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POLICY DISCUSSION PAPER NO. 4¹

STRUCTURAL CHANGE: THE ONLY EFFECTIVE STIMULUS

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

Overview

This paper responds to a request from the Vietnamese government for an analysis of the impact of the global economic crisis on Vietnam, and policy recommendations to help the government stimulate growth and reduce the risk of financial crisis. The government has proposed an economic stimulus valued at six billion US dollars, although details of this plan are still being worked out as we prepare this note. We have made the case in previous research and policy discussion papers that the roots of macroeconomic instability in Vietnam are domestic, and that the appropriate policy response is structural change. We argue in this paper that the deepening of the international economic downturn strengthens the case for structural reforms. Further, we are concerned that the fiscal and monetary stimulus proposed by the government will not have the desired impact but will instead accelerate inflation and increase systemic financial risks. We therefore recommend an alternative set of policies including gradual depreciation of the VND and adjustments to the public investment program to delay capital and import intensive projects in favor of labor intensive projects that do not rely heavily on imports. At the same time, the government must not lose sight of long-term objectives and should strive to ensure that when the global economy recovers, the Vietnamese economy is competitively positioned to return to rapid and sustained growth. This will require continuing to address regulatory and infrastructure bottlenecks and reducing systemic risks.

The present policy discussion paper makes five points:

1. The current global recession is likely to prove the most serious since the 1930's. Some of the world's largest economies will see their output shrink in 2009 and estimates of global growth continue to fall. The volume of global trade is likely to contract, as will the level of capital flows and investment. Households are cutting back sharply on consumption and businesses on investment, as banks are reluctant to lend due to their large loan losses. Measures to cut interest rates, restore liquidity and boost fiscal spending in the US, Europe and Japan will moderate but not fully offset this downward pressure in 2009. Growth rates in developing countries are likely to be half to two-thirds of their 2007 levels.
2. The recent deceleration of consumer price inflation in Vietnam is a positive development that is largely a result of the government's success in curbing credit growth in the second half of 2008. While some state owned corporations are claiming credit for slower price rises, in our view their efforts to control prices by administrative fiat were either ineffective or counterproductive. The important

¹ This paper is the fourth in a series undertaken in the context of a policy dialogue initiative with the Vietnamese government that is coordinated by the Ministry of Foreign Affairs, the Harvard Vietnam Program's principal policy dialogue partner. This paper responds to a recently renewed request from the Vietnamese government to the Harvard Vietnam Program for regular independent policy analysis. It has been prepared by a team of policy analysts from the Harvard Kennedy School and the Fulbright School, including Nguyen Xuan Thanh (thanhnx@fets.vnn.vn), Vu Thanh Tu Anh (anhvt@fets.vnn.vn), David Dapice (david_dapice@harvard.edu), Jonathan Pincus (jonathan_pincus@harvard.edu), and Ben Wilkinson (ben_wilkinson@harvard.edu). The views expressed in this paper are those of the authors alone and do not necessarily reflect those of the Harvard Kennedy School or Harvard University. *During the period of embargo, this paper cannot be quoted or cited without the permission of the Harvard Kennedy School Vietnam Program.*

- lesson from this experience is the close relationship between the money supply and inflation in Vietnam, and the inflationary risks posed by excessive credit growth.
3. As a small economy with a fixed exchange rate and large fiscal and trade deficits, Vietnam's policy options are more limited than large countries like China. While China is correctly undertaking a large fiscal stimulus, it does so from a much stronger initial position. China has huge current account surpluses while Vietnam has large deficits. China has \$1,500 in foreign exchange reserves per capita, compared to Vietnam's level of \$250 per capita. Its rate of inflation is much lower. The domestic stimulus is more likely to stay within the country, as the import to GDP ratio is much lower than in Vietnam. The most likely outcome of a fiscal and monetary stimulus in Vietnam is an acceleration of inflation and a widening of the trade deficit. Vietnam will find it difficult to finance a larger deficit in 2009 because of the expected slowdown in exports and FDI.
 4. The main policy levers available to the government are the level of the currency and the composition of the public investment program. The VND should be allowed to depreciate gradually, and the public investment program should delay import and capital intensive projects while accelerating implementation of labor intensive projects that do not rely heavily on imports. In order to accelerate productive public investment, we recommend the establishment of a task force to streamline investment approval processes and to make them more transparent and accountable. This is preferable to suspending competitive bidding as suggested by some large state conglomerates.
 5. At the same time, Vietnam should begin now to prepare for the resumption of rapid economic growth at the end of 2009 or early 2010. Public investment should focus on the removal of infrastructure bottlenecks rather than prestige projects and heavily subsidized state industries. Strengthening of the banking sector is needed to reduce systemic risk.

The paper proceeds as follows. Section I provides a brief overview of the international economic crisis. The evidence increasingly points to a deeper and longer recession in the US and Europe than has been forecast previously. Economic policy in Vietnam must start from a "worst case" scenario under which demand for exports and the supply of foreign investment remain weak throughout 2009 and into 2010. Section II reviews the causes of inflation in 2008 and draws lessons for 2009. Section III discusses the scope for fiscal and monetary loosening in Vietnam in the context of the global crisis. Given the country's fixed exchange rate regime, large fiscal and trade deficits, low foreign exchange reserves, an overvalued currency, weak banks and dependence on foreign savings, Vietnam cannot simply replicate the expansionary fiscal and monetary policies of large economies like China, the US and the UK. Policies more appropriate to Vietnam's situation include a gradual depreciation of the VND, a reallocation of public investment toward labor intensive projects that do not rely heavily on imports and the creation of a Public Investment Task Force to propose reforms to streamline public investment and make it more efficient, transparent and accountable. Section IV turns to the future, and proposes policies to prepare Vietnam for the resumption of global growth towards the end of 2009 or early 2010. Two technical appendices address the origins of the US recession and Vietnam's macroeconomic policy space in the face of a slowdown in global growth.

Section I. The global financial crisis and its implications for Vietnam

"There are no quick or easy fixes to this crisis, which has been many years in the making, and it's likely to get worse before it gets better."

-- U.S. President-elect Barack Obama.

It is now clear that the recession resulting from the global financial crisis will be longer and deeper than previously thought. IMF Chief Economist Olivier Blanchard calls this "the worst crisis in 60 years."² Citigroup's near collapse and subsequent government bailout is a reminder that credit markets are still impaired. Investors are still willing to buy US treasury bonds that yield no interest at all, content only to preserve their capital rather than lose it in vulnerable banks, risky corporate bonds or plunging equity markets. The combined effects of the liquidity crunch and the drop off in consumer demand has brought the entire US automobile industry to the brink of bankruptcy. Auto makers in Europe, Japan, Korea and China are also

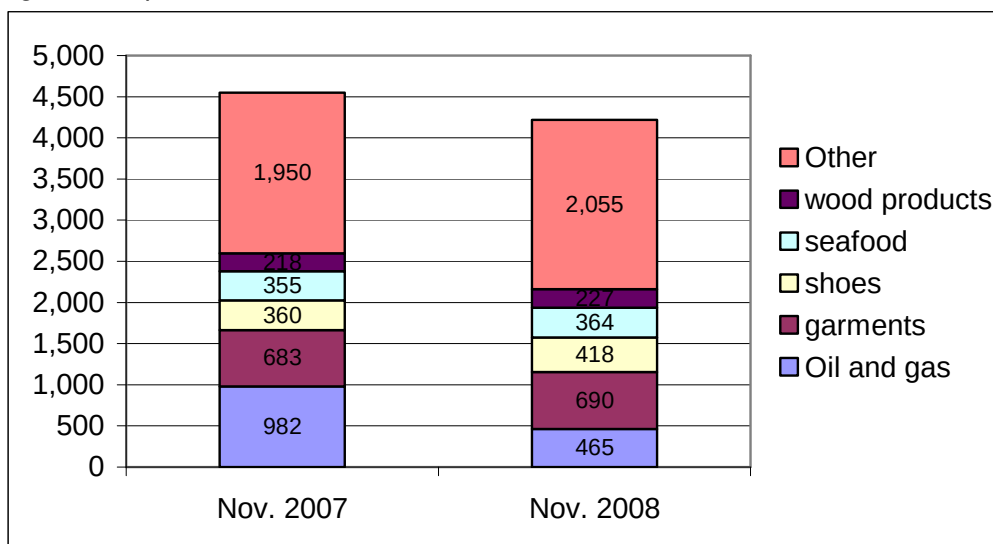
² Olivier Blanchard, "Cracks in the System: Repairing the Damaged Global Economy," *Finance and Development*, December 2008, p. 8.

receiving or requesting government support. November retail sales in the US recorded the largest one-month drop in thirty years. The most recent US jobs report revealed that the economy shed more than half a million jobs in November, pushing the unemployment rate up to 6.7%. Nearly two million US jobs have been lost since the end of 2007. Early estimates suggest that the US economy in the final quarter of 2008 is shrinking at the fastest rate since the 1982 recession. Although it is difficult to predict with any amount of accuracy, most economists expect negative growth in the US until the end of 2009 or early 2010 (see Appendix I for details on the US financial crisis and the prospects for economic recovery).

The gloom is not confined to the United States. The Bundesbank forecasts that the German economy will shrink by 0.8 percent next year. The chief economist of Deutsch Bank considers this optimistic, predicting that the contraction could be as much as four percent of GDP. Japan's economy shrank by 0.5% in the third quarter of 2008 or 1.8% on an annualized basis, and Japanese exports fell at the record rate of 27% year on year according to recently released figures for November. The economies of Singapore and Hong Kong have already contracted for two consecutive quarters. November exports were down 24% year on year in Taiwan and 18% in Korea. China has recorded its first monthly fall in exports for more than seven years. Year-on-year house prices are down 20% in Ireland, 17% in the US and 14% in the UK. In Spain, prices have dropped by 10% in Madrid and Barcelona. Even China is not immune, with residential property prices in Shanghai falling by one-fifth in the third quarter of 2008, and exports falling for the first time in many years. Manufacturing is contracting in the US, the Eurozone, the UK, Sweden, Japan and China. Iceland, Pakistan and Ukraine have turned to the IMF for help.

The global crisis will affect Vietnam's macroeconomy in at least five ways. First, demand for some Vietnamese exports will weaken. To date Vietnam's export performance has remained remarkably strong, but a slowdown is inevitable. As shown in Figure 1, Vietnamese trade data indicate that exports fell by 7% in November, largely as a result of falling oil prices. Prices of other commodities produced in Vietnam are also falling (Figure 2). Anecdotal evidence suggests that orders for manufactured exports including garments, footwear and furniture are dropping quickly, and seafood producers are also under pressure.³ According to the Ho Chi Minh City branch of the Vietnam General Confederation of Labor, 30,000 jobs have already been lost in the city in these industries.⁴ With exports equal to 70% of GDP, and more than half of export demand originating in crisis-hit US, Europe and Japan, export contraction is likely.⁵

Figure 1. Exports, November 2007, November 2008



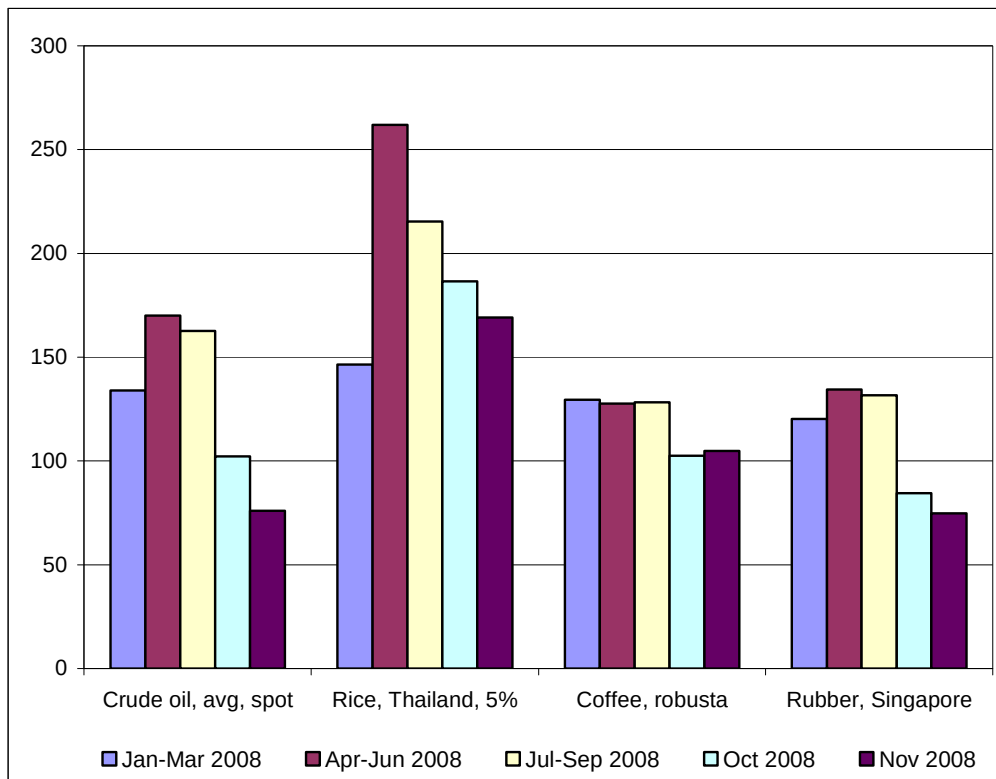
Source: GSO

³ "Seafood Industry Tangled in the Nets of Global Turmoil," *Thanh Nien Daily*, December 8, 2008, p. 6.

⁴ "Vietnam Says More Jobless in 2009," *Deutsche Presse-Agentur*, December 23, 2008.

⁵ In 2007, Vietnamese exports to US, EU, and Japan account for 26%, 19%, and 16% of total exports respectively.

Figure 2: Commodity price trends (2007=100)



Source: World Bank

Second, foreign investment will fall over the short to medium term as investors face financing constraints and reassess earnings prospects in 2009 and 2010. The *Financial Times* reported in early December that estimates of global foreign direct investment flows predict a 15% decline in 2009.⁶ While the decisions of individual investors and outcomes in individual countries will not necessarily conform to the global trend, Vietnam must be prepared for a drop off in FDI next year and perhaps 2010. Although the registered FDI in 2008 may reach US\$ 60 billion, only a small fraction of that amount will be disbursed. Moreover, since the equity ratio in these FDI projects is only 28 percent on average (compared to 43 percent for the period between 1988 and 2007), the global credit crunch will result in project delays and cancellations.⁷ The domestic bond market will also suffer as investors steer away from riskier offerings. Forced sales by money-losing hedge funds have already driven Asian corporate bond prices to record lows in 2008. Foreign borrowing is more expensive than just a few months ago as lenders demand larger risk premia. Most private Vietnamese firms already face credit constraints and must pay high interest rates when they do gain access to credit.

Third, tourist arrivals are also likely to fall. Culture, Sport and Tourism Minister Hoang Tuan Anh said recently that Vietnam will miss its annual tourism target in 2008, the first time that this has happened since the Severe Acute Respiratory Syndrome (SARS) outbreak in 2003. Tourism is an important source of foreign exchange and employment in Vietnam. Vietnamese banks have lent billions of dollars for hotel and resort development, and cannot afford to see these investment projects fail.

⁶ Stephen Fidler, "Foreign Direct Investment Faces 15% Fall," *Financial Times*, December 4, 2008.

⁷ We are informed that an international real estate group has just pulled out its US\$10-billion project in Quang Nam. It's very likely that this group will also stop another equally big resort project in Phu Yen.

Fourth, remittances from overseas could fall. It is likely that overseas Vietnamese are subject to the same income-asset price-credit problems that have affected other residents of the US and Europe. This could reduce inflows by billions of dollars.

Finally, the fall in commodity prices will result in a shortfall in government revenues. The government must now recalculate the central budget since the current version assumes an average oil price US\$ 100 per barrel in 2009. It is estimated that the budget will be reduced by US\$ 2 billion if oil prices remain at current levels. Moreover, other sources of revenue, particularly trade taxes, will also fall. In 2007, for example, import taxes, VAT and excise taxes on imported goods accounted for about 16% of government revenues.

In sum, the global crisis will reduce domestic demand generated by investment spending at home and exports. However, as we discuss in the next section, any attempt to substitute domestic for overseas demand will increase pressure on the balance of payments because much of what Vietnam consumes is not produced domestically, and because domestic production is import intensive. With foreign capital inflows declining, the balance of payments situation could be decisive.

Table 1: Current GDP Growth and Growth Forecasts

	2008	2009
Actual	6.23	n.a.
Government of Vietnam	6.7	6.5
<i>International organizations</i>		
World Bank	6.5	6.5
Asian Development Bank	6.3	5.0
IMF	6.25	5.0
<i>Others</i>		
BMI	6.0	5.0
Citigroup	6.3	5.2
CLSA	5.6	2.6
Deutsche Bank	6.1	4.1
Economist Intelligence Unit	6.1	4.3

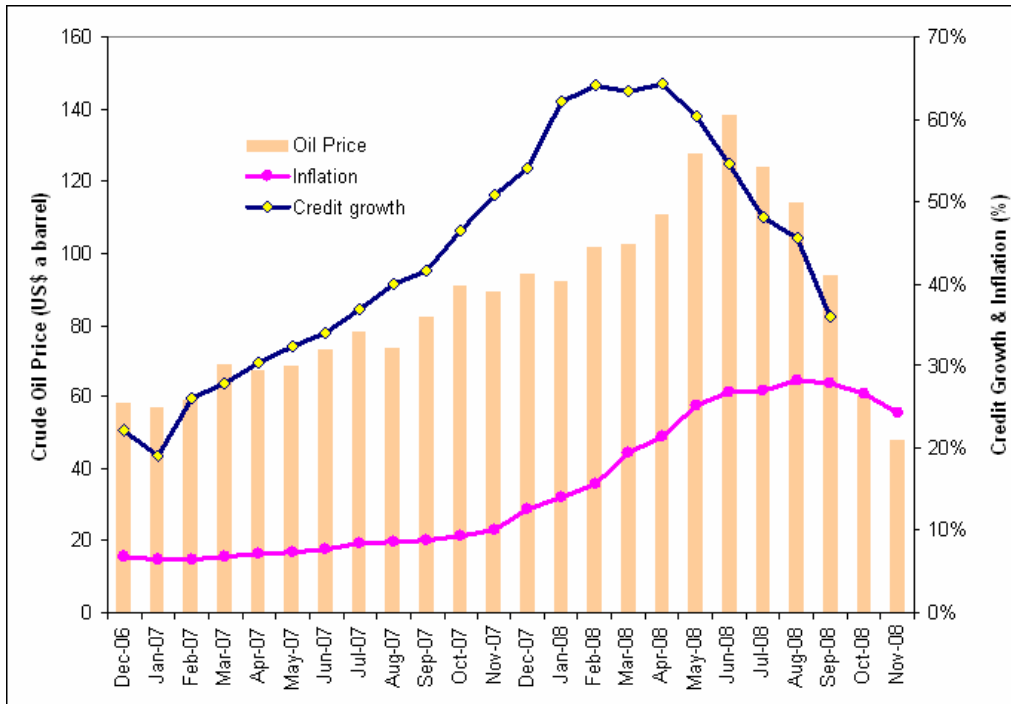
The combination of these factors has led most observers to reduce their growth forecasts for 2009. Only the government and the World Bank predict that growth will exceed six percent next year, with a consensus view forming around the five percent mark. Forecasting growth is never an exact science, and it is made even more difficult this year by the turbulence in international markets and the sensitivity of the final outcome to policy shifts. Nevertheless, economists agree that 2009 will be a difficult year, and that the government should prioritize job creation and price stability to protect the most vulnerable people in Vietnam.

Section II. The causes of inflation and effective policies for price stability

In previous policy discussion papers we have argued that the acceleration of consumer price inflation in 2008 was caused by rapid credit and money growth combined with a large fiscal deficit. Rising international commodity prices also played a role, but the fact that inflation was much worse in Vietnam than in neighboring countries signals the importance of domestic factors. Consistent with this analysis, the slowdown in money and credit growth in the second half of the year and the rescheduling of VND 49 trillion in public investment resulted in a deceleration in consumer price inflation. As shown in Figure 3, Vietnam's consumer price inflation began to ease before world oil prices began falling. While lower global oil and food prices

certainly contributed to the reduction in inflation, in the absence of monetary and fiscal tightening Vietnam would still be struggling with high rates of inflation.

Figure 3: Credit growth, inflation and oil prices



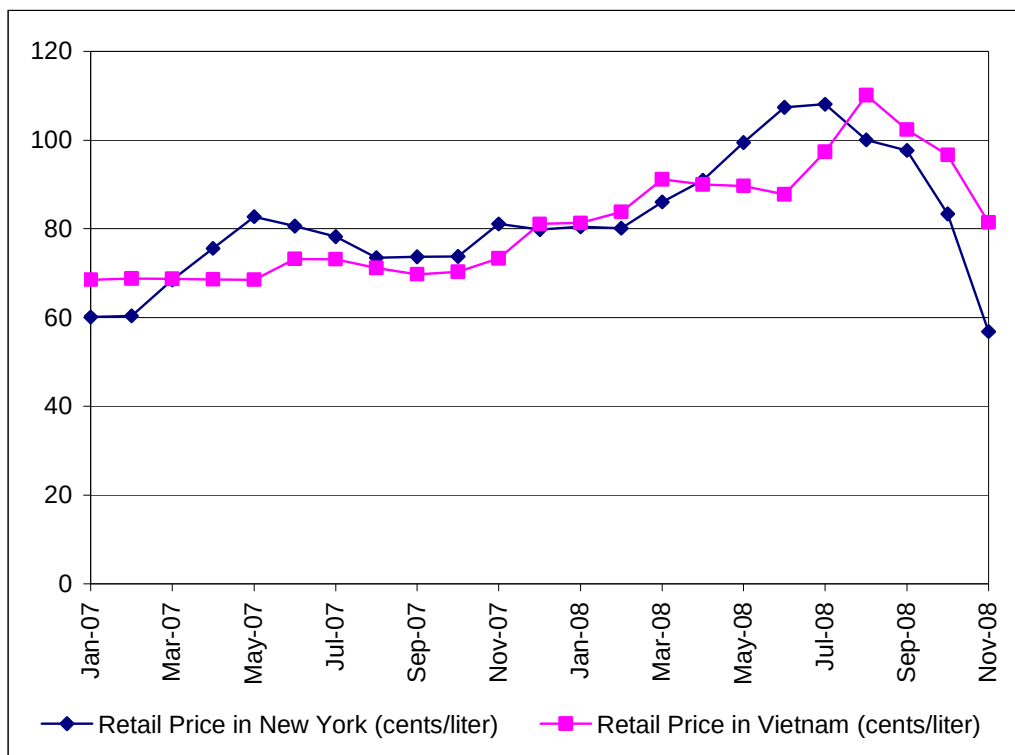
Source: State Bank of Vietnam, Global Financial Data

The government's decision to reign in credit growth and government spending are largely responsible for the reduction in inflation. But it is also important to remember that although the problem has been controlled, it has not gone away. Loss of control over credit growth—even in the context of a global slowdown—would again result in rapid price inflation. A sharp rise in the government budget deficit would also be inflationary. As we argue in the next section, running an even larger fiscal deficit would simply widen the trade deficit without stimulating economic growth.

Another lesson from the experience of 2008 is that administrative price controls did not work. Although some state conglomerates would like to claim that they stabilized prices of key goods, there is no evidence to support this assertion. As shown in Figure 4, retail prices of controlled commodities continued to rise throughout this period. The retail price of gasoline in Vietnam has generally reflected fluctuations in the international price. However, as the price of oil has returned to the level of two years ago, bringing gasoline prices down with it, the retail price of gasoline in Vietnam has remained higher, directly contributing to inflation. Similarly, while the price of raw paddy has returned to its December 2007 level, retail prices in major urban areas remain 30% higher. This suggests, first, that farmers are not benefiting from higher prices, a situation that is likely due to the dominant market position enjoyed by the two general food corporations. It also reveals inefficiencies in the internal distribution system that impose costs on consumers. It is likely that the main effect of administrative controls was to increase profits for traders—many of which are state-owned companies or related to state-owned companies—that were able to acquire goods cheaply at the administered price and sell them on the market at the retail price.

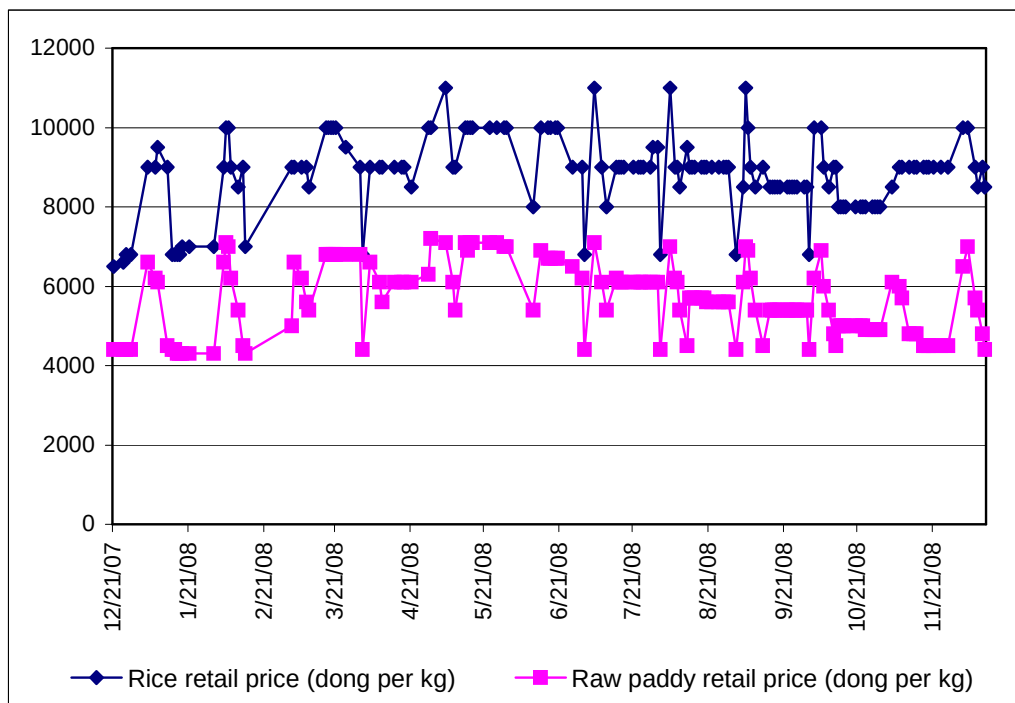
Figure 4: Market Prices of Selected Controlled Commodities

Gasoline



Source: Global Financial Data, Ministry of Industry and Trade

Rice



Source: Ministry of Agriculture and Rural Development

SOE managers often point to the fact that they sacrifice their own profits by selling products at a loss, something that no private firm would accept. Despite the fact that recent turmoil in markets for key economic inputs like steel, cement, electricity, and fertilizer suggest that state firms are not very good at ensuring market stability, this is a seductive argument and worthy of careful scrutiny. Maintaining low prices is only one goal; another is ensuring adequate supply. In the well known case of electricity, price restrictions create powerful disincentives to invest in electricity generation, which in turn have led to supply shortages, which are an obstacle to economic growth and impose huge hardships on consumers and businesses. The essence of the stabilization argument is that state enterprises are an essential bulwark against market forces which, left unchecked, would prey upon the poor and breed massive inequality. There is no question that modern market economies require sound policies to overcome market failures like negative externalities, asymmetric information and the under-supply of public goods. The question for Vietnamese policymakers is whether SOEs are the best vehicle for achieving these objectives. There are already many examples in Vietnam of how the power of competition can be harnessed within a sound regulatory framework to generate outcomes that benefit companies and consumers. Telecommunication services have developed rapidly not because they were sheltered under one state monopoly, but because providers were forced to improve services and value for money to win over customers.

Moreover, the subsidies that conglomerates provide to consumers are compensated by subsidies delivered to the conglomerates in the form of cheap or free land and capital and other special favors. The main problem with this system is that it is not transparent. Neither the government nor the conglomerates make enough information available to the public to analyze the macro and microeconomic implications of these various subsidies. The argument that the conglomerates subsidize consumers has been asserted, but it is not proven. Lack of information also conceals the inefficiency of individual firms, which is apparent in the aggregate but difficult to show at the firm level because the requisite information is not provided to the public.

Section III. What kind of stimulus?

The government announced a six billion US dollar stimulus plan on December 16. Although details of the plan have not yet been released to the public, newspaper reports indicate that the government intends to fund public works projects, guarantee some loans for large state-owned corporations, lower interest rates and taxes, inject liquidity into the banking sector and relax investment rules to accelerate disbursement of public investment funds.

At first glance, the idea of a fiscal and monetary stimulus seems logical and in accordance with the actions of governments across the region and globally. However, all economies are not the same and therefore governments cannot use the same set of economic tools to stimulate growth. Small economies that import much of what they consume cannot increase demand by simply running larger government deficits or lowering interest rates. The extra demand will leak out in the form of imports, and the resulting money growth will lead to price inflation. Similarly, when countries with fixed exchange rates lower interest rates, domestic businesses and households do not spend more money, they just buy dollars and gold.

Vietnam's policy options are much more limited than China's, a large country that boasts a substantial trade surplus and massive levels of foreign exchange reserves. While China posted an estimated current account surplus of 11% of GDP this year, Vietnam recorded a deficit of 12% of GDP. The result is that China has added to reserves and exported capital while Vietnam must find foreign savings to finance its deficit. China has accumulated \$1,500 in foreign exchange reserves per capita, compared to Vietnam's \$250 per capita. This means the Vietnam is more vulnerable to sudden shifts in capital flows. The rate of price inflation in China is also much lower than in Vietnam. Moreover, as a large country that meets most of its consumption requirements from domestic production, extra demand in China is likely to stay in the country.

Technical details on the macroeconomics of fiscal and monetary policies to stimulate growth are given in Appendix 2. The remainder of this section concentrates on the policy options available to the government to stimulate economic growth in the context of a serious and long-lasting global recession.

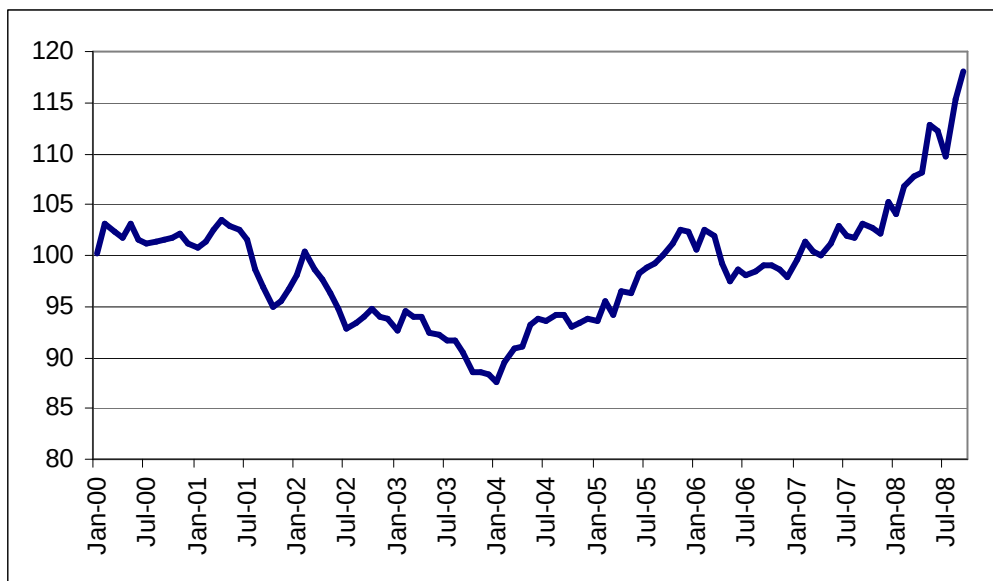
Policy Option 1: Gradual depreciation of the VND

Vietnam recorded large trade deficits in 2007 and 2008 as a result of extremely large capital inflows, the large fiscal deficit and economic overheating. Another reason for the trade gap is that the VND is too strong relative to the currencies of Vietnam's trading partners. Figure 5 shows the real effective exchange rate (REER) from January 2000 to September 2008. The REER tracks movements of the VND against the currencies of Vietnam's trading partners after adjusting for inflation.⁸ As shown in the figure, the VND fell in real terms from 2000 to 2003, but began to appreciate after January 2004 as domestic inflation began to accelerate. By September of this year the VND was 33% above its real value in January 2004 and 20% above that of January 2000. The trend has probably accelerated in the October-December period as the US dollar has strengthened against the currencies of a number of Asian countries and against the euro.

An overvalued currency makes imports cheaper and exports more expensive and less profitable to produce. As a country that relies heavily on export markets and is increasingly open to imports, Vietnam cannot afford to allow the real value of VND to rise too high. This is particularly true in years of slow global economic growth like 2009. Moreover, Vietnam already has a large trade deficit. Simply increasing government spending while leaving the exchange rate unchanged will widen the trade deficit without doing much to increase domestic demand. Domestic producers are also at risk from competition from cheap imports.

From this perspective, the government should assign a high priority to reducing the value of the VND gradually, paying careful attention to trends in the REER. The decision to devalue the currency by 3% on December 25 is a good start, and the initial market reaction has been positive. Non-deliverable forwards for the VND fell in the wake of the decision. But the fact that market rate immediately rose to the top of the trading band signals that further action is expected.

Figure 5. Real Effective Exchange Rate January 2000 to September 2008



Source: GSO trade statistics, IMF International Financial Statistics, authors' calculations

A managed depreciation of the VND is necessary but not without risks. First, Vietnamese companies have borrowed in dollars from domestic and international banks. If they earn in VND and pay back their debts in

⁸ This calculation is based on VND exchange rates against the country's 15 largest trading partners, which together account for more than 90% of trade by value.

dollars, a weaker VND would squeeze their profit margins and in some cases could increase the likelihood of default. Banks could accumulate more non-performing loans. For this reason, the adjustment must be gradual and must be signaled clearly by SBV to give borrowers time to adapt.

The second risk is inflation. Depreciation of the domestic currency makes imports more expensive. When close substitutes are available in the home market, consumers and business switch from imports to domestically produced goods. But many things that households and companies buy in Vietnam are not produced here, or at least at a price and quality comparable to imported goods. The result is that there is a good deal of “pass through” inflation when the VND depreciates. This is one reason why increasing the fiscal deficit now is very risky. If inflationary pressures are already strong, a depreciation of the currency could lead to a rapid upturn in prices. For a small, open economy like Vietnam, it makes more sense to allow the currency to depreciate than to increase the fiscal deficit. Doing both will lead to more rapid inflation.

Third, exchange rates sometimes “overshoot” when domestic residents and foreigners lose confidence in the capacity of the monetary authorities to manage the money supply. Households and businesses rush into safe currencies like dollars, or into assets like gold, when the domestic currency begins to lose value. In their desperation to preserve their wealth, they are willing to pay very high rates to acquire foreign currency, and no interest rate is high enough to entice them back into the domestic currency. For this reason, the government cannot cut interest rates and allow the currency to depreciate at the same time. Savers in VND must be able to make up through higher interest rates what they lose through currency devaluation. In other words, the annual rate of VND depreciation should reflect the difference between USD and VND interest rates on savings.

Policy Option 2: Adjustments to public investment priorities

Vietnam’s fiscal deficit is already large. Increasing it further will accelerate inflation and widen the trade gap. In view of the difficult external environment in 2009, Vietnam may not be able to finance a large current account deficit without resorting to emergency measures.

Although the level of the deficit should not be allowed to rise, this does not mean that fiscal policy is ineffective. According to official statistics, public investment accounts for about 18% of GDP and about 45% of total investment. The actual figure is probably much larger given the important role of the state in many joint stock companies. The government can therefore influence the overall pattern of investment through its public investment priorities.

Next year the government should change its investment priorities to emphasize job creation to protect the incomes of working people and domestic demand to minimize the trade deficit and stimulate domestic production. Public investment should also focus on providing essential infrastructure to sectors and industries that are the most labor intensive and that generate exports. For example, inadequate and deferred maintenance of irrigation and drainage systems has reduced the efficiency of government investment in agriculture.⁹ Too much emphasis has been placed on building new irrigation systems rather than maintaining existing ones. Maintaining and managing irrigation and drainage systems directly creates employment and also raises the productivity of agriculture in the areas affected.

At the other extreme, the government has recently approved a fourth oil refinery requiring an investment of \$4.4 to 4.8 billion dollars. The government has yet to publish a feasibility study demonstrating the economic benefits of this project. They are likely to be small if not negative. Major oil companies around the world were already reducing capacity even during the recent oil boom in response to narrowing margins and low profitability. The government also announced plans to construct a large port facility near Mong Cai in Quang Ninh. In earlier papers we have criticized overinvestment in port facilities. Projects such as these are unlikely to create jobs or address real bottlenecks. Aside from the inefficient use of state capital, projects of this sort add to the trade deficit and do little to create jobs for Vietnamese people.

⁹ Randolph Barker, Claudia Ringler, Nguyen Minh Tien and Mark Rosegrant, “Macro Policies and Investment Priorities for Irrigated Agriculture in Vietnam,” Comprehensive Assessment of Water Management in Agriculture Report 6, International Water Management Institute, 2004.

Policy Option 3: A new public investment task force

The examples cited above, and many other like them, indicate that the government's public investment program does not pay sufficient attention to efficiency and broader macroeconomic effects. Investment decisions appear to follow local and sectoral rather than national priorities. Economic criteria are not prioritized, and rigorous cost benefit analysis of project proposals is the exception rather than the rule. Despite complicated and time consuming approval and implementation procedures, the quality of decision-making has not improved with the increase in the size of the public investment program.

The solution proposed by managers of state conglomerates is to relax competitive bidding procedures and to allow them to spend state money with less oversight.¹⁰ This could perhaps speed up implementation, but it is unlikely to improve efficiency or the quality of decision-making.

Reform of state public investment procedures is important—in fact too important to leave to guess work or the vagaries of corporate interests. Careful research is required to identify the most important bottlenecks in the process and to propose solutions that enhance rather than undermine public transparency and accountability. We recommend that this research be undertaken by a special government Task Force on Public Investment, established as a cross-agency body capable of conducting in-depth investigations of the planning, approval, implementation and evaluation of public investment projects. The Task Force would operate much in the same way as the government's Task Force on the Implementation of the Enterprise and Investment Laws, and initiative that achieved considerable success in streamlining business registration procedures after the enactment of the Enterprise and Investment laws.

The Task Force would exist as an advisory rather than as a regulatory body. It would conduct research and propose policy changes affecting public investment to the Prime Minister. Procedural changes not requiring National Assembly action could be undertaken by the government under the direction of the Prime Minister, while proposed changes to existing laws could be referred to the appropriate National Assembly committee.

Section III. Preparing for Renewed Growth

For small economies, the external economic environment is like the weather. Nothing can be done to change it, and it always pays to be prepared for the worst. The best approach is to try hard to minimize the damage caused by stormy economic conditions while doing what we can to prepare for better times ahead.

We have already discussed the steps Vietnam needs to take in the short term to cope with next year's difficult external environment. In this section we propose measures to prepare the country for recovery and growth over the medium to long term. Our suggestions will be familiar to readers of "Choosing Success" and our other policy discussion papers.¹¹ In short, the government needs to maintain macroeconomic stability, supply essential public infrastructure, widen access to secondary and tertiary education and improve the quality of education at all levels, reduce systemic risk in the banking sector and increase international competitiveness by getting rid of monopolies and special favors for well-connected companies in the domestic market.

In addressing short term economic challenges Vietnam must not lose sight of its long term economic goals. Central to achieving high growth in the long term should be promoting the emergence of competitive firms, irrespective of ownership. When assessing policy options, Vietnamese policymakers should ask a few basic questions. One question that needs to be asked more often than it is at present is whether proposed policy changes are likely to make domestic firms more or less competitive. Some of the policies now under consideration might ease difficulties for a few companies in the short run but may prove counterproductive in the long run. For example, abolishing competitive bidding is likely to reinforce existing, uncompetitive

¹⁰ See "Sớm khởi động kích cầu 6 tỉ USD," *Tuổi Trẻ*, December 17, 2008.

¹¹ "Lựa chọn Thành công: Bài học từ Đông Á và Đông Nam Á cho tương lai của Việt Nam," available in Vietnamese at http://www.fetp.edu.vn/index.cfm?rframe=/research_casestudy/research_caseintro.htm. Other policy papers also available at this website.

practices such the “asking and giving” mechanism in public investment. Similarly, calling on the state owned commercial banks to contribute to the stimulus package by lowering interest rates and restructuring loans will not promote the improvements in governance and capacity that are necessary to create a competitive financial system. Indeed, this policy may reinforce existing practices, if it encourages banks to lend to favored borrowers and evergreen nonperforming loans.

A second crucial question is the impact of government policies on job creation. Table 2 presents employment elasticities of non-agricultural growth for the state sector, the non-state sector and the foreign invested sector.¹² A larger elasticity means that more jobs are created for every unit of economic growth. The table points to several worrying conclusions. First, Vietnam now produces far fewer jobs for every unit of growth than just a few years ago. Second, the state sector produces considerably fewer jobs per unit of growth than either the non-state sector (which also includes a large number of partially owned state firms) or the foreign invested sector. Indeed, from 2005 to 2007 growth in the state sector was essentially jobless.

Table 2: The Employment Elasticity of Nonagricultural Sector Growth

	2001	2002	2003	2004	2005	2006	2007
Total non-agriculture	0.915	0.972	0.822	0.727	0.654	0.640	0.542
State sector	0.412	0.613	1.036	0.264	-0.213	-0.344	0.121
Non-state sector*	0.877	0.836	0.631	0.738	0.678	0.625	0.419
Foreign invested sector**	2.775	4.411	2.987	1.981	1.431	1.233	1.209

* Includes joint stock companies partially owned by the state.

**Defined as a minimum of 30% foreign ownership.

Source: Author's calculations from GSO data.

Jobless growth in the state sector means that directing funds from the government's stimulus package to state firms will not generate steady and secure employment for Vietnamese workers. Vietnam's state-owned companies already draw down about half of all business investment in the country. Their hunger for investment and inability to create jobs is the main reason that Vietnam's economy does not create more employment. Giving them even more money will not reverse this trend. Instead, the government should use its resources to create the conditions required to enable all firms—regardless of ownership—to generate sustainable and equitable growth.

Here too, the design and implementation of the Enterprise Law can provide a model for the approach needed now. The architects of the Enterprise Law conducted a careful analysis of the external costs imposed on firms and then designed a new, streamlined regulatory framework that eliminated as many unnecessary or inefficient regulations as possible. Vietnam would be well served by applying this type of efficiency analysis to other economic policy areas, including state investment in enterprises, infrastructure and other public goods.

Reducing systemic risks in the financial sector should also receive more attention. The government has allowed corporate interests, particularly state-owned conglomerates, to expand their activities in the financial sector. They have taken strategic positions in banks and opened new banks, finance, insurance, leasing and securities companies. This is a common pattern in under-regulated developing countries. But everywhere that it has been tried it has ended in disaster. From Indonesia's family owned conglomerates to Chile's *grupos*, interlocking corporate and financial interests has led to intra-group lending, the concentration of risk, loss of control over the money supply and eventually to financial crisis. For example, Vietnam Airlines has recently opened an insurance company with the state-owned machine manufacturer Lilama. From the standpoint of risk minimization and good corporate governance, the prospect of an airline insuring itself makes no sense.

¹² This paragraph and the accompanying table are based on Alex Warren-Rodriguez, “The Impact of the Global Economic Downturn on Employment Levels in Vietnam: An Elasticity Approach,” Hanoi: UNDP Vietnam Technical Note, December 18, 2008.

Neither of these companies has enough expertise in insurance or the financial capacity to do anything other than sell off risk to reinsurers. This is an example of state companies making easy profits through their connections rather than competing in national and international markets and creating value through innovation and hard work.

Banks and other financial sector enterprises are managed better when their owners are focused on the profitability of the company rather than the favors that the company can do for their other interests. Many countries therefore impose limits on bank ownership to ensure that one group or individual cannot exert undue influence on banking decisions. Banks and other financial firms must also possess governance structures that ensure that they put the interests of the institution ahead of those of strategic shareholders. A sound financial system is an essential prerequisite for sustained growth. To achieve this objective, Vietnam must begin the process of separating financial from other corporate interests. SBV should begin with a moratorium on new bank, insurance and finance company licenses, and a thorough review of the shareholding structures of existing institutions.

Section IV. Conclusions and policy recommendations

The central message of this paper is that Vietnam's policy options in the face of the current global economic situation and its own precarious macroeconomic position are limited. Although the proposed fiscal stimulus package is attracting a great deal of attention in the media, it is unlikely to have a significant impact on the economy, and may actually do harm if the funds are directed to capital and import intensive investments. In the short term, adjusting the exchange rate and reallocating existing spending are the two most effective tools Vietnamese policymakers have at their disposal. Vietnamese policymakers must not lose focus on the structural inefficiencies that are the root causes of the macroeconomic instability. In particular, they must make certain that in their eagerness to blunt the impact of the global crisis they do not damage Vietnam's ability to return to high growth when global conditions improve, this is why the policy recommendations listed below includes both "do's" and "don'ts."

1. **Gradually depreciate the VND.** A controlled depreciation of the VND against the currencies of major trading partners should be accompanied by tight control on the fiscal deficit and a close eye on interest rates for savers. It must be recognized that achieving this policy will put heavy demands on the State Bank of Vietnam and will require a thorough restructuring of the institution, which we have recommended in earlier policy discussion papers. Among other changes, the State Bank must communicate its policies clearly and convincingly to the market and the public.
2. **Reassess public investment priorities.** Vietnam's public investment program should focus on labor intensive projects that do not require imports and will resolve major bottlenecks. This will mean concentrating on projects in economic centers on which the national economy depends for growth and job creation. Capital and labor intensive investment projects should be postponed. Projects lacking a sound economic justification, such as oil refineries and port complexes, should be cancelled.
3. **Create a public investment task force.** A public investment task force to identify procedural changes in the selection, implementation and evaluation of public investment projects to accelerate disbursement, increase transparency and accountability and ensure higher rates of return on public funds.
4. **Impose a moratorium on new bank, finance and insurance company licenses, and conduct a review of the shareholding structures of existing firms.** Now is the time to strengthen the financial system by eliminating intro-group lending and other arrangements that concentrate financial power and risk within a few large companies.
5. **Do *not* increase the fiscal deficit.** Vietnam is already running a large fiscal deficit. As explained above, this means that its space for fiscal stimulus is limited, allowing the deficit to grow even larger will increase risks.

6. Do *not* lose control over credit and money growth. Inflation has slowed down, it has not gone away. Rapid credit growth will simply accelerate price inflation and draw in imports that Vietnam cannot finance at the moment. It is also likely to lead to asset bubbles rather than sustainable growth.

7. Do *not* restrict competition. Vietnamese firms will not become competitive abroad if they do not operate in a competitive environment at home. Current economic difficulties should not be used as an excuse to revert to uncompetitive practices, such as doing away with competitive bidding.

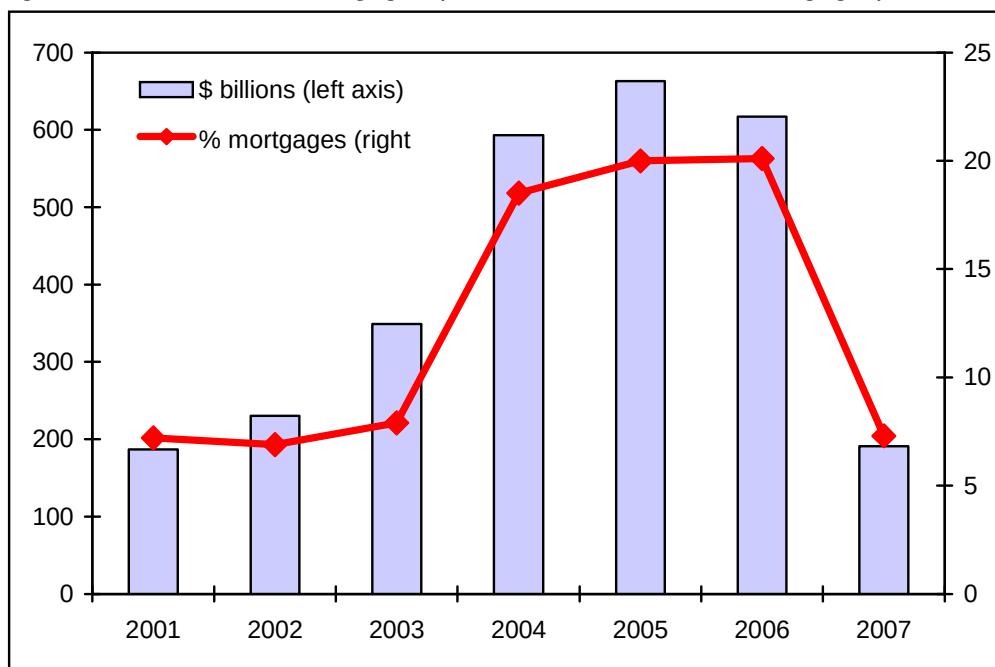
Appendix I. The Origins of the US Recession

As a small, export-oriented economy, Vietnam depends heavily on global demand and inward investment to generate economic growth. A long, deep global recession will therefore have a negative impact on economic growth in Vietnam. Some commentators in Vietnam have suggested that the worst of the current recession will be over by the middle of 2009. In our view, this is overly optimistic. In order to explain why we think so, this appendix presents a brief summary of the origins of the US financial crisis. A better understanding of the fundamental problems in the US is needed to form a more objective assessment of the likely length and depth of the recession.

After 2001, but particularly during the period 2004-2006, millions of American households took out mortgages to buy homes that they could not afford. Home ownership rose from 64% of households in 2000 to 70% in 2007. Additional demand for houses drove median house prices up 40% between 2000 and 2006, and the ratio of median house prices to household income rose from 3 for the period 1970-2000 to 5 in 2006. Simply put, Americans borrowed too much to buy houses at inflated prices that they could not afford.

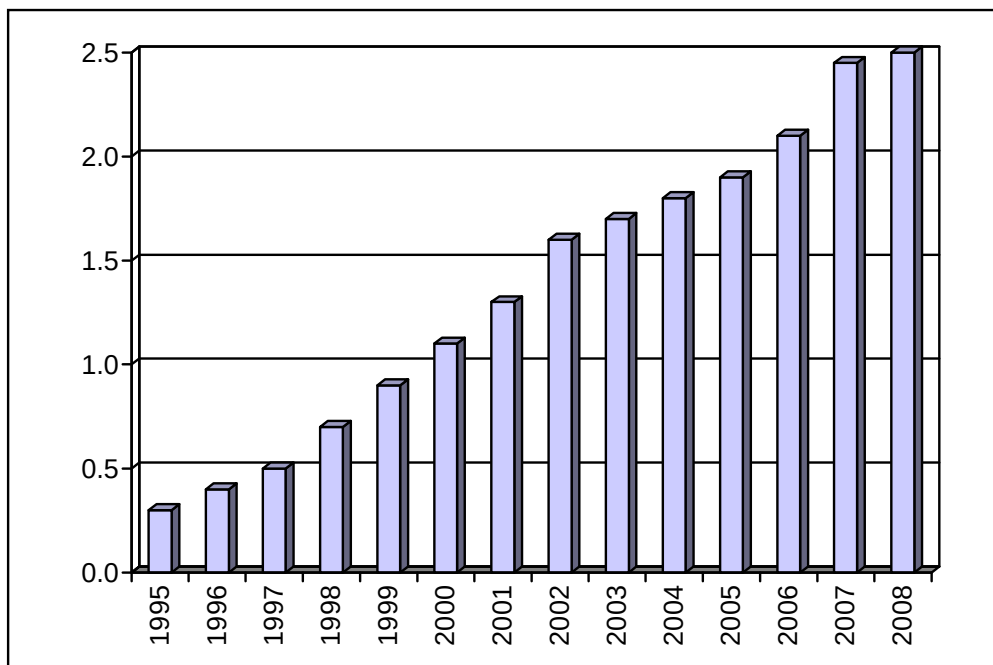
As we have since discovered, the financing underlying this surge in house buying was unsustainable. As shown in Figure 6, sub-prime loans (that is, loans to risky borrowers) accounted for one-fifth of all US mortgages in 2005 and 2006, up from just 7% in 2001. The banks then sold on most of these risky loans to investors in the form of mortgage-backed securities of various kinds. Investment and commercial banks bought these securities and loaned money to hedge funds and other investors to buy them, too. When house prices began to fall in 2007, the market for mortgage-backed securities froze up. Banks found that they had over \$600 billion in assets on their books that either took the form of or were secured by Collateralized Debt Obligations (CDOs) and other securities that were now of uncertain value. The face value of these assets is (held by all parties) about \$2.5 trillion, much larger than the \$700 billion rescue package approved by the US government (Figure 7).

Figure 6: US Sub-Prime Mortgages (total and share of all US mortgages)



Source: Harvard Joint Center for Housing Studies

Figure 7: Outstanding US Asset-Backed Securities (US\$ trillions)



Source: www.economist.com

It is not an exaggeration to say that American consumers drove the global economic boom from 2002-2007. Easy access to credit, rising asset prices and cheap imports led to a spending spree of historic proportions. US household debt rose steadily from just 94% of disposable income in 1998 to 140% in 2007. Falling prices started an avalanche of bad debt and home foreclosures. The more prices fall, the more unsold homes enter the market. But American households are not in a position to borrow money to buy them, and in any case the banks are not lending. So house prices fall further and household debt and consumption is actually declining.

When will prices stop falling? Although it is difficult to say, it is unlikely to be soon. Let's assume that if banks stop offering sub-prime mortgages home ownership will return to its long term rate of 64-65% of households. This means that the stock of unsold properties will reach about five million houses, precisely at a time when the banks are unable or unwilling to lend. It is therefore likely that excess supply will continue to exert downward pressure on US house prices for the next two years and possibly longer. Indeed, one in ten mortgages in the US is now behind in payments or in foreclosure, and 12 million home owners are "underwater," meaning that they owe more money to the bank than their homes are worth on the market. Many of these homeowners will simply walk away from their mortgages.

Sub-prime loans and mortgage-backed securities were not the only sources of bad debt in the international financial system. Once the trouble began, the underlying value of many kinds of financial instruments was called into question. In 1997, the market value of all derivative contracts (futures, options, swaps, and so forth) was approximately 75 trillion dollars, or 2.5 times global GDP. At the time this was regarded as a remarkable and potentially destabilizing sum given the unregulated and nature of most of these contracts and that fact that in some cases (for example credit default swaps) massive risk exposure can be generated by a small initial position. But by 2007 the total exceeded 600 trillion dollars, or 11 times world output.

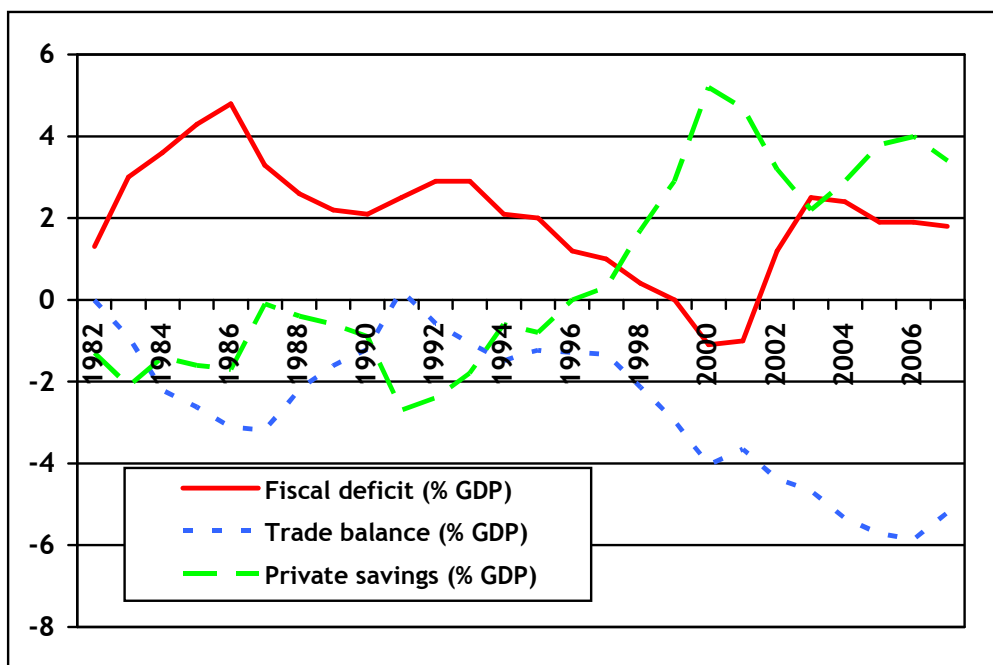
Banks were affected in three ways. First, many institutions held these instruments in their portfolios, and need to replenish their capital as they lost value. Second, banks extended credit to hedge funds and other businesses to buy CDOs, options and swaps, and many of these loans have gone bad. Finally, and probably most importantly, banks rely for liquidity on the interbank market. Investment banks like Lehman Brothers, Bear Stearns and Merrill Lynch operated a model that required high gearing ratios and easy access to short term loans from other banks to finance immediate cash requirements. When the crisis hit, banks hoarded cash and

stopped lending to other banks. This not only destroyed the US investment bank model, but also brought down banks like Britain's Northern Rock and HBOS that had funded long term positions with short term loans.

It is likely that the new US administration will extend some form of support to home owners. This could shorten the amount of time required to clear the housing market and restart lending. The government will undertake a range of stimulus measures to encourage American households to spend money. One of the problems facing the new administration is that with household indebtedness so high, Americans are likely to save rather than spend their tax rebates (which is why the Bush administration's fiscal stimulus did not work). As households deleverage, they will extract hundreds of billions of dollars from global demand. At the same time businesses are also deleveraging, postponing investment projects, hoarding cash to meet immediate obligations (salaries and input costs) and to pay down debt. The government will have to spend more to stimulate demand. However, as shown in Figure 8, the fiscal deficit was already large (about 2% of GDP) even before the financial bailouts began. The deficit will certainly increase, but this will not be sufficient to replace all of the demand extracted from the economy by higher savings rates, lower rates of investment and reduced consumer spending.

It is also clear from Figure 8 that the largest drain on US aggregate demand is the trade deficit, which is still more than 5% of GDP. As the economy slows, the US will import less. This has massive implications for China, Vietnam and other countries that rely heavily on US demand for export growth. China in particular will need to shift rapidly from reliance on US demand to a greater emphasis on the home market. The \$500 billion stimulus package announced by the Chinese government is a start, but it is not enough to support global demand at a time when the US is quickly retreating from its role of "consumer of last resort."

Figure 8: Source of demand, USA 1982-2007



Source: US Bureau of Economic Analysis (www.bea.gov)

Even a large fiscal stimulus will not restore US and global economic growth over the next year. Households and businesses will continue to deleverage until indebtedness falls to more sustainable levels. According to the IMF's most recent projections, the US economy will contract by 0.7% next year, while the euro area will shrink by 0.5% (Table 3). But even this may be overly optimistic if house prices continue to drop and if China is unable to attain the 8.5% growth rate predicted by the IMF. China must counter-balance weak consumer demand in the US and Europe without relying on exports to sustain demand. This will require China to shift

away from the exports-profits-investment strategy that it has pursued so successfully in recent years to a new strategy that relies more heavily on Chinese consumers and social spending.

As the crisis began in the US housing market, most economists agree that the economic recovery will not get underway until US house prices find their floor. But this still appears to be some way off. New home construction fell 19% in November to its lowest level since 1959. Foreclosure filings in the same month were 28% percent higher than last year. About 12 million Americans now have mortgage balances bigger than the market value of their homes. Consumer spending will not recover until home values stop falling and home owners are able to reduce the size of their debt relative to the long term value of their homes, which for most households is their most important capital asset.

Table 3: Most recent IMF growth projections, 2008 and 2009

	2006	2007	2008	2009
World	5.1	5.0	3.7	2.2
Advanced countries	3.0	2.6	1.4	-0.3
USA	2.8	2.0	1.4	-0.7
Euro area	2.8	2.6	1.2	-0.5
Emerging and developing countries	7.9	8.0	6.6	5.1
China	11.6	11.9	9.7	8.5
Vietnam	8.2	8.5	6.25	5.0
ASEAN 5	5.7	6.3	5.4	4.2

When will this happen? Although it is difficult to know for sure, most US observers expect conditions in the housing market to continue to deteriorate throughout 2009 and possibly for all of 2010 or even longer. For the US as a whole, house prices are 19% off their peak, but they are still 17% above the long term relationship between house prices and household income. If history is a guide, it will take at least two and perhaps a long as five years before the market begins to stabilize and recover.

Appendix II: The Macroeconomics of the Stimulus

Vietnam is a small economy that is open to trade and maintains a fixed exchange rate. The macroeconomic policy options open to such an economy are not the same as those that are available to large economies that produce most of what they or economies with flexible exchange rates. This appendix provides a short summary of the economics of stimulus packages, and explains why Vietnam must be careful to adopt policies that accord with objective conditions in Vietnam.

A. Monetary stimulus

Lowering interest rates and injecting liquidity into the banks makes sense in countries that meet the following criteria: i) massive losses have forced banks to hoard cash, which has tightened conditions in credit markets, particularly interbank markets; ii) exchange rates are flexible; iii) the country is large enough that growth in the money supply will reduce the real interest rate *and* the real exchange rate (in small, open economies an increase in the supply of money will typically result in a real exchange rate depreciation but not a fall in real interest rates); and iv) borrowing and lending take place for the most part in the domestic currency.

Vietnam does not meet any of these criteria. It is true that many banks in Vietnam are carrying too many non-performing loans, mostly due to overexposure to the property sector. But most Vietnamese banks are not short of liquidity and they are not hoarding cash. The interbank market is liquid and behaving normally. According to Vũ Tiến Lộc, Chairman of the Vietnam Chamber of Commerce and Industry, the biggest problem is not the lending rate but rather that fact that the banks cannot find enough viable borrowers.¹³ The State Bank of Vietnam (SBV) does not need to pump money into the banks like the Federal Reserve, the Bank of England or the European Central Bank.

Vietnam's exchange rate is fixed by the State Bank of Vietnam (SBV). Therefore monetary policy has a limited effect on output. Under flexible exchange rates, an increase in the money supply causes a depreciation of the domestic currency, which boosts domestic demand by redirecting spending to the home market and stimulating exports. Under fixed exchange rates, money growth cannot cause the domestic currency to depreciate. At the fixed rate, real interest rates (in other words, the nominal interest rate adjusted for VND inflation) fall below the international rate (dollar interest rates adjusted for dollar inflation). Domestic residents switch to assets denominated in foreign currencies, and if these are not available they move into assets like gold and land. The monetary authorities buy the domestic currency to defend the exchange rate, and in doing so they reduce the money supply. If the central bank does not step in to defend the exchange rate, the result is inflation and the sort of panic buying of foreign currency that we experienced in July of this year. With over \$100 billion of broad money supply and less than \$25 billion of foreign exchange reserves, it would be difficult to defend the exchange rate at a time of rising unemployment, still-high inflation, and stagnant exports.

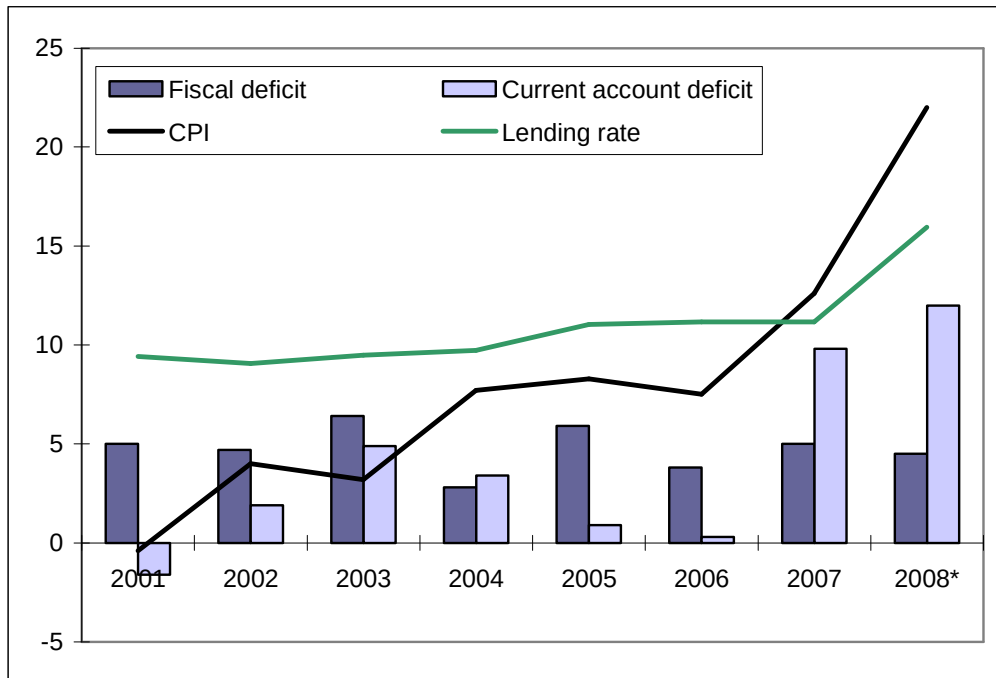
In other words, under fixed exchange rates monetary easing results in asset switching rather than more economic activity. This is clearly the case in Vietnam. Real interest rates are still broadly negative in Vietnam, and have been for most of the year. Negative real interest rates have not prevented economic growth from slowing down, but it has stoked inflation.

It is also important to remember that Vietnam is a small country that is very open to foreign trade. Large economies like the US, the Eurozone and China take on some of the characteristics of closed economies because such a large proportion of transactions in goods and capital markets take place in the home market. The ratio of imports to GDP is much lower, meaning that increments to consumption are more likely to stay in the country. Monetary loosening is therefore a reasonably effective way for large economies to stimulate consumption and investment. Small countries, whether their exchange rates are flexible or fixed, do not really have this option. A small country that attempts to create a gap between domestic and international interest rates will simply be subject to destabilizing capital flows that will eventually force the monetary authorities back into line. If their foreign exchange reserves are small, their margin of error can be very small.

¹³ "Kích cầu 1 tỉ USD: nên chi vào đâu?" *Tuổi Trẻ*, December 11, 2008.

“Dollarization” is another reason that monetary loosening would not stimulate the economy in Vietnam. Lowering VND interest rates could persuade depositors holding VND savings accounts to switch to dollars or gold, which would have the effect of reducing demand for money. The imbalance between the supply and demand for VND generates inflation, and the increased demand for dollars puts downward pressure on the VND exchange rate. We know that about 25% of bank loans in Vietnam are denominated in US dollars rather than VND. A large and sudden depreciation of the VND relative to the dollar would make it difficult for many of these borrowers to pay back their loans. This could create problems for the banking system, which is already struggling with high rates of non-performing loans.

Figure 9: Vietnam's Macroeconomic Indicators



*Figures for 2008 are estimates.

Source: IMF; average lending rate for 2008 authors' estimate.

B. Fiscal stimulus

Under fixed exchange rate systems like Vietnam's, fiscal policy is much more effective than monetary policy. When exchange rate are flexible, more government spending can increase demand but it is also likely to make the domestic currency appreciate, which acts to reduce domestic demand by reducing exports and drawing in imports. Under a fixed exchange rate, the fiscal stimulus attracts an inflow of foreign capital. To maintain the exchange rate, the central bank buys the foreign exchange and increases the money supply. So under fixed exchange rates a fiscal stimulus can increase output, but often at the cost of higher rates of inflation.

The problem that Vietnam faces is that the fiscal deficit is already large, and has been for some time. According to the IMF, the fiscal deficit including off-budget spending was 5% of GDP in 2007 and 4.5% this year. We have made the case in previous policy discussion papers that the government's large budget deficit has widened the trade gap and contributed to price inflation. Even if the government does not spend more money in 2009, the fiscal deficit is likely to widen as oil revenues and income from trade taxes fall. Adding another billion dollars to the deficit could destabilize the macroeconomic situation, primarily because Vietnam would find it difficult under current conditions to finance a big trade deficit. As noted above, exports, foreign investment, remittances and tourism revenue are all likely to fall in 2009.

Some domestic commentators have argued that Vietnam should emulate China's efforts to stimulate domestic consumption through a fiscal stimulus. But we must recognize that conditions in the two countries are very different. Because China is a large country with a low import to GDP ratio, much of this extra spending will stay in China. China is also running a current account surplus in contrast to Vietnam's large deficits. China has \$1,500 in foreign exchange reserves per capita, compared to Vietnam's \$250. Finally, China's rate of inflation is much lower than Vietnam's, which gives the Chinese government more room for maneuver.

While expanding the fiscal deficit is too risky, the government can increase the growth-enhancing effects of existing spending. The main reason that the budget deficit is so large now is that spending is very inefficient. Too much money is spent on capital and import-intensive projects that do not contribute enough to economic growth. Too much money is given to large state-owned enterprises for speculative purposes. Spending on public infrastructure is not adequately prioritized. We have made the case in our previous paper that Vietnam does not need 20 deep water ports, and that two ports would be adequate to handle Vietnam's current and foreseeable trade volumes. It is hard to justify a second oil refinery, let alone a third.

Therefore, the government should focus on redirecting public spending away from capital and import-intensive projects and to labor-intensive projects rather than increasing the total amount of spending. This would mean postponing prestige projects like a new airport terminal for Hanoi and a high speed rail link from north to south in favor of the construction and maintenance of roads and irrigation systems. The objective should be to use existing spending to create as many jobs as possible without adding unduly to the trade deficit. This will help to create employment, reduce poverty, increase domestic consumption and stimulate domestic production. It would reduce the trade deficit and therefore pressure on foreign exchange reserves.