market rates for their capital and to deprive them of the central government guarantees that they have enjoyed until now. The discipline of competitive markets works better than government decrees.

Inflation will be impossible to control as long as cheap capital is directed to the state conglomerates. There is no monetary solution to this fiscal problem. Tighter credit conditions will squeeze the private sector, because these small and medium sized firms do not have access to subsidized credit. (See below.) These firms are efficient because they are subject to market discipline. But unless government borrowing is brought under control, tight monetary policy will kill off the small private firms long before inflation begins to decline.

B. The Vulnerability of the Private Sector

The current economic situation is squeezing the private sector in a pair of pincers. First, private firms are being starved of capital. The private sector relies upon access to bank capital in order to finance their ongoing

[19] In the aftermath of the crisis, the Korean government pressured the *chaebols* to focus on core businesses and sell non-core businesses to firms that specialized in those areas.
[20] See http://vietnamnet.vn/chinhtri/2008/04/779915/
[21] It is rumored that a joint stock bank affiliated with PetroVietnam is one of the banks at greatest risk of failure.
[22] http://www.baomoi.com/Home/KinhTe/2008/5/1619682.epi?refer=www.baothuongmai.com.vn%2Farticle.aspx%3Farticle_id%3D52335

operations but at present profitable firms are encountering difficulties in borrowing money. If liquidity continues to be soaked up by the state sector, this situation is likely to grow even more acute. Even exports that generate revenue in foreign currency, such as fish processing plants in the Mekong Delta, a crucial source of jobs and foreign exchange, complain that they cannot borrow in dollars.[23] A decline in export growth could be very damaging. We note that a slow-down in export growth proved to be one of the final triggers of the crisis in Thailand in 1997. While high commodity prices are supporting Vietnam's export growth at present, a stagnant period is possible unless normal lending starts up soon. Second, inflation is driving up the costs of inputs, wages, and capital threatening their international competitiveness. *The significance of a competitive private sector cannot be overstated.* Vietnam must create at least one million new jobs every year, just to keep pace with population growth. At the same time, job creation in the state sector is zero or negative. The Vietnamese government must ask itself which sectors are most likely to produce critically needed job growth moving forward. The answer is obvious.

C. The Vulnerability of the Financial Sector

Banking is more risky than most other kinds of economic activity because financial assets are lucrative and financial markets are subject to numerous unpredictable disturbances. Because banks are at the center of long chains of financial obligations linking savers to borrowers, their failure imposes costs not only on their owners and employees but on the economy as a whole. Imprudent lending also renders monetary policy ineffective. For these reasons and others, governments tightly regulate and supervise banks and other financial intermediaries to prevent them from taking unreasonable risks and to reduce the likelihood that the government will be forced into costly bail-outs of failed financial institutions.

Vietnam has moved in a relatively short period of time from a rudimentary financial system dominated by state banks to a diversified financial system consisting of state, private and foreign banks, government and corporate bonds, two equity markets, insurance, leasing and non-bank finance companies. A key characteristic of Vietnam's financial reform is that its quick-track financial liberalization is not adequately accompanied by a strengthened supervisory system. Space does not permit a full discussion of the risks accompanying this rapid transformation. However, it is important to highlight three immediate sources of vulnerability in Vietnam's financial system in which banking is currently the most vulnerable sector.

First, it is too easy to open a bank in Vietnam. Like Argentina and Chile in the 1970s, and Indonesia in the 1980s, the government is not sufficiently selective in the awarding of bank licenses. As in these countries, and numerous others, the result is rapid credit growth as inexperienced bankers acquire high risk assets and fail to diversify their portfolios.[24] The end result in these countries was loss of control over monetary policy, bank failure and recession.

Second, Vietnam is also repeating the mistake of many developing countries that have allowed non-financial interests to open banks. In addition to the risks associated with ill-planned diversification discussed above, this leads to distortions in the allocation of credit, as conglomerates use their banks as ATM machines to loan money to companies within their business group without properly assessing the risk of such loans. This led to greater systemic risk in countries as diverse as Japan, Chile, and Indonesia, and also financed the growth of powerful business interests that came to dominate these economies while increasing risk to the entire nation.

Third, Vietnam has allowed the number of banks, securities companies and non-bank financial firms to mushroom while failing to put in place a rigorous system of regulation, supervision and enforcement. The amount of intra-group lending in Vietnam is unknown. It is known that many small banks hold little or no fixed income assets and are over-exposed to the property market. This is recipe for disaster. Inadequate

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[23] http://www.tienphongonline.com.vn/Tianyon/Index.aspx?ArticleID=121113&ChannelID=3

[24] Immediately prior to the East Asian financial crisis, Indonesia had 240 banks. Credit growth in the small private banks averaged over 40 percent a year between 1988 and 1996. This is about half of the corresponding rate among Vietnam's joint stock banks in 2007. In South Korea, there were 25 domestic banks before 1997, but only 13 including 7 national banks and 6 regional banks exist today serving a one trillion dollar economy, far fewer than in Vietnam.

regulation, supervision and enforcement open the door to excessive risk taking, and leave the entire financial system vulnerable to sudden shocks.

IV. Policies for Stabilization and Long Term Growth

A. Regaining fiscal and monetary control

Vietnam is in uncharted waters. It needs foreign capital, but too much, if used improperly, can be harmful. It needs to cut back severely on public investments, but lacks a mechanism to identify those projects that are really productive and needed and those that are simply desired by some province or group, even if they accomplish little. Unless or until it knows more, it will find it hard to be decisive without creating trouble. Meanwhile, the conglomerates are powerful and well represented, so any attempt at rational policy making will be fought by those who see their own interests as being very much in the national interest, even when this is not the case. Who can resist their pressure? *It would take a political coalition that understands the importance of a stable macro-economy for continued growth and social stability*. But such a coalition needs to be created, for it does not clearly exist yet.

In a calmer world, a country like Vietnam would have higher interest rates than in Japan, but its currency would be expected to (and often would) depreciate against the yen at an annual rate about equal to the differences in interest rates on government bonds. That way, there would not be a huge expected profit to be made from borrowing yen and buying dong bonds, and thus not a huge capital inflow to destabilize the economy. Higher interest rates, especially higher deposit rates than inflation, would attract funds from local private holdings of dollars and gold and create more "home grown" financial savings. If banks grew more skilled at lending, then such savings would finance useful things like firms creating stable jobs rather than luxury real estate. (And firms would not expect to borrow at rates less than inflation – essentially taxing savers.) Moving more wealth out of dollars and gold would also give control of the money supply back to the State Bank. That is where Vietnam wants to end up. How it gets there, or even whether it gets there, is a difficult but urgent question.

In order to get inflation under control, credit growth cannot be allowed (in total, not for a particular bank) to grow at 40-50 percent a year. Yet even achieving this is difficult when so much of the money supply is effectively in dollars or gold. These are not under central bank control and often flow into the economy without even being registered. So the monetary brakes are not strong.

The first priority must be to regain control over government spending, including the growth of credit to state owned enterprises. The government must impose the discipline of the market on the state owned conglomerates, and force them to divest themselves of financial sector interests. Public investment projects must be rigorously appraised, and projects that do not deliver value for money must be cancelled. The markets are waiting for the government to impose these policies and implement them forcefully. If the government cannot regain control over fiscal policy and the conglomerates, it will not achieve macroeconomic credibility. Without credibility, there is the risk of a large capital outflow, which would be very painful.

B. Restructuring the state sector: Lessons from China

The most dynamic and competitive sectors of the Vietnamese economy are also the most integrated. By contrast, the much of the financial sector and the state-owned sector have resisted meaningful integration. This must change. As macro-economic credibility is recovered, there has to be an infusion of international capital and expertise into the financial sector and the state-owned sector. The main point of Vietnam's international trade pacts, especially WTO, was to enter the global trading and financial system on favorable terms. These agreements can and should be accelerated to attract foreign capital into the now severely undercapitalized banking system. Since the bubbles of stocks and real estate are popping, it would now be helpful to move to 2008 the phased-in liberalizations of 2009 and 2010. Banks in the United States are following a similar strategy; having lost billions of dollars in unwise loans, they are now seeking and getting foreign capital to bolster their balance sheets. Foreign capital will want to be able to ensure that loans are made only on commercial terms without undue risk. This will help to transform and professionalize the financial system and force all borrowers to pay interest rates appropriate to their condition.

Vietnam's WTO membership can also a powerful tool for forcing a transformation of the state-owned sector. We note that China decided to accelerate the implementation of its WTO commitments in order to put pressure on the state sector to reform.[25] The transformation of a number of Chinese state conglomerates into globally competitive firms offers important lessons for Vietnam. First, Chinese state firms have been permitted to operate similarly to their private sector competitors. The most successful have abandoned the state personnel apparatus and pay scale and adopted personnel systems that more closely resemble those found in the private sector. Compensation is performance based; as a result managers at private firms are often recruited by state firms. An additional factor is that given the size of the Chinese market, there is competition among state firms; the state regulatory apparatus recognizes the value of maintaining competition and has acted to prevent collusion among state firms that is commonplace in Vietnam. Second, some conglomerates have sold stakes to international strategic investors, taking international executives onto their boards. In light of Vietnam perilous fiscal situation, and the lack of capacity within the state sector, we believe that Vietnam will need to allow foreign investment in the state sector. The string of failed efforts to identify strategic investors in equitized companies suggests that the government must adopt a new approach to the valuation process. The objective of foreign investment is to enhance the competitiveness and value of these firms, yet it appears that the government is more focused on securing the highest possible share prices.

Vietcombank's recent failure to find a strategic investor is illustrative. The requirement that potential strategic investors purchase shares at the average auction price (a reversal of an earlier policy), was explained by a Vietcombank representative as necessary both to ensure that state assets were not sold too cheaply and to protect small investors.[26] Commercial banks in China, such as the Industrial and Commercial Bank of China (ICBC) have followed a very different strategy. ICBC sold a 10 percent stake to foreign strategic investors at a price equal to only 25-30 percent of the market price, but, with the contribution of these investors, within one year the share price of ICBC had more than doubled, benefiting both the state and small investors. At the same time, Vietcombank's share price has fallen from 107,800 VND at the end of 2007 to 30,000 VND now. Of course, Vietcombank's share performance is influenced by the general economic environment, but is could be argued that it would not have declined so rapidly if the initial offering price had been determined more accurately with the participation of strategic investors.

V. A Ten Point Recovery Plan[27]

The following list of action points forms the basis of a government-led stabilization program. It is important to emphasize that policy makers cannot pick and choose from this list. Failure to implement it in its entirely could result in worsening conditions in all the key macro areas, namely inflation, exchange rate, and banking liquidity/solvency, and eventually a crisis/recession, for example if monetary policy is tightened to the point at which private sector producers are forced out of business, resulting in a fall in domestic supply of goods and services, at the same time increasing unemployment, reducing exports, and expanding the trade deficit. Moreover, it will be critical to closely monitor on an ongoing basis key economic indicators including those analyzed in Section I above.

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[25] This is a very different approach from that followed in Vietnam. In *Choosing Success*, we argue that the conglomerates and general corporations are following a strategy to circumvent Vietnam's WTO commitments.

[26] We note that Vietcombank is not an isolated example. The initial public offerings of several large state companies such as Bao Viet, Sabeco, and Habeco suffered similar fates.

[27] This section concentrates on policies needed to restore macroeconomic stability and position the economy to retain macroeconomic stability in the long-term. This does not mean that other socioeconomic policies are less important. On the contrary, protecting the poor and those most likely to suffer under the current conditions must remain a government priority.

A. Immediate Policy Actions

1. Fiscal policy tightening. Cut or postpone $public investment projects in addition to the government's plan to economize on recurrent expenditures.

   Policy: Make a list of public investment projects ranked by economic internal rate of return; Cut/postpone projects with the lowest internal rates of return until the amount of $1.65 billion í reached to reduce the official budget deficit by 2 percent. Prepare to make additional cuts/postponements as needed.

   Objective: 1) bring down the fiscal deficit to a prudent level in line with international norms, 2) Synchronize fiscal policy with monetary policy to reduce overheating in the economy which is fuelling inflation, 3) Help contain the trade deficit as the current surge in imports is partly caused by import demand by public projects and reduce dependence on capital inflows which are needed to finance the deficit; 4) On-budget public expenditures are difficult to cut; 5) Send a clear signal to the business community and the public about the government determination to quell inflation

2. Gradual Increase in Interest Rates. The State Bank of Vietnam's decision to remove the deposit interest rate ceiling and increase the base interest rate to a level closer to market reality is a positive step, in keeping with monetary policy control in a market economy. This policy will lessen the current negative interest rates, encourage savers to put their money in banks, and help overcome the current liquidity crunch. However, when this policy takes effect, commercial banks will immediately increase interest rates to mobilize capital, perhaps sparking a new interest rate race. At the same time, because the margins of small banks are often very thin, they may look to expand credit to compensate for their squeezed margins, thereby creating additional inflationary pressure. The State Bank of Vietnam should prepare for this scenario.

   Policy: Raise the base rate in order for commercial banks to gradually raise deposit rates, moving towards actual positive interest rates. Ensure necessary liquidity in the interbank market. Prepare a response to a possible interest rate race among commercial banks, especially among small join stock banks.

   Objective: This will achieve the following: 1) ease the liquidity problems for commercial banks by attracting money back into the banking system; 2) taking pressure off the exchange rate by encouraging businesses and households to hold VND; 3) contain inflation by encouraging savings and reducing consumption

3. Impose 12-month moratorium on issuance of new bank licenses

   Policy: SBV issues a directive

   Objective: This will achieve the following: 1) limit the expansion of new credit to reduce inflation; 2) help stabilize the banking system; 3) prepare for mergers and acquisitions of weak banks; 4) Reduce burden on overextended supervision system

B. Short- to Medium-Term Policy Actions (immediate impact)

4. Consolidate the government budget to include all off-budget revenues, expenditures, borrowings, funds, and contingent liabilities, including those of provincial governments and state owned enterprises. Develop budget projections for a five year period (that is, move beyond liquidity to present information on the government's solvency). Publish consistent estimates of the government's deficit and show how this deficit is financed. Make these estimates public and up to date.

5. Strengthen bank supervision and reporting to defuse fears about bank insolvency and to enable SBV to prepare for possible bail-outs. Develop plans and legal instruments to conduct mergers or takeovers of insolvent banks, including allowing mergers with or takeovers by foreign banks. Conglomerates must be required to divest all investments in banks and financial companies. Improve bankruptcy procedures to enable firms to liquidate their assets quickly.

6. Remove government backing from new SOE borrowing, foreign and domestic. Require foreign banks to provide (at least) 10 percent of any new borrowing, but based on commercial loan analysis, not government guaranties. Proceeds of past foreign borrowings may best be allocated to Vietnam's foreign exchange reserves.

7. Strengthen the National Financial Supervisory Commission. Several months have passed since this commission was established but it still has no professional staff. The advantage of this institution is that it's relatively independent and tasked with the mandate of supervising both bank and non-bank financial institutions. While it takes time to improve the skills and personnel of the SBV and MOF, a small group of talented and experienced technocrats in the NFSC can be part of an urgent solution.

C. Short- to Medium-Term Policy Actions (longer-term implementation and impact)

8. Restructure SBV, Ministry of Finance, and the National Financial Supervisory Commission. Acquire external expertise to achieve these tasks, including retired officials from neighboring countries that have managed to strengthen their central banks and finance ministries over time.

9. Accelerate the implementation of WTO requirements in order to increase pressure on the state-owned sector to become more competitive.

10. Conduct independent audits of all 19 state owned conglomerates. These audits should be conducted by reputable international firms; appropriate state authorities must be empowered to enforce the full cooperation of the conglomerates. The results should be made public.