

Chapter 2:

MANAGING CAPITAL FLOWS : THE CASE OF VIET NAM

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Abstract

Thanks to reforms and international integration, Viet Nam has recorded impressive economic development achievements. Deepening integration and accession to the WTO has brought about both new opportunities and challenges to a country on its way to accelerating reform and development. The recent surge in capital inflows has led to a financial boom in Viet Nam as well as risks, especially in the context of macroeconomic policy inconsistencies, weaknesses in the banking sector and financial supervision. The macroeconomic policy responses so far (up to February 2008) seem to be less effective in stabilizing the economy and in reducing policy inconsistencies as well as financial risks. The key question for Viet Nam, now, is how to sustain economic growth and sound financial development while mitigating possible financial risks. This paper recommends a broad reform package including tackling the bottlenecks in the economy (the weaknesses of economic institutions, infrastructure, and human resources), modernizing the State Bank of Vietnam (SBV), and strengthening risk management in the banking sector and financial supervision system. The focus is also on capital market development based on improvement of its fundamentals and the reform of large state-owned corporations. In particular, this paper argues for having a firm commitment to combating high inflation and combining tightened monetary policy with a more flexible exchange rate and tightened fiscal policies. The scope and scale of the macro-policy mix should aim to test the market for necessary adjustments rather than create policy shocks. Considering the evident policy inconsistencies, prudential screening and monitoring should be strengthened to prevent speculative financial activities.

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1. Introduction

Viet Nam officially launched its Doimoi (Renovation) in 1986, but only started a radical and comprehensive reform package aimed at stabilizing and opening the economy in 1989. During the period from 1996-1999, market-oriented reforms were somewhat stalled. Since 2000, a new wave of economic reforms has been stirred up with emphasis on structural reforms (state-owned enterprise [SOE] and financial reforms and development of the private sector) and further trade and investment liberalization. The years 2000-2007 witnessed a boom in the private sector and deeper international economic integration. In 2000, Viet Nam and the US signed the Bilateral Trade Agreement (VN-US BTA), which became effective in December 2001. Since then, the country has also joined several regional integration clubs such as ASEAN + 1 Free Trade Areas (FTAs). Most importantly, Viet Nam became the 150th member of the WTO in November 2006.

Since 2005, SOE and banking system reforms have shifted their focus on large corporations, including the State-owned commercial banks (SOCBs), though the pace of these reforms has been slower than expected (see also Table 1). The first SOCB with the second-largest market size, the Bank for Foreign Trade of Vietnam (VietcomBank), after successive delays, got the approval of the Prime Minister of Viet Nam to proceed with its initial public offering (IPO) on the domestic market in December 2007.

Meanwhile, a notable observation during 2006–07 is an expansion of the banking system and a boom of the stock market coupled with massive capital inflows and much higher consumption prices and asset inflation.

Market-oriented reforms have led to major positive changes in Viet Nam. The liberalization of trade and the balance of payments (BOP) as an essential ingredient of the reform process have contributed significantly to Viet Nam's economic growth and development. The financial and currency crises in the 1980s and especially the Asian crisis in the 1990s, nevertheless, showed that the process of the BOP liberalization, if not properly implemented, could also involve risks¹.

¹ There has been extensive literature on the nature of the BOP and financial crises. Though being different in terms of strengths, current account (CA) deficit and its financing, and the degree of capital account (KA) openings and their composition, these crises share some common causes such as inefficient investments, weaknesses in their corporate governance and the financial sectors, and inconsistencies in macroeconomic policies.

Table 1. A Chronology of Viet Nam’s Economic Reforms and International Economic Integration Process (1976–2007)

1976–80	1980–88	1989–onward	1996–99	2000–07
Centrally-planned and relatively autarkic economy	Modified-planned economy 1980–81 and 1987–88: Micro-reforms 1985: The “price-salary-money reform” and its failure 1986: Doimoi began	Market-oriented reforms Trade liberalization and further integration (EU: 1992; ASEAN: 1995; APEC: 1998)	Slowdown of the reform process and Effects of the Asian crisis	Stronger commitments to further reforms but uneven implementation Acceleration of international economic integration. 2006-07: Party Congress X and new government New wave of reforms?

Source: Authors’ own assessment

Experiences from various countries and the current position of Viet Nam are drawing attention to *how Viet Nam can sustain economic growth and sound financial development while mitigating financial risks*. This paper seeks to answer that question, taking into consideration the whole period before and after the Asian crisis (1995–2007), but with a focus on the recent financial and policy developments.

The paper is structured as follows. Section II briefly describes the changes in Viet Nam’s major economic fundamentals and the financial sector development. Section III analyzes in greater detail the capital flows and their impacts on real economic activities as well as on macroeconomic stability. Section IV then reviews recent macroeconomic policy responses to the surge in capital inflows, aiming to assess the strengths and weaknesses of those policies in Viet Nam. Section V summarizes the major findings and makes some policy recommendations for sustaining high economic growth and sound financial development in the country while mitigating possible financial and inflation risks.

2. Economic fundamentals and financial sector development

2.1. Movement of the Major Macroeconomic Variables

Viet Nam has recorded quite high economic growth over nearly 20 years, averaging 7.4% per annum during the period 1990–2007 (Table 2). Viet Nam is currently the third fastest growing country in East and South East Asia after The People's Republic of China (PRC) and Cambodia, and it offers tremendous growth potential in the coming years. The country is expected to overcome the status of a poor country in the meantime (by the year 2008?) due to the ambitious plans of the Government of Viet Nam. There are some fundamental factors that have allowed Viet Nam to successfully implement the plan: (i) poverty was reduced substantially, from 70% by the end of 1980s to 14.7% in 2007; and (ii) a middle class has emerged in urban cities, especially in Ho Chi Minh City and Hanoi, with continuing wealth accumulation. In recent years, the country has been undergoing rapid urbanization with the urban population increasing at a compound annual growth rate (CAGR) of 3.6% between 2000 and 2006.

Table 2 suggests that Viet Nam had been successful in combating inflation. Yet since 2004, inflation has emerged as a major concern. After a spike in 2004 - 05, inflation began moderating progressively and consequently reached the highest level of 12.6% in 2007.

The structure of the economy has changed towards industrialization. The share of manufacturing in the GDP increased from 12.3% in 1990 to 21.4% in 2007. The contribution of services and the financial sector to the GDP did not change correspondingly; there was, however, an impressive contribution by the financial sector to the GDP in 2006 and 2007, at 1.9% and 2.0% respectively, reflecting rises from the steady state level of 1.8% during 2000–05 (Table 2).

The rather high economic growth corresponded with a significant increase in investment and in both public and private savings (Table 2). The growth has still been driven much by state investment (which is still inefficient), though its ratio in total investment has tended to decline since 2000 (Table 3)². However, since 2000, the savings-investment gap has been widening as the investment ratio is increasing while the savings ratio has tended to stagnate. A simple regression has shown that there could be a time threshold in which an increase in income

² State investment includes investment from budget, state credit, and SOEs' retained profit in investment. Note also that about 28% and 38% of the GDP are accounted for by the SOE and state sectors, respectively.

Table 2. Economic Size, GDP Growth, Inflation, Investment and Domestic Savings

	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
GDP (VND bil.)	41955	228.892	272.036	313.623	361.017	399.942	441.646	481.295	535.762	613.443	715.307	837.858	973.791	1.144.000
GDP (USD bil.)	6	21	25	27	27	29	31	33	35	40	45	53	61	71
GDP per capita (\$)	98	288	337	361	361	374	402	415	440	489	554	635	715	835
GDP growth (%)	5.1	9.4	9.3	8.2	5.8	4.8	6.8	6.9	7.1	7.3	7.7	8.4	8.2	8.5
Share of GDP	1000	1000	1000	1000	1000	1000	1000	1000	1000	1000	1000	1000	1000	1000
Agriculture	38.7	27.2	27.8	25.8	25.8	25.4	24.5	23.2	23.0	22.5	21.8	21.0	20.4	20.0
Industry-Const.	22.7	28.8	29.7	32.1	32.5	34.5	36.7	38.1	38.5	39.5	40.2	41.0	41.5	41.8
Manufacturing	12.3	15.0	15.2	16.5	17.1	17.7	18.6	19.8	20.6	20.5	20.3	20.7	21.3	21.4
Services	38.6	44.1	42.5	42.2	41.7	40.1	38.7	38.6	38.5	38.0	38.0	38.0	38.1	38.2
Fin. Institutions	1.2	2.0	1.9	1.7	1.7	1.9	1.8	1.8	1.8	1.8	1.8	1.8	1.9	2.0
Inflation (%)	67.5	12.7	4.6	3.6	9.2	0.1	-0.6	0.8	4.0	3.0	9.4	8.4	6.7	12.6
Total investment	144	27.1	28.2	28.3	29.1	27.6	29.6	31.2	33.2	35.4	35.6	38.9	41.0	41.2
Domestic savings	29	18.2	17.2	20.1	21.5	24.6	27.1	28.8	28.7	27.4	28.5	30.3	31.3	31.2
Budget saving	3.4	1.5	3.2	2.2	2.5	3.1	3.3	3.4	4.3	5.0	6.0	5.3	5.6	3.9
Other savings	-0.5	16.7	14.0	17.9	19.0	21.5	23.8	25.4	24.4	22.4	22.5	25.0	25.7	27.3

Note: All data of 2007 in this paper are estimates.

Source: GSO (various issues) and data provided by Ministry of Planning and Investment (MPI), and the authors' calculations.

could reduce the private savings ratio. A one percentage point increase in economic growth can decrease in the short run and long run of about 0.8 percentage point and up to 2.1 percentage points in the other-than-budget saving ratio³. Meanwhile, foreign savings have played an essential role and have consistently contributed 14.2% - 21.2% to total investment in Viet Nam.

Recently, total retail sales of goods and services have increased by more than 22% per annum, much faster than the nominal GDP. This observation reinforces the conclusion that the savings ratio has stagnated. Moreover, the income gaps between urban and rural areas and between the rich and the poor have also increased quite significantly.

Table 3. Shares of Total Investment by Ownership (1995–2007)

	Total	State investment	Budget	State credit	SOEs	Non-state investment	FDI
1995	100.0	42.0	28.5	8.4	5.1	27.6	30.4
1996	100.0	49.1	32.4	9.5	7.2	24.9	26.0
1997	100.0	49.4	29.4	11.7	8.3	22.6	28.0
1998	100.0	55.5	30.0	15.7	9.8	23.7	20.8
1999	100.0	58.7	29.7	18.8	10.2	24.0	17.3
2000	100.0	59.1	31.1	18.4	9.6	22.9	18.0
2001	100.0	59.8	32.4	16.9	10.6	22.6	17.6
2002	100.0	56.3	30.9	17.6	7.8	26.2	17.5
2003	100.0	52.9	23.8	16.3	12.8	31.1	16.0
2004	100.0	48.1	23.9	12.2	12.0	37.7	14.2
2005	100.0	47.1	25.6	10.5	11.0	38.0	14.9
2006	100.0	46.4	25.1	10.3	11.0	37.7	15.9
2007	100.0	47.2	22.2	7.9	17.1	31.6	21.2

Source: Data provided by the MPI.

³ The regression is $stp = 12,292 - 0,054*gt^2 + 0,629*spt-2$ with the sample of 1990-2005
 (0,00) (0,04) (0,00)

(R-bar)² = 0,916; D-W = 1,597; Cusum-square test is stable at 5% significance level.
 Where stp is other than budget saving ratio and gt is economic growth rate (see Vo ed. 2007).
 For instance, AgriBank is assigned to primarily provide credit to the agricultural and rural sector.

2.2. Development of the Banking System

Key Policy Reforms

Until 1988, Viet Nam had operated under a mono-banking system with the State Bank of Vietnam (SBV), the country's Central Bank which performed both central and commercial banking functions. In 1988, the banking industry became a two-tier system, with four SOCBs created to assume the SBV's commercial banking activities while the SBV retained the central banking responsibilities. Given the state-driven nature of the Vietnamese economy, up until the recent economic reforms, the SOCBs traditionally focused on lending to the SOE sector.

Barriers to entry were reduced in 1991, opening the market to competition from both foreign players (subject to strict restrictions) and joint stock commercial banks (JSCBs). But over-competition among JSCBs eventually brought about a round of restructuring and mergers, particularly during 1999–2001, and as a result, the number of the JSCBs fell from 51 to 34 by 2006. Since 2005, some JSCBs such as Asia Commercial Bank (ACB) and Sacombank have been listed on the stock market. The SOCBs have been under restructuring since 2001 and some are now under equitization, being listed on the stock market.

The banking sector was further liberalized following the VN-US BTA and commitments in the WTO framework (Box 1). Viet Nam's commitments were subjected to the relevant laws and regulations as promulgated by the competent authorities of Viet Nam to ensure consistency with Article VI of the GATS and Para 2(a) of the Annex on Financial Services. In addition, the provision of banking services and products was subjected to relevant institutional and juridical forms.

The Banking System and Its Major Characteristics

There are at present over 75 banks operating in Viet Nam, comprising five SOCBs, one policy bank (VSPB), 34 JSCBs, 31 wholly - owned branches of foreign banks and 5 joint venture banks, and more than 900 people's credit funds (PCFs) (Table 4). In addition, there are 47 representative offices of foreign banks operating in Viet Nam.

Box 1. Viet Nam's WTO Commitments

Under Viet Nam's commitments to the WTO, foreign credit institutions are permitted to establish a commercial presence in Viet Nam in a number of forms including representative offices, branches of foreign commercial banks, commercial joint venture banks with foreign capital contribution not exceeding 50% of charter capital, and banks with 100% foreign-owned capital. The banking market is set to open up to full foreign competition.

During the 5 years from the date of Viet Nam's WTO accession, Viet Nam may limit the right of a foreign bank branch to accept deposits in Vietnamese Dong from Vietnamese citizens with which the bank does not have a credit relationship to a ratio of the branch's allocated capital according to the schedule below:

- 1 January 2007: 650% of allocated capital;
- 1 January 2008: 800% of allocated capital;
- 1 January 2009: 900% of allocated capital;
- 1 January 2010: 1,000% of allocated capital;
- 1 January 2011: Full national treatment.

Viet Nam may limit equity participation by foreign credit institutions in equitized Vietnamese State-owned banks to the same level as equity participation by Vietnamese banks. For capital contribution in the form of buying shares, total equity held by foreign institutions and individuals in each of Viet Nam's joint stock commercial bank may not exceed 30% of the bank's chartered capital, unless otherwise provided by Viet Nam's laws or authorized by a competent authority of Viet Nam. A branch of a foreign commercial bank is not allowed to open other transaction points outside its branch office. Upon accession, foreign credit institutions are allowed to issue credit cards on a national treatment basis.

Table 4. Banks and Non-Banking Credit Institutions in Viet Nam (2006)

	Type of credit institution in Viet Nam	Number
1	State Owned Commercial Bank (SOCB)	5
2	Vietnam Social Policy Bank (VSPB)	1
3	Joint Stock Commercial Bank (JSCB)	34
4	Joint Venture Bank (JVB)	5
5	Foreign Bank Branch	31
6	Finance Company	6 (5 belong to State General Corporations)
7	Finance Leasing Company	11 (6 are affiliates of SOCBs)
8	People's Credit Funds (PCFs)	Central People Credit Fund (24 branches) + 926 Local credit funds

Source: SBV (2007). The SOCBs are: Bank for Agriculture and Rural Development, Bank for Foreign Trade, Bank of Investment and Development, Industrial and Commercial Bank, and Mekong Housing Bank

Viet Nam's banking sector is often considered both heavily fragmented and concentrated. Credit structure by sector has only changed slightly despite a considerable shift in economic structure. Indeed, the shares of total outstanding loans to the agriculture-forestry-fishery and industry sector in 1995 were 26.5% and 37.5% respectively; in 2005, the corresponding figures were 29.7% and 39.8% (SBV 2006). The highly fragmented banking market caused by assigned commercial banks has, to a certain extent, restrained risk - sharing within the banking system and narrowed borrowing choices of businesses.

In 2006, Viet Nam's top 15 banks together controlled 92.4% of market share by assets (excluding foreign bank branches). In 2006, the SOCBs shares had still accounted for nearly 70% of total deposits and 65% of total credits. However, since 2006, the role of the JSCBs has changed significantly and in 2007, they already accounted for much larger shares in total deposits and total credits (Table 5). In terms of operating features, the SOCBs own the largest distribution networks (AgriBank: 1468; VietcomBank: 207; BIDV: 500; ICB: 832). The JSCBs have also quickly developed a network since 2005 (ACB: 111; Sacombank: 161, Eximbank: 59, Techcombank: 120); in terms of size, however, their branches would qualify only as sub-branches of the SOCBs.

Table 5. Market Share of the Credit Institutions in Viet Nam (%)

	2000	2001	2002	2003	2004	2005	2006	2007
Market share in deposits								
SOCBs	77.0	80.1	79.3	78.1	75.2	74.7	68.8	59.3
JSCBs	11.3	9.1	10.1	11.2	13.3	15.7	21.8	30.4
Foreign bank branches + JVBs	10.3	10.0	9.4	9.3	9.7	8.0	8.1	8.8
PCFs	1.0	0.8	1.1	1.1	1.0	1.0	1.0	1.0
Others	0.4	0.0	0.1	0.3	0.8	0.6	0.3	0.5
Market share in lending								
State owned commercial banks	76.7	79.0	79.9	78.6	76.9	73.0	64.5	55.1
Joint stock commercial banks	9.2	9.3	9.5	10.8	11.6	15.0	21.2	28.6
Foreign bank branches + JVBs	12.4	10.4	8.8	8.9	9.5	9.6	9.3	9.0
PCFs	1.4	1.2	1.7	1.5	1.4	1.5	1.4	1.3
Others	0.3	0.1	0.1	0.2	0.6	0.9	3.6	6.0

Source: Data provided by the SBV and authors' estimates.

Financial depth has also changed significantly (Table 6). Until 2004, Viet Nam was still seen as an economy with a rather shallow financial depth. Fast growing credit with an annualized average growth rate of 33.4% fueled by strong credit demand from both the corporate and retail markets since 2004 promoted financial deepening. As a result, in 2007, there were sharp increases in financial deepening with indicators such as the credit/GDP ratio (reaching 82.5%), and M2/GDP (112.1%, increasing from 23.8% in 1996). The outstanding credit of the banking system to SOE had gone down dramatically from 52.7% of total outstanding credit in 1996 to 31.5% in 2007. This movement in the credit business of Viet Nam's banking industry reflects fundamental changes in client appraisal based on normal market practices.

In recent years, the banking industry has significantly developed its financial strength by cleaning up banks' balance sheets and increasing capital through issuing new stocks as well as increasing financial reserves. As a result, the financial position of banks has been improved significantly in terms of capital adequacy and non-performing loans (NPLs) (Figures 1-4). For example, the NPLs of the SOCBs were reduced from 13% in 2000 to about 3% in 2006⁷.

⁷ There are, however, some problems with the officially announced NPLs. Some suggest that the figures for NPLs would be 3 times higher if the estimates are based on rigorous international accounting standards.

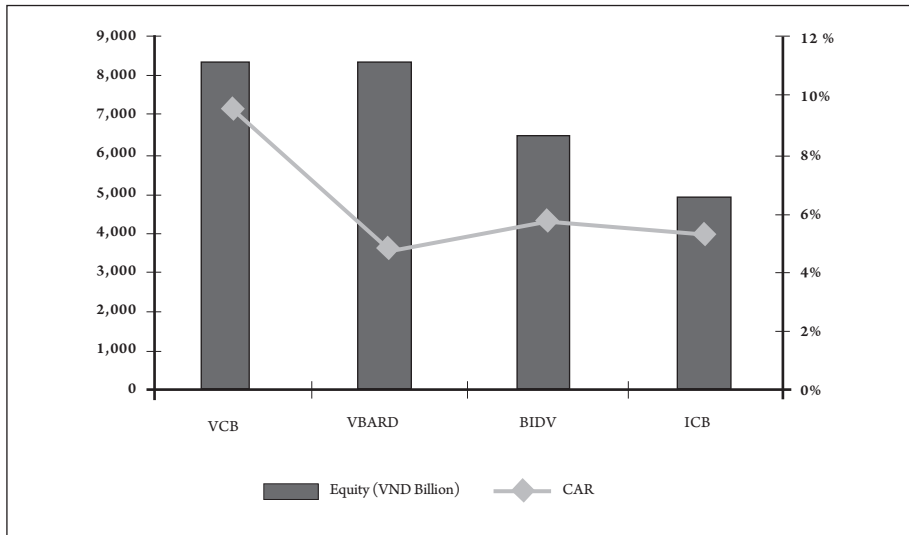
Table 6. Total Credits and Deposits

(VND trillion unless indicated otherwise)

	1996	1999	2000	2001	2002	2003	2004	2005	2006	2007
Broad M. (M2)	64.7	160.4	222.9	279.8	329.0	411.2	532.3	690.7	922.7	1,282.6
% change	22.7	56.6	39.0	25.5	17.6	24.9	29.5	29.7	33.6	39.0
% GDP	23.8	40.1	50.5	58.1	61.4	67.0	74.4	82.4	94.8	112.1
Credit to economy	50.9	112.7	155.7	189.1	231.1	296.7	420.0	553.1	693.8	943.6
SOE share (%)	52.7	48.2	44.9	42.1	38.7	35.5	34.0	32.8	31.4	31.5
Others share (%)	47.3	51.8	55.1	57.9	61.3	64.5	66.0	67.2	68.6	68.5
% change	20.1	55.0	38.2	21.5	22.2	28.4	41.6	31.7	25.4	36.0
% GDP	18.7	28.2	35.3	39.3	43.1	48.4	58.7	66.0	71.2	82.5

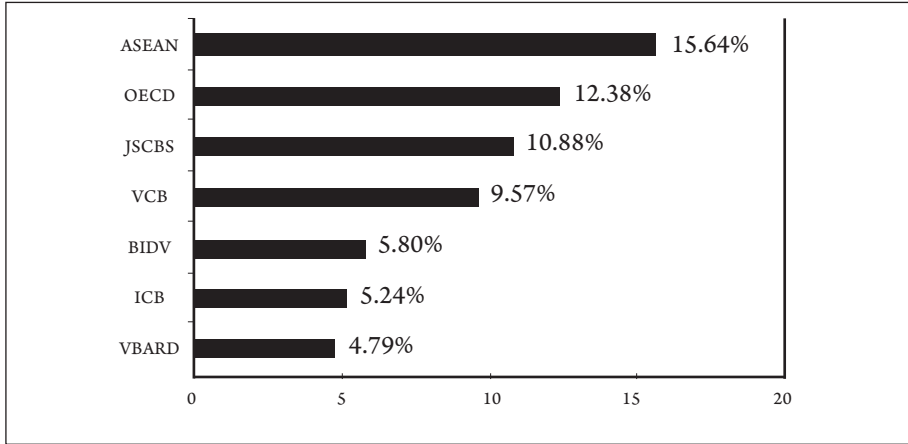
Source: IMF (2006, 2007); Credit figures in 2007 have been adjusted by the latest SVB estimates.

Figure 1. Equity/Total Assets of 4 SOCBs



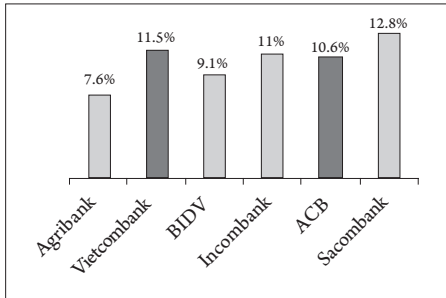
Source: Pham et al (2007).

Figure 2. CAR of SOCBs Compared to JSCBs and Other Countries (%)



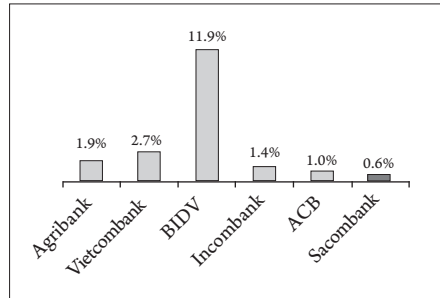
Source: Pham et al (2007).

Figure 3. Capital Adequacy Ratio



Source: Company audited financials and reports (where available), newswires (as of 31 December 2006).

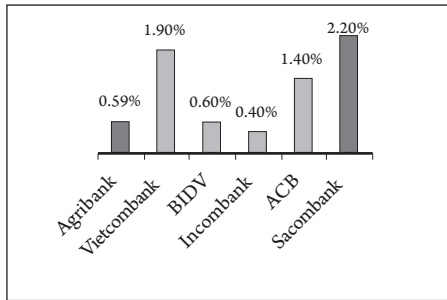
Figure 4. Gross NPL Ratio



Source: Company audited financials and reports (where available), newswires (as of 31 December 2006).

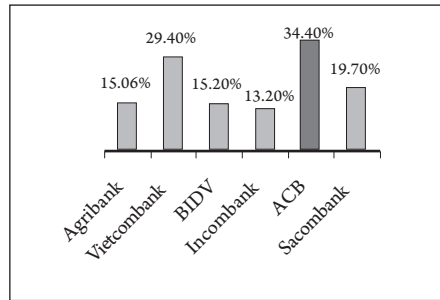
Banks' profitability is uneven relative to asset size. The incumbent SOCBs have relatively high provisioning expense levels, reflecting a legacy of loans to the SOEs, whereas the newer JSCBs have lower provisioning expenses. As a result, profitability measured by ROE (Figure 5) and ROA (Figure 6) of SOCBs tends to be lower than that of JSCBs (with the exception of VietcomBank).

Figure 5. Return on Average Assets



Source: Company audited financials and reports (where available), newswires (as of 31 December 2006)

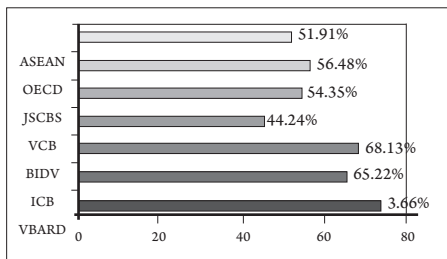
Figure 6: Return on Average Equity



Source: Company audited financials and reports (where available), newswires (as of 31 December 2006).

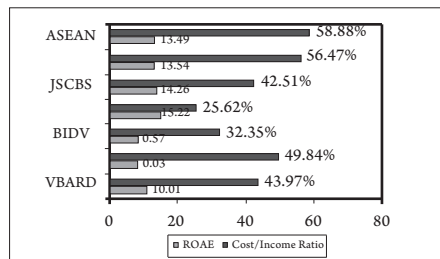
The differences in profit between SOCBs and JSCBs are also clearly explained by the structure of the assets of those banks as described in Figure 7. The asset structures show that the outstanding debt/total assets ratio in JSCBs (54.35%) is much lower than that of the SOCBs (62.81%), except again the unique case of VietcomBank (44.24%). This indicates JSCBs' lower riskiness in terms of asset allocation, and hence, JSCBs have more chance to increase profitability by increasing asset allocation for credit. The outstanding debt/total assets ratio of JSCBs is slightly higher than the average ratio of ASEAN banks (51.91%) and lower than that of OECD banks (56.48%).

Figure 7. Outstanding Debt/Total Assets of SOCBs Compared to JSCBs and Other Countries (2005)



Source: Pham et al (2007).

Figure 8. Performance of SOCBs Compared to JSCBs and Other Countries (2005)



However, in terms of efficiency proxied by ROAE and Cost/Income ratios, Viet Nam's commercial banks, including both SOCBs and JSCBs, are less efficient than their counterparts in ASEAN and OECD. Details from Figure 7 indicate that SOCBs are generally less efficient than JSCBs, and in turn, JSCBs are less efficient than other foreign banks in ASEAN and OCED.

Current Dimensions of Banks' Development and Behavior for Seizing New Business Opportunities

Due to increasing competitive pressure from deepening integration, especially after the VN-US BTA and WTO accession, Viet Nam's local banks have rushed into expanding their business operations by setting up new branches and developing retail banking activities. These areas are basically to build the local banks' competitive advantages against potential foreign competitors. The heightened network and business expansion of banks has given rise to an urgent need for human resources at every level of the banking industry, from senior executive managers to more junior level staff. That is not said about the human resources demand from newly established banks. As an estimate, the banking industry would need about 40,000 people from 2007 to 2010, which the Vietnamese economy is unable to meet.

Up to 2006, more than 70% of the banks' income came from lending. The last 3 years have witnessed a diversification trend in banking services, especially in developing a card market and retail banking. In 2007, consumption and real estate related lending by some JSCBs accounted for 20%–30% (and 30-40%) of the total credits, respectively. Other fee-income businesses of banks have increasingly contributed to their income. In recent years, the off-balance sheet business has gradually prospered, accounting for an average of 20-25% of income for the sector.

Furthermore, the M&A trend has boomed in recent years, especially since 2006. This trend has been enhanced mostly by large State General Corporations (such as PetroVietnam, EVN, VNPT, etc.) intent on acquiring small/rural JSCBs and making them become dependent entities. Consequently, in addition to the core businesses, these corporations could heavily and directly get involved in the financial markets. Not only have major corporations implemented such diversification plans, the banks themselves have also attempted to be universal. Many banks have become engaged in insurance, securities, investment banking activities (equity acquisition and investments in the real estate market) and have had strategic partnerships with large corporations, mostly the State General Corporations or newly established State Business Groups.

The past 3 years have also seen a lot of marriages between the JSCBs and foreign financial institutions. Several JSCBs have made extensive efforts to secure strategic investments with foreign banking partners (Table 7). By building strategic partnerships with very well-known global names, the JSCBs can develop their brand name and take advantage of new products, skills and expertise from the partners. However, the strategic partnerships could also be easily broken, especially if the partner entered to the partnership as a speculative investor rather than a strategic investor.

Besides the mentioned-above trends, in 2007 and for the first time since 1996, the SBV reviewed applications for establishing new local commercial banks and applications from foreign banks seeking to operate locally-incorporated, wholly-owned banking subsidiaries. In December 2007 and January 2008, the SBV approved in principle the setting-up of 9 new JSCBs and the licensing of branches of 3 new foreign banks. Furthermore, the SBV is reviewing the granting of full licenses for HSBC, ANZ and Standard Chartered to set up wholly owned banks in Viet Nam.

In 2007, the Prime Minister also approved in principle the equitization of 3 SOCBs (VietcomBank, MHB, and BIDV). However, only the IPO of Vietcombank was conducted in late December 2007 after it was continually delayed.

Table 7. Foreign Strategic Investments in Vietnamese JSCBs

Target Bank	Acquirer	Acquisition Announcement Date	Stake Acquired	Target Bank Asset Size*	
				VND trillion	USD bil.
Sacombank	ANZ Bank	24 Mar 2006	10.0%	24.9	1.5
Asia Commerce Bank	Standard Chartered	17 Jun 2005	8.6%	44.6	2.8
Techcombank	HSBC	28 Dec 2005	10.0%	17.5	1.1
VP Bank	OCBC	21 Mar 2006	10.0%	10.2	0.6
Orient Commercial Bank	BNP Parisbas	17 Nov 2006	10.0%	6.4	0.4
Southern Bank	UOB	25 Jan 2007	10.0%	9.2	0.6
Techcombank	HSBC	25 Jan 2007	10.0%	17.5	1.1
Habubank	Deutsch Bank	01 Feb 2007	20.0%	11.6	0.7
Eximbank	SMBC	30 Mar 2007	15.0%	24.9	1.5
PVFC	Morgan Stanley	13 Nov 2007	10.0%	34.5	2.15

*Note: As of 31 December 2006.

Source: Company announcements, newswires.

II.3. Stock Market Evolution and Its Recent Boom

Key Policy Reforms

The most memorable moments in developing the stock market in Viet Nam were the establishment of the State Securities Commission (SSC) in 1995 and two securities trading centres, the Ho Chi Minh City Securities Trading Centre (HOSTC) in 2000 and the Hanoi Securities Trading Centre (HASTC) in 2005⁸. To promote stock market development, several policy measures were undertaken.

- In parallel with the establishment of the two securities trading centers, the legal framework on listing conditions, information transparency and exposure, and supervision, has been significantly improved (Decree 48/2001/CP, Decree 144/2003/ND-CP, Law of Securities in 2006, etc.).
- The process of equitizing SOEs, especially the large ones, has been gradually tightening to their listing on the stock market.
- The development of financial intermediaries has received more attention. Recent emergence of several financial institutions such as securities companies, investment management funds, and investment funds has created an important pre-condition for development of the stock market.
- The opening up of financial markets with more foreign participation has been undertaken gradually. The equity share of listed companies that foreign investors can hold increased from 20% to 30% in 2003 and to 49% in 2005. Regarding securities services, under the WTO commitments, joint ventures can have foreign capital of no more than 49% upon the accession, but of 100% after 5 years.
- Depending on the health of the stock market, some incentives such as easing the conditions for listing on the market (in 2003) and a provision of corporate income tax deductions for firms listed on the HASTC (in 2006) have been introduced⁹.

Recent Evolution of the Stock Market: the Boom and Shrink

After a short-lived surge up until June 2001 (peak of VN-Index=571), the HOSTC had cooled off. Up to 2005, the stock market was generally very weak

⁸ The HOSTC was transformed into Ho Chi Minh City Stock Exchange (HOSE) in May 2007.

⁹ The Personal Income Tax Law approved in 2007 states that investors should pay income tax on capital gains (20%) or 0.1% of each transaction from the stock investment. The enforcement will be effective from the beginning of 2009. Due to a sharp decrease in stock price indexes, in December 2007, the Ministry of Finance (MOF) requested that the Government delay the application of the law.

and ailing on both the supply and demand sides. In 2006 and 2007, it skyrocketed in terms of market capitalization, number of listed companies and investors' accounts, participation of securities companies, and investment management funds. The corresponding figures are listed in Table 8. Notably, the total value of the over-the-counter (OTC) stock market is estimated to be 3–4 times higher than that of the former one.

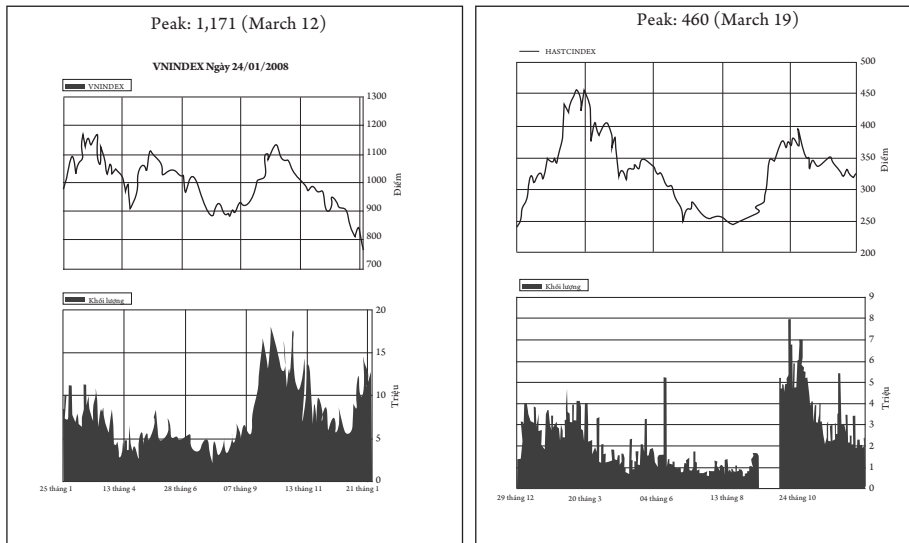
Table 8. Some Key Indicators of Viet Nam's Stock Market (2001–07)

	2001	2004	2005	2006	2007
Market capitalization (%GDP)	0.3	0.5	1.1	22.8	43.0
VN index	235 (peak=571)	241	307	752	≈927 (peak=1,170 in March)
HASTC-Index	91.3	243	≈324 (peak=460 in March)
Number of listed firms	10	26	41	193	253
HOSTC/HOSE	10	26	32	106	138
HASTC		...	9	87	115
Investment funds	0	1	1	3	4
Securities companies	8	13	14	55	78
Investment management funds	0	?	6	18	25
No. of investors' accounts	8,774	21,616	29,026	≈130,000	≈330,000
Institutional	71	193	257	≈ 400	≈ 500
Foreign	0	207	427	1,650	8,140

Source: The SSC and other sources (end of year)

In fact, the boom began in the 2nd half of 2006. The VN-index rose by 144% in 2006 and 40% in the first quarter of 2007, reaching a peak of 1,170 on 12 March 2007. It has since fluctuated within a range of 900–1,100, but has tended to decline from October 2007. Similar trends could also be observed at the HASTC (Figure 9). As of early March 2008, the VN-index and HASTC-index stood at below 600 and 200, respectively.

**Figure 9. VN-/HASTC Indexes and Transaction Volumes
(29 Dec 2006–31 Dec 2007)**

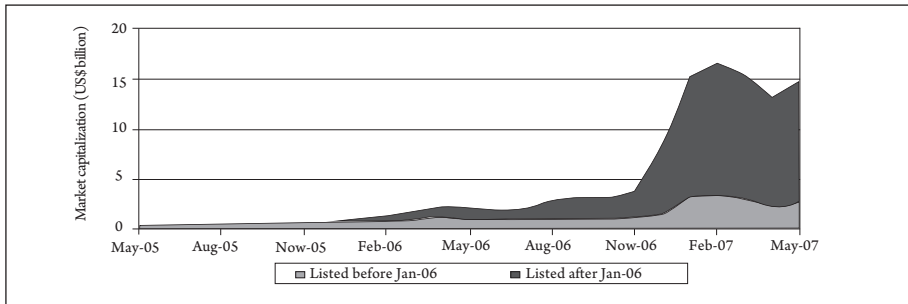


Source: SSI.

Key factors behind the market boom during November 2006–March 2007, inter alia, can be attributed as follows:

- The first is Viet Nam’s high economic growth period and the country’s bright prospects after the accession to the WTO.
- The second is firms’ rapid response following the tax incentive in 2006. A sharp increase in market capitalization for HASTC (Figure 10) is mainly due to new listings since November 2006 (predominantly equitized SOEs).
- The third is exuberance and sizeable foreign participation, including overseas Vietnamese in Russia and Eastern Europe. Foreign portfolio investors have shown a keen interest in investing in Viet Nam’s equity market not only because of Viet Nam’s strong economic growth and bright outlook, but also because of an appetite and room for higher risk–higher return assets in their portfolios.
- The fourth is herding behavior spread amongst local short-term individual investors in the context of insufficient information disclosure and transparency. The boom in stock prices is not attributed to foreign investors alone. Domestic investors, accounting for the major proportion of market capitalization, have also been very active in bidding up prices.

Figure 10. Market Capitalization of Firms Listed on HOSTC



Source: World Bank (2007).

The recent sharp decline of the stock market price indexes can be attributed to various factors, namely, tightening of lending by commercial banks due to stock investment and monetary policies, high inflation rate and higher VND deposit interest rates, and a possible recession of the US economy. However, while local (individual) investors have tried to avoid the market, foreign investors have been more interested in buying rather than selling the stocks they own. On 6 March 2008, the SCIC was forced to intervene in the stock market by purchasing several stocks (mostly blue chip) to prevent further decline in stock prices.

Salient Features

Market liquidity of Viet Nam's stock market is still modest. The average daily turnover stood at USD 51.5 million in August 2007 compared to USD 8.3million in 2006. Table 9 suggests that up to 2007, market liquidity in HOSTC is slightly comparable with that of the Colombo and Philippines Stock Exchanges.

Furthermore, the stock market has seen wide fluctuations in prices of both individual stocks as well as the overall index. Individual shares have frequently hit their daily trading price limits of 5 percent on HOSTC and 10 percent on HASTC in both directions. Dramatic increases in prices inevitably led to questions as to whether the market was overheated. After reaching a peak of 1,170 on March 12, the index fell by almost 23 percent over the following 30 days, leading commentators to posit that a correction was underway. Trading volumes fell sharply and net buying by foreign investors dipped from USD 150 million in February to almost zero at the end of March and of 2007.

Table 9. Global Indices Growth and Liquidity

	2006 % yoy	CAGR 03-05	2006 Average daily turnover USD mil.	2006 Annual turnover: Market cap. (x)	2005 Annual turnover: Market cap. (x)
HSTC	144.5	21.3	8.3	0.3	0.3
Shanghai SE	130.4	(8.2)	3,078.6	0.8	0.8
Shenzhen SE	97.5	(13.2)	1,765.4	1.9	1.3
Jakarta SE	55.3	44.1	203.5	0.4	0.5
Mumbai SE	46.7	42.5	895.9	0.3	0.3
National SE India	34.0	33.1	1,767.7	0.5	0.6
Hong Kong SE	43.2	18.7	3,468.3	0.5	0.4
Philippines SE	42.3	25.6	46.9	0.2	0.2
Colombo SE	41.6	34.3	4.2	0.1	0.2
Kuala Lumpur SE	21.8	10.6	314.5	0.3	0.3
Karachi SE	5.0	36.3	573.1	2.8	2.9
Thailand SE	(4.7)	24.5	419.4	0.7	0.8

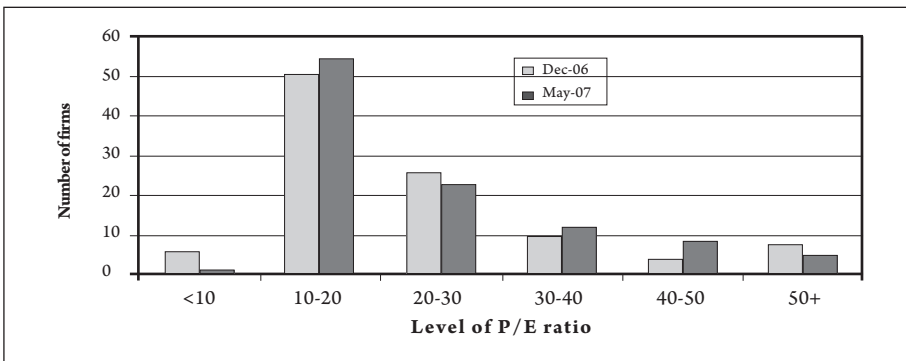
Source: World Federal of Exchange, KSE, HCSTC, Reuters.

The ratio of price to earnings per share (P/E ratio) is commonly used to gauge over-exuberance in equity markets. However, the P/E ratio is also a notoriously fickle indicator in rapidly developing markets. Fundamentally, the higher the P/E ratio for a stock, the more investors expect the company to deliver strong incomes in the future, or that future incomes have a low risk accompanying them. P/E ratios tend to vary by industry and the maturity of firms, and it is very difficult to point to a level of P/E which is considered high or reflects an overvaluation of the stock. Historically, while the P/E ratios in excess of 30 have provided signs of overvaluation, it is not unusual to find P/E ratios greater than 75 or 100 for companies in high tech areas. Concerning the P/E ratios of companies on the Vietnamese stock market, the IMF (2007) suggests that the average E ratio is rather high, while World Bank (2007) concludes that this is not abnormal.

Figure 11 provides a distribution of P/E ratios for firms listed on HSTC. Most firms have P/E ratios in the 10-20 range. However, several of the larger listed firms have P/E ratios in excess of 30. The average P/E for the market stood at 33 in mid-May 2007 compared with around 36 at the end of 2006. An accurate measure of earnings is required for the Vietnamese stock market, because the

figure is highly vulnerable to accounting manipulation. The presented figures are only trailing P/E ratios as they rely on the previous year's earnings. It can be argued that in a fast growing economy, it is better to look at forward P/E ratios based on expected earnings over the following 12 months. The expectation is that faster growth in earnings tends to bring the P/Es down to more normal levels. For example, if the earnings-per-share grows by an average of 25 percent over the next 12 months, the forward P/E would be around 26.

Figure 11. Trailing P/E Ratios for Firms on HOSTC



Source: HOSTC.

II.4. Development of the Bond Market

Policy Measures

According to the State Budget Law of 1993, the Government can no longer finance the budget deficit by printing money. Since the mid-1990s, it has paid more attention to the issuance of bonds for financing budget deficit and development needs. However, improvement of the legal framework for bond market development has been rather slow. The first decree on the issuance of government bonds was only in 2000 and it was amended in 2003. In 2006, the Government issued Decree No. 52/2006/ND-CP on the modalities for corporate bond issuance. And a decree on the issuance of government and corporate bonds in international markets was drafted in 2007, and is now under consideration for approval.

Characteristics of the Bond Market

Viet Nam's bond market remains relatively underdeveloped despite a recent expansion. At the end of 2007, there were 570 outstanding bonds in the securities market, with a market value of about VND 115.660 trillion, or 10.1% of the GDP.

Most of them are government bonds (85%). Other debt securities include municipal bonds (Ho Chi Minh City and Hanoi), Development Assistance Fund's (ADF's and now Development Bank's) bonds, education and infrastructure bonds, SOCB recapitalization bonds, BIDV bonds, Vietcombank convertible bonds, and some other corporate bonds¹⁰.

Despite continuing improvement, the market is still illiquid as investors hold the bonds to maturity. Long-term bonds (10–15 years), making up about 40% of the total, are typically purchased by insurance companies and held to maturity, while 60% of 2-3-5 year bonds (mostly 5-year) are held by SOCBs.

The market is also highly segmented due to multiple issue channels, methods, and registers, and to the lack of market making function. The State Treasury currently issues more than 100 issues per year of VND-denominated treasury bills, with terms of 6, 9 and 12 months, and bonds of 2, 3, 5, 10 and 15 years through four different channels and methods¹¹. Treasury Bonds accounted for more than 80 percent of the Government's debt securities issued in 2003 and 2004 (Table 10).

The designated financial institutions are locally called "primary dealers," but they do not have market making obligations. The State Treasury issues an issuance calendar of auctions and underwritings every quarter. Treasury-Bond auctions are held every week, bond auctions on the securities markets every two weeks, and bond underwritings every two weeks. In addition, the SBV also issues its own short-term securities for liquidity management purposes from time to time.

¹⁰ Municipal Bonds: Ho Chi Minh City and Hanoi are permitted to issue bonds equivalent to 100% of their annual investment budget (for other cities, the applicable limit is 30%) subject to the Ministry of Finance's approval. DAF Bonds: The DAF (now VDB) has become one of the largest financial institutes in Viet Nam, and has outstanding loans equivalent to about of 20% of the GDP, half of which are financed through ODA.

Education and Infrastructure Bonds: The National Assembly has authorized issuance of total VND110 trillion (about USD 7 bil.) of the education and infrastructure bonds for the period 2005–2040. SOCB recapitalization bonds: In 2001, as a part of the government's restructuring program for SOCBs, NPLs worth VND10.9 trillion (2.5% of the 2000 GDP) were provided in the form of recapitalization bonds (9.7 trillion) and cash.

¹¹ The methods and channels are (i) treasury bill auctions to designated banks through the SBV as the fiscal agent for the State Treasury and as the registrar, (ii) bond auctions to designated banks, insurance companies, finance companies and securities firms through the STCs with the SCC as the registrar, (iii) underwriting by a syndication of designated banks and securities firms with each underwriter as a registrar, and (vi) direct placement of bonds with the public through a national network of about 600 State Treasury offices with each Treasury office as a registrar. At present, the Treasury stopped retail issuance of bonds to individual investors to reduce transaction costs.

Table 10. Government Securities Issue Amount by Channel and Method

	2003		2004	
	TB auction through SBV	15,130	86.7%	18,411
Bond Auction on STCs	672	3.9%	1,419	6.4%
Underwriting	1,650	9.5%	2,390	10.8%
Direct Placement	-	0.0%	-	0.0%
Foreign currency bond auction through SBV	0	0.0%	0	0.0%
Total	17,452	100%	22,220	100%

Source: HOSTC and Reuters.

Some new developments should, however, be noted. In October 2005, the Government issued its first international bonds since the Brady issues in the 1990s, amounting to USD 750 million, with a yield of 7.125%, which was lower than Indonesian and Philippine bonds¹². Meanwhile, the S&P rating upgraded Viet Nam's credit rating outlook from BB- positive to BB stable in September 2006. The funds were on loan to Vinashin, the shipbuilding state-owned corporation. The Government is now considering raising another USD 1 billion through a new sovereign issue, the proceeds of which will largely be devoted to the construction of the Dung Quat oil refinery; the rest will go to Viet Nam National Shipping Lines (Vinalines) for purchasing new vessels, and to Song Da Corporation for the construction of a hydro plant. These corporations have yet to obtain international credit ratings.

Beginning in the second half of 2006, foreign buyers started to show an interest in Vietnamese bonds, as many think that they are being undervalued and ripe for higher returns. Foreign participation has created a new liveliness in the bond markets, especially on the HASTC. Forty-four Government bond tenders took place in 2007, which helped raise VND 18.939 trillion in capital. The secondary bond market in Hanoi has also experienced rather strong growth. At the policy level, the Government has been trying to strengthen the five-year bond as a liquid benchmark issue through big-lot auctions. A specialized bond market will be built up at the HASTC. Government bonds, municipal bonds, and

¹² The issue has widely been regarded as successful and the spread over US treasuries has declined from 256 basis points at issuance to about 110 basis points as of April 2007.

government-guaranteed bond tenders and transactions will take place in this specialized market.

In 2006, Vinashin announced Viet Nam's third and thus far largest corporate issue of 3 trillion dong (10-year bonds with an annual coupon of 9%). The bond was reportedly oversubscribed three times, with 95 percent being sold to foreign investors. EVN had issued a corporate bond that was also sold mainly to foreign investors (10-year bonds with an annual coupon of 9.6% for the first year and 9.96% thereafter). In 2008, EVN and PetroVietnam are likely to issue their own bonds.

III. Capital flows and their impacts

3.1. Foreign Direct Investment Inflows

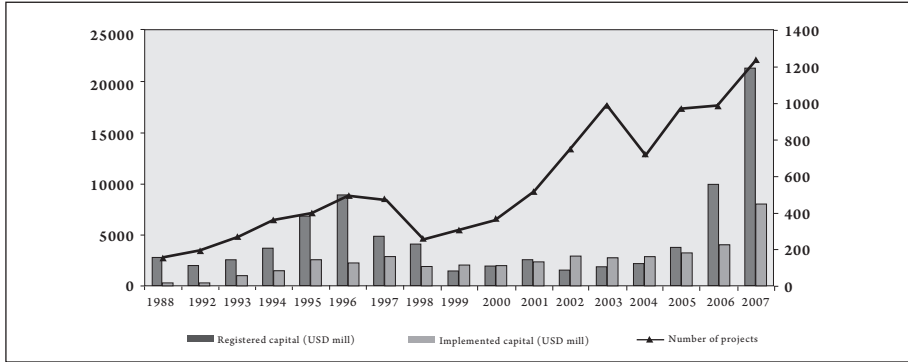
The Foreign Investment Law was passed in December 1987. During 1988-2007, Viet Nam attracted 9,492 FDI projects with committed capital of USD 83.2 billion in total, 52.7% of which were realized¹³. After reaching a peak in 1996, FDI inflows into Viet Nam had declined since Asian crisis. However, since the 2nd half of 2004, it has expanded rapidly, reaching more than USD 10 billion and USD 21.3 billion in terms of commitments in 2006 and 2007, respectively (Figure 12). The sudden increase of FDI in these recent years reflects investors' confidence in Viet Nam's reform and international integration process and development prospect as well as the restructuring of FDI in Asia in some labor-intensive industries such as outsourcing logistics, electronics, garments and manufacturing from the People's Republic of China (PRC) to Viet Nam¹⁴.

Until the end of 2007, the realized (accumulated) FDI was allocated in the manufacturing industry (42.7%), oil and gas (18.8%), hotel and tourism (8.1%), construction (7.2%), offices and apartments (6.2%), building urban areas and industrial zones (2.8%), (Figure 13).

¹³ The figure for implemented/realized FDI is different from that of FDI in BOP.

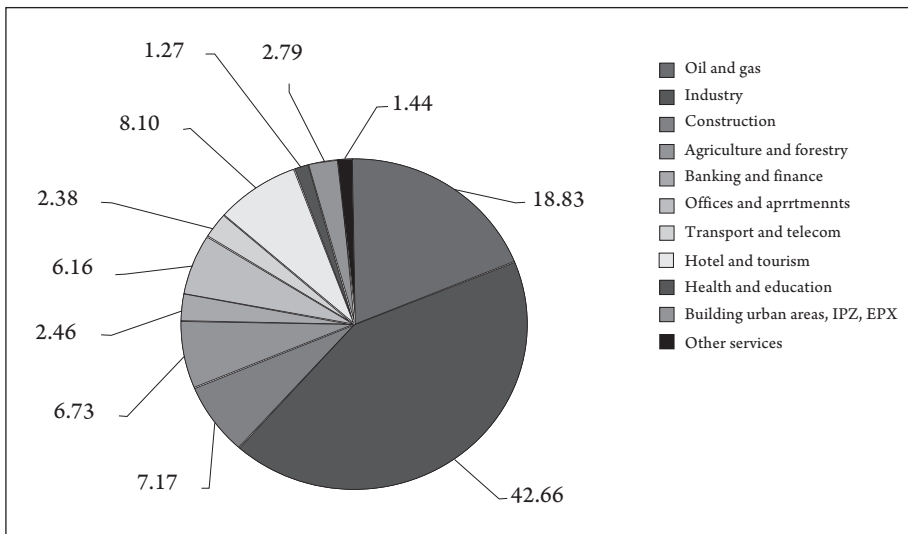
¹⁴ Intel has decided to establish a USD 1 billion semiconductor assembly and test facility in Viet Nam that is not only a landmark for Viet Nam, but also a clear indication of a growing trend. In the same sector, Hong Hai-Foxcom (Taipei, China) has plans to invest up to USD 5 billion over the next five years at several sites in Viet Nam to manufacture electronic goods and computer products, from digital cameras to music players, motherboards and other computer components.

Figure 12. FDI in Viet Nam: Commitments and Realization (1988–2007)



Source: MPI

Figure 13. Realization of FDI by Sector (% of the Total to October 2007)



Source: MPI.

Source: In the 1990s, FDI was concentrated in import substitution industries. However, since 2000, there has been a trend towards the export manufacturing sector and services sectors. The share of FDI in total export turnover (excluding oil exports) accounted for only 23.4% in 1996 and 22.2% in 2000, but then rose sharply to 36.9% in 2006 (Table 14). There has been also a radical change in the FDI trend in recent years. Almost all registered FDI in Viet Nam has changed structurally and has become focused on industry and

construction and the services sector. During 2004 and 2007, the total registered FDI in these two sectors increased 74.9% and 56.0%, respectively, compared to a modest increase in the agriculture sector at 26.6% (Table 13). As a result, until October 2007, the total registered FDI in these two sectors accounted for 94.2% of the total, while that in agriculture accounted for only 5.8%.

Table 13. Accumulated FDI as of Oct 2007 Compared to Oct 2004

	Projects (USD mil.)	% change	Registered Capital (USD mil.)	% change	Realized Capital (USD mil.)	% change
Industry and Construction	5,418	61.2	46,114	74.9	21,258	19.4
Agriculture	911	32.4	4,306	26.6	2,085	25.5
Services	1,837	89.0	24,346	56.0	7,618	17.3
Total	8,166	62.6	74,766	64.8	30,961	19.3

Source: Data provided by the MPI and authors' calculations.

In the early 1990s, the foreign invested enterprise (FIE) sector played a rather insignificant role in Viet Nam's economy. But since the mid-1990s, it has become an integral part of the economy. In 1996, FIEs directly employed 222,000 workers and accounted for 7.4% of the GDP. In 2006, these figures increased to nearly 1,130,000 employees and 17.1% of the GDP (Table 14). As mentioned earlier, the FIE sector is currently a driving force for Viet Nam's exports and the development of various manufacturing industries such as textiles and garments; machinery and equipment; office, accounting and computing; electrical machinery and apparatus; radio and communication equipment and apparatus; medical, precision, and optical instruments; motor vehicle and transport equipment; and furniture (Appendix A).

Table 14. FIEs' Contribution to Viet Nam's Economy

	1992	1996	2000	2004	2005	2006
FIE contribution to the GDP (%)	2.0	7.4	13.2	15.1	16.0	17.1
Share of FDI in total investment (%)	22.0	26.0	18.0	15.5	15.7	16.4
Exports by FIEs, excl. oil exports (USD mil.)	112	920	3320	8601	11,144	14,620
- Share of FIEs' exports (%)	5.3	23.4	22.2	33.1	34.4	36.9
No. of employees in FIEs (1,000 persons)	n.a.	220	379	739	935	1,129

Source: MPI.

However, FDI still has limited spillover effects and benefit sharing in the regional production network. Viet Nam generally exhibits a similar trade pattern as in the cases of other East Asian economies, but only at the early stage (Box 2).

Box 2. Viet Nam's Engagement in the Regional Production Network

In general, Viet Nam is following a similar trade pattern experienced by other East Asian economies, but still is at an earlier stage of regional trade engagement (Vo and Nguyen 2006).

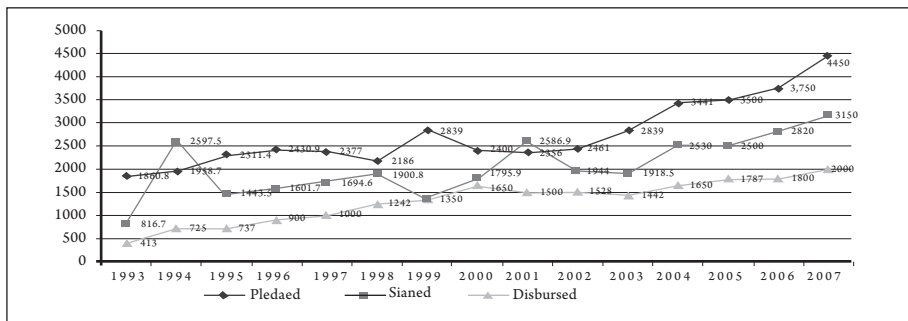
- **Firstly**, the East Asian economies began their growth relying strongly on exports of labor-intensive products but they have gradually gained a comparative advantage shift to increasingly capital and technology-intensive products. At present, Viet Nam's manufacturing exports are concentrated in labor-intensive products such as textiles and garments, footwear, and furniture with low value added in the production value chains.
- **Secondly**, East Asia saw a huge expansion of trade in intermediate goods such as machinery parts and components and a rising regional intra-industry trade. Viet Nam seems to be following a similar pattern. Viet Nam's regional intra-industry trade index increased from 2.2 in 1985 to 19.0 in 2000, but it is much smaller than that of other East Asian economies. East Asia has become the largest source of Viet Nam's imports of parts and components for industrial production.
- **Thirdly**, while trade in intermediate goods is mainly within East Asia, a majority of the markets for the final products is still extra-regional. The significantly increasing role of the EU and the US as important destinations for Viet Nam's exports can also be seen in the case of Viet Nam. Since the enactment of the Viet Nam-US BTA in December 2001, Viet Nam's exports to the US have increased from USD 1.05 billion in 2001 to about USD 5.0 billion in 2004.
- **Fourthly**, the People's Republic of China (PRC) has played an increasing role as a trade partner, especially in intermediate goods and components in East Asia. PRC has also become a key trade partner of Viet Nam, but with characteristics of the "North-South" trade and a huge deficit on Viet Nam's side (the deficit increased from USD 0.2 billion in 2001 to more than USD 5 billion in 2006¹⁵).

¹⁵ Note that in recent years ASEAN -5 has had a large surplus in trade with the People's Republic of China (PRC).

II.2. Official Development Assistance

Official development assistance (ODA) was resumed in 1993 and, together with FDI, has also significantly contributed to investment and GDP growth in Viet Nam. From 1993–2007, total committed ODA for Viet Nam reached USD 41.2 billion, of which USD 30.7 billion (or 74.5%) was signed, and USD 19.7 billion (or 47.9%) was disbursed (Figure 15).

Figure 15. Pledged, Signed and Disbursed Values of ODA (1993–2007)



Source: MPI.

In the years from 1993-2005, ODA represented about 11.4% of the total investment and 50% of the investment from the State budget (MPI 2005). Until recently, ODA allocation in Viet Nam had been in favor of more developed areas. But it has gradually been allocated in a more equal manner: less developed areas also tended to receive more of the ODA allocation.

Table 15 points out the sectors and areas that ODA has focused on. They include infrastructure development, poverty reduction (particularly in isolated areas), human resources development and institutional improvement. ODA has supported the enhancement and formulation of various important laws such as the Enterprise Law, the Land Law, the Investment Law, the Competition Law and the Anti-Corruption Law. ODA-financed projects also helped strengthen the managerial capacity of officials and the personnel of ministries, sectors and localities, and improve their professional and English levels substantially.

Despite encouraging achievements with resulting remarkable increases of ODA so far, the mobilization and utilization of ODA has been exposed to a typical set of weaknesses and limitations, including¹⁶:

¹⁶ See Institute of Vietnam Economy (2007).

**Table 15. Structure of Signed ODA by Sector and Area
(1993–2005)**

Sectors/Areas	Total ODA	Loans	Grant
Agricultural and Rural Development, Poverty Reduction	14%	10%	4%
Energy and Industry	21%	20%	1%
Transportation and Telecommunications	25%	24%	1%
Science, Technology, and Environment	12%	9%	3%
Health Care, Education and Training, Social Development	10%	5%	5%
Others	18%	14%	4%
Grant Total	100	100	

Source: MPI.

- Limited awareness and understanding on the nature of ODA, which is in many cases understood as a “free gift”;
- Slow materialization/concretization of directions, guidelines, policies and strategies on ODA mobilization and utilization into specific programs and projects, leading to passive role of governmental agencies in their cooperation with donors in a number of cases;
- Weak institutional arrangement and human capacity for ODA management and utilization. Human resources involved in ODA-financed programs and projects remain weak in professional capability, international cooperation skills and foreign languages. Organizational and operational regulations of ODA-financed programs and project management units remain inadequate;
- ODA management and legal framework for utilization exposes many constraints: inconsistencies between regulatory documents on ODA management and utilization and those on ODA allocation; lack of enforcement regarding regulatory documents on ODA mobilization and utilization; inadequate harmonization in ODA management processes and procedures of Viet Nam and donors, reducing investment efficiency and increasing transaction costs; and
- Limited monitoring and evaluation with regard to ODA projects and programs. This limitation is arguably due to the lack of strict compliance and inadequate disciplinary actions with regard to financial reporting, payments and settlement regulations.

3.3. Portfolio Investment Flows

The development and outlook of Viet Nam's economy and securities market has been appealing to many foreign investors. Foreign portfolio investment (FPI) inflows, together with the presence of a number of foreign investment funds, became a real new phenomenon in 2006. Foreign portfolio inflows accounted for 2.2% and 10.4% of the GDP in 2006 and 2007, respectively (Appendix B). Foreign portfolio investors have shown a keen interest to invest in Viet Nam's equity market due to their appetite for higher risk-higher return assets and prevailing liquidity in the global economy.

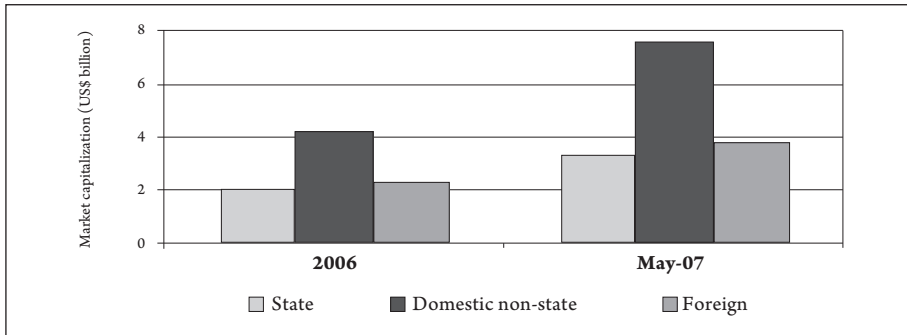
There were 436 foreign investors as of 2005, including 38 institutional investors and 389 individual investors. However, the number of foreign accounts increased by nearly twenty-fold from 2005 to 8,140 in 2007. The trading volume of foreign investors is rather high, accounting for 21% of the total market trading volume in 2006. This number increased to 29% by the end of 2007. In 2007, the trading value increased significantly to around 55% of market trading value (Dang, 2008).

In 2006, there was around USD 1.3 billion of FPI in Viet Nam, of which 70% was invested in stocks, bonds and real estate, and 30% was held as deposits in the banking system. In 2007, FPI increased sharply to USD 7.4 billion (Appendix B).

The exuberance and sizeable foreign participation, including overseas Vietnamese in Russia and Eastern Europe, has contributed to pushing up the financial boom and investments in the real estate market.

- In May 2007, foreigners accounted for a 25% share of HOSE capitalization or just under USD 4 billion (Figure 16). This amount is higher than actual inflows as it incorporates capital gains since the inflows took place.
- Equity acquisition has been considered a partnership strategy for investments in various areas, especially in financial activities, real estate, energy and infrastructure development.
- Since the 2nd half of 2006, the appetite of foreign investors has shown more favor towards both Government and corporate bonds. The participation of foreign investors has contributed to the growth of a secondary Government bond market in Hanoi. As previously mentioned, there are 75% and 95% of EVN bonds and Vinashin bonds, respectively, that have been sold to foreign investors.

Figure 16. Market Capitalization of HOSTC by Ownership



Source: HOSTC.

The above-mentioned increase of FPI was further explained by the transfer items on the BOPs. Private remittances increased substantially, from 0% of the GDP 1990 to 5.1% of the GDP in 2000, and further to 6.2% of the GDP in 2006 and 8.7% of the GDP in 2007 (Appendix B). The IMF (2006) supports the portfolio approach for Viet Nam because remittances appear positively correlated with the favorable economic conditions in Viet Nam, its overall investment climate and relaxation of the regulatory environment, particularly in the late 1990s¹⁷. Anecdotal evidence has shown that a large proportion of remittances has recently been used for investment in real estate and the stock market.

3.4. Capital Inflows and Macroeconomic Stability

In the last five years, there were high trade deficits but much less the CA deficit as in the mid-1990s. An exception is 2007, which had a very high CA deficit, reaching 9.9% of the GDP. Furthermore, the way of financing trade deficits in recent years has also been altered. In the mid-1990s, trade and CA deficits were largely funded by FDI. But since 2005, remittances and portfolio inflows have played an increasing role in financing trade deficit¹⁸. Also, as a result of huge capital inflows, foreign exchange reserves have recently accumulated rapidly, increasing from USD 3.0 billion in 2000 to USD 11.5 billion in 2006, and further to a record-high of around USD 23 billion (32.3% of the GDP) by the end of 2007.

Since the agreement on debt restructuring with the Russian Federation in 2000, Viet Nam's external debt has decreased substantially. In relative terms, the

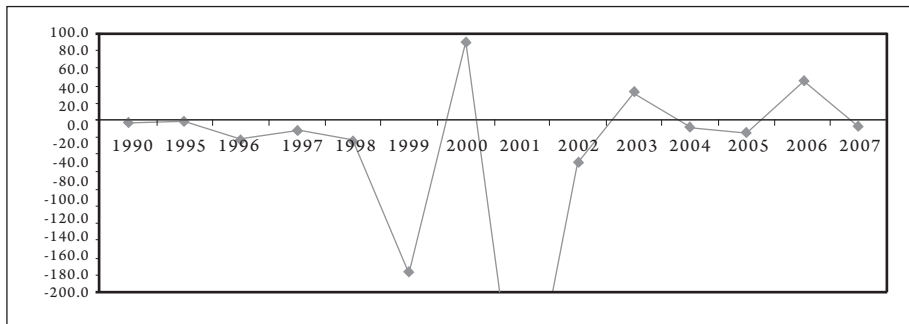
¹⁷ For example, remittances are not subject to tax and can be withdrawn in foreign currencies.

¹⁸ See Appendix B for more detailed information on Viet Nam's BOPs.

total external debt as a proportion of the GDP went down from 41.1% in 2000 to about 30.2% in 2006 and 30.8% in 2007 (IMF). The debt service ratio (5–6% recently) is well within a controllable level. There are, however, some concerns:

- Debt-induced financing has constituted a majority of capital inflow, and hence, the costs of financing CA deficit may increase;
- FDI inflow has also entailed considerable commercial loans;
- Capital utilization efficacy, especially in the public sector, is low. Moreover, the issue of Government bonds on the international market for lending to the SOEs is always associated with the moral hazard problem; and
- Errors and omissions in the BOP are high due to statistical errors which may reflect shortcomings in controlling short-term capital flows (Figure 17). Furthermore, to a given extent, it also slows up the trading volume in Viet Nam.

**Figure 17. Errors and Omissions of Viet Nam's BOPs
(% of KA Balance)**



Source: Estimations from Appendix B.

As mentioned before, a surge in capital inflows, especially during 2006-07, was also associated with domestic credit expansion, higher inflation and asset prices. But the outcomes, to a significant extent, have been dependent on responses of key macroeconomic policies.

4. Major financial issues and recent policy responses

Despite the possibility of sustaining high growth over the medium-term, vulnerabilities in economic growth and the financial systems still remain in Viet

Nam. There are a number of reasons for such a concern. To a certain extent, Viet Nam's economy still relies significantly on external resources to finance its investment-savings gap. Meanwhile, domestic capability to efficiently serve and absorb those resources is quite limited and the economy has been financially nurtured by rather ailing banking systems. Moreover, the economy can be hit by international trade and capital flow shocks or a global recession.

The Banking System

The first issue concerns the non-performing loans (NPLs) of the banking industry. It has gone down significantly in recent years but the sustainability of loan quality is seriously questionable in the future. Some major factors may increase future NPLs. The large SOEs' and public investments inefficiency, and the conflict of interest issues related to the lending of funds raised through bond issuances of SOEs could result in the loss of repayment capability of those borrowers. Moreover, the risks associated with real estate and securities-related loans, which were substantial in several JSCBs, are quite high in the context of high inflation and an asset bubble.

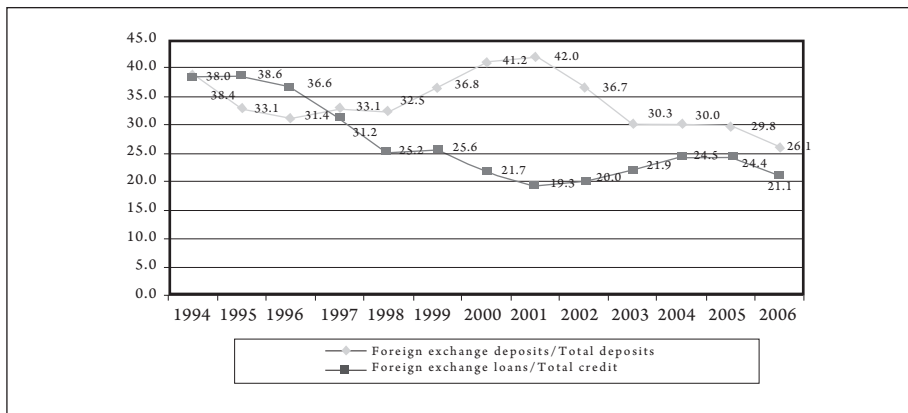
Obviously, one of the key measures in conjunction with restructuring the banking system is to reform the SOE sector. Since 2005, SOE reform has changed significantly in nature, with its focus shifted to large SOEs with the goal of their equitization and listing on the stock market. Several state business groups were established, hoping to gain stronger competitiveness in the new environment and international markets thanks to improvements in their efficiency and management capability. At first, the transformation of large SOEs was allowed as an experiment; but later on this somehow became a movement and nearly all of them have engaged in various kinds of business activities, including financial ones. There are concerns about the transparency of the SOE reform process and risk management of these business groups.

The banking industry has also faced a prolonged double mismatch problem (maturity mismatch and currency mismatch). Normally, short-term deposits account for 75% of total deposits, but the share of medium-and long-term loans in total credit rose from 22% in 1995 to about 40% in recent years (this figure is much higher for some JSCBs in 2007). At the same time, commercial banks have only been allowed to use about 25–30% of short-term deposits to make medium and long-term loans. The risks seem to be magnified in the presence of direct lending and conflict of interest issues, especially when related to loans of questionable real estate deals and other big projects.

The currency mismatch was most severe during 1999-2002 due to sharp increases in foreign currency deposits and a decrease in foreign currency loans,

measured as shares in total deposits and total loans, respectively (Figure 18). It has recently been narrowed, but remains problematic due to its sensitivity to the exchange rate and interest rate fluctuations, especially in the context of a rather high degree of dollarization¹⁹. The SBV has attempted to gradually eliminate dollarization. However, this is no easy task as some contradicting policies continue to be in place (such as policies for encouraging remittances) and in the context of having capital flows.

Figure 18. Ratios of FX Deposits to Total Deposits and FX Loans to Total Credit



Source: SBV and authors' estimations

The problem of macroeconomic policy consistency should be looked into for greater clarity. Consistency between monetary and exchange rate policies is approached as, according to Johnston and Otker-Robe (1999), the relationship between exchange rates (ERs) and interest rates at a point in time and the sustainability of these policy mixes over time. The consistency at a point in time can be best demonstrated by the conditions of covered and uncovered interest rate parities (CIP and UIP)²⁰. These two parities indicate the interdependent

¹⁹ Measured as ratio of foreign currency deposits to M2, dollarization in Viet Nam remained stable between 20-23% in the mid-1990s. It started to increase in 1997 to reach a peak of 31.7% in 2001, before dropping to 24.4% in 2005 and less than 20% in 2007.

²⁰ The CIP equation is: $i_{t,k} = i^*_{t,k} + fd$; where, $i_{t,k}$ and $i^*_{t,k}$ are rates of return on domestic and foreign assets of the same maturity and are otherwise identical, except that they are denominated in different currencies, and fd is the forward discount on the domestic currency for that maturity. The UIP holds if investors are assumed to be risk neutral, expectations are formed rationally, and the expected future depreciation of the home currency (Δset_{t+k}) equals the forward discount: $i_{t,k} = i^*_{t,k} + \Delta set_{t+k}$

relationship between the domestic interest rate and ER at a point in time, when investors consider different returns on various financial assets to maximize return on their portfolios. The policy consistency over time determines the sustainability of the chosen policy mix. The risks and costs of this kind of policy inconsistency are ineffectiveness of monetary policy and encouragement of speculative activities. This point can be illustrated by two case studies: the intensification of dollarization during 1998–2001, and the “mini-crisis” in 1996–97 (Box 3).

The present situation seems to be reversed due to the weakening USD and increasing VND-denominated interest rates (Table 16). The VND became more attractive than the USD (a reason for the declining degree of dollarization). This has contributed to the encouragement of VND-based foreign exchange investments in such as local bonds, real estate, equity markets, and foreign currency borrowings for imports (given high inflation and expectation of stability/appreciation of nominal ER). Some of these kinds of investments can also be speculative.

Box 3. Dollarization, Double Mismatches and Speculative Activities

Following the UIP condition, it can be observed that during 1997–2001, given the expectation of further exchange rate (ER) depreciation and lower VND-denominated interest rates, the public had shifted from the preferred portfolio in favor of USD (Table 16). This was particularly the case in 2000 when the FED raised the prime rate to remarkable levels. Due to capital controls, commercial banks attempted to attract foreign-currency deposits for deposits abroad to earn the differential spread. The deposits abroad rose remarkably, from USD 537 million in 1998 to USD 2.088 billion in 2000 and 1.197 billion in 2001 (Appendix B). In other words, the macroeconomic policy inconsistency in favor of holding USD was a major underlying determinant of the dollarization in intensification during 1999–2001, and in certain circumstances this encouraged commercial banks to speculate on currency gains rather than focus on productive investments.

The mini-crisis in 1996–97 is another illustration of the danger of macroeconomic policy inconsistency and problem of double mismatch (Vo et al 2003). In 1996 the very high VND-denominated interest rates attracted a substantial increase in banking deposits, while credits were hardly expanded due to the high lending rates and tight regulations on credit ceilings. Reserves in commercial banks rose substantially and many banks had excessive reserves (some banks even refused to accept more deposits). This

Table 16. Annual Savings Interest Rates of USD and VND, 1992–2007 (%)

Year	CPI-based inflation	VND depreciation rate	VND savings interest rate	Real VND savings rate	Return on VND in USD	USD savings interest rate	Difference in rates
	0	1	2	(3)=(2)-(0)	(4)=(2)-(1)	5	(6)=(4)-(5)
1992	17.5	-8.13	34.10	16.60	42.23	4.05	38.18
1993	5.2	2.62	20.40	15.20	17.78	3.20	14.58
1994	14.5	1.92	16.80	2.30	14.88	3.50	11.38
1995	12.7	-0.33	16.80	4.10	17.13	4.50	12.63
1996	4.5	0.33	9.60	5.10	9.27	4.80	4.47
1997	3.6	11.57	9.60	6.00	-1.97	5.00	-6.97
1998	9.2	12.70	9.60	0.40	-3.10	5.00	-8.10
1999	0.1	0.89	5.25	5.15	4.36	4.70	-0.34
2000	-0.6	3.54	4.45	5.05	0.91	4.43	-3.52
2001	0.8	3.90	5.95	5.15	2.05	3.00	-0.95
2002	4.0	2.11	7.20	3.20	5.09	2.50	2.59
2003	3.0	2.20	7.40	4.40	5.20	2.50	2.70
2004	9.4	0.40	7.70	-1.70	7.30	2.60	4.70
2005	8.4	0.90	8.40	0.00	7.50	4.20	3.30
2006	6.7	0.87	8.80	2.10	7.93	4.70	3.23
2007	12.6	-0.20	9.10	-3.50	9.30	5.00	4.30

Note: The end of period ER is used to calculate the depreciation rate.

Source: Nguyen (2002) for the data up to 2001 and authors' estimates for the 2002–07 data

situation created incentives for banks to evade government controls. A letter of credit (LC) was one important channel for evasion since up to that time LCs were excluded from credit ceilings. LCs were seen as an off-balance activity of banks, generating opacity on the balance sheets of banks.

Firms also attempted to evade regulations on limits of foreign-currency borrowings (only importers and other import-related activities can obtain loans in foreign currencies). Although at that time Viet Nam had imposed certain restrictions on CA and KA, the flows of funds from abroad through deferred payments on LCs had been outside those restrictions. Domestic enterprises were allowed to have their trade credit guaranteed by commer-

cial banks through deferred LCs. In fact, this was equivalent to enterprises borrowing short-term foreign currency loans from abroad through domestic commercial banks. Moreover, in an environment of a very high VND interest rate and limited foreign currency loans, but with stability and rigidity of exchange rates as an implicit government guarantee against foreign exchange risk, there was, of course, a strong incentive for domestic firms to borrow from abroad. Thus both commercial banks and firms had incentives to lend and borrow through LCs.

As a result, domestic firms (both SOE and private enterprises) borrowed a large amount of short-term USD loans. The amount of LCs was estimated to have accumulated to USD 1.5 billion by early 1997. Net flows on short-term debt increased significantly, from about USD 120 million in 1993 and 1994 to USD 311 million in 1995 and USD 224 million in 1996. It had become thereafter largely negative in 1997.

The consequences were severe. First, it widened the CA deficit at an alarming level (Appendix B). Second, a large part of this short-term borrowing was channelled into a speculative real estate market, resulting in a market boom. But the market turned into bust later, in early 1997, when those firms could not pay back the debt. Third, it weakened the banking system and the financial sector as a whole. Around 40% of the LCs (equivalent to 3 percent of the GDP) guaranteed by commercial banks became bad debts.

As a result, the SOCBs and some other JSCBs defaulted on these guaranteed short-term debts, leading to the concern about the level of foreign exchange reserves and about Viet Nam's commitment to international financial arrangements. The SBV had to use foreign reserves to bail out these commercial banks. It was estimated that the stock of foreign reserves fell by the equivalent of 5 weeks of imports. Viet Nam's sovereign credit rating was lowered from Ba3 to C.

Moreover, the evasion of banks weakened the effectiveness of the monetary policy because the direct control mechanism was eroded, distorting monetary aggregates. In addition, it generated upward pressure on the exchange rate. Due to a sharp increase in demand for foreign exchange by the end of 1996 and early 1997, the SBV broadened the band between selling and buying rates of foreign exchange from 1% to 5% in February 1997. In addition, in mid-1997, the SBV set strict limits on the amount of deferred LCs and tightened controls over commercial banks' LC guaranteeing. To import goods on the restricted goods list a deposit equivalent of 80% of each LC was required instead of the previous 0-30% level. As a result, during the second half of 1998, the value of late LC payments fell from around USD 350 million to some USD 200 million at the end of 1998.

Another issue is that the management capability at both the macro- and micro-levels cannot keep pace with the new development dimensions of the banking sector. In fact, there are still shortcomings in the banking industry as much as there is still a weak financial capacity of commercial banks (low CAR, low reserves and low loan quality) and weak risk management. According to a survey by Ernst & Young, the banks' application of 19/25 principles (3/25) does not fully comply with the BASEL Core Principles (Nguyen 2007). Furthermore, the underdevelopment of a regulatory framework with limited supervision and monitoring capacity of the key bodies, the SBV, the MOF and the SSC, makes banking activities less transparent and more fragile. As mentioned by Vo et al (2007),

Viet Nam's banking system is still vulnerable due to limited supervision, monitoring and governance capacity. On-site monitoring and supervision is constrained due to inadequate quantity and quality of human resources. Off-site supervision, meanwhile, fails to meet contemporary requirements in compiling and processing information. Lending supervision has yet to cover all credit-related financial institutions due to lack of effective collaboration amongst authorized agencies and de-facto institution-based financial system governance. Certain international practices and standards have been recently adopted; yet banking governance standards generally have yet to meet the CAMEL and BASEL provisions.

The SBV is now undergoing more radical reforms to be a modern, relatively independent central bank. The Government also began reforming the entire supervision system towards the establishment of a new single supervision system like the FSA (Financial Service Authorities) in the UK.

The Stock and Bond Markets

During a stock market boom, the greatest concerns of the Vietnamese authorities have been how to control speculative activities that make the stock market too volatile and at the same time, how to facilitate long-term investment for the development of the economy as a whole. Facing such challenges, the SSC has repeatedly warned investors of risks associated with overheating in the market's development, followed by the SBV's measure to restrain loans to bank-backed securities companies in December 2006. Within a few days, the SSC promulgated six measures to improve regulation and monitoring of the securities market's operations, including: (i) postponing the lifting of maximum shares of listed companies permitted to foreign investors; (ii) cooperating with the SBV to monitor lending for security investment, repo transactions and other transactions related to security collateralization of commercial banks; (iii) investigating securities companies which reportedly discriminate between customers, and/or

misuse information; (iv) requiring listed companies to disclose and disseminate their operational and financial results as of 2006 to better inform investors in the market; (v) re-registering representative offices of foreign investment funds in Viet Nam; and (vi) promoting further information disclosure so that investors can make better informed, rational investment decisions.

However, the reaction of the stock market proved that such policy measures were not significantly effective. There has not yet been a clear sign of market fever relief (Figure 9). In order to protect the stability of the banking system in particular, and the financial system as a whole, with the fear that stock-collateralized loans could become NPL, in April 2007, the SBV decided to impose a ceiling of 3% of total lending for stock-collateralized loans (Direction 03/QD-NHNN). The VN-Index afterward has fluctuated with a declining trend.

Development of the stock market in Viet Nam is obviously very much dependent on the SOE reform process. To be aware of the problem, the Government has focused on reforming large SOEs with a determined action plan. According to a public announcement plan, there are about 2,100 SOEs at present, of which about 1,500 have been or will be equitized over 2006-2010. This suggests also that close to 80 corporations and large firms will have to go public. Moreover, 550 SOEs were to be equitized in 2007. However, in 2007, only 65% of these SOEs were successfully equitized. As stock market indexes have been declining, the Government was observedly puzzled over the trade-off between the financial surplus it could gain from initial public offerings (IPOs) and implementation of the committed SOE reform schedule. In turn, this has created a serious disequilibrium in the stock market. With the IPOs of some large state-owned corporations (e.g. Dam Phu My, Bao Viet Insurance Company, and Vietcombank), the market sentiment is that the Government is desirous of getting a greater financial surplus from such IPOs.

Furthermore, there are also some concerns about the role of the State Capital Investment Corporation (SCIC), which was set up in 2005 closely following the model of Singaporean Temasek. Motivations are to remove a conflict of interest concerning line ministries or provinces and to achieve a more rational and efficient use of state capital through divesting state shares, including outright sale, and seeking strategic partners and mergers. The SCIC is also determined to increase transparency when utilizing state capital, including in operations of entities in which it invested. Although the SCIC has a profit oriented mandate, whether it could be a market stabilizer remains questionable. Risks due to the agent-principal relationship can arise if there is not effective supervision over the SCIC and the SCIC does not have sufficient expertise in dealing with complex financial activities (more about the SCIC in Box 4).

Box 4. Role of the SCIC

The SCIC began operations in August 2006 to concentrate state shareholding in the equitized SOEs under one single entity. Important companies in its portfolio include VinaMilk, Pacific Airlines, FPT, and Bao Minh. By the end of March 2007, the SCIC had received ownership rights from 433 equitized SOEs with a total book value of about 3.4 trillion dong. By the end of 2007, the SCIC expected to receive ownership rights in 1,033 enterprises, excluding banks, with state holdings of 7.2 trillion in book value and an estimated market value of 36 trillion dong.

The SCIC has classified equitized SOEs into three groups, A, B, and C. It will concentrate on strengthening or restructuring enterprises in Group A, which operates in sectors considered strategic. Group B enterprises with good potential will be supported for listing on the stock market. Group C comprises enterprises where the state does not need to invest in them over the long term. SCIC will gradually sell state shares in companies of this group. In 2007, it planned to sell stakes in 50 companies with a total book value of about 227 billion dong (USD 14.2 million).

One area that needs to be clarified is the role of the SCIC in relation to the General Corporations or Economic Groups which operate under the holding company structure. At present, it appears that SCIC will receive ownership rights on a case-by-case basis. Reportedly, for the two banks to be equitized later this year, Vietcombank and MHB, it has been instructed by the Prime Minister to receive the rights.

Source: World Bank (2007).

Until now, policy responses for developing an effective bond market, which is quite a long-term process, have been insufficient and inappropriate. Equity markets may exist where bond markets fail to thrive. The bond market in Viet Nam is still very modest and lacks necessary components including the following²¹:

- An appropriate legal framework with the effectiveness of a judiciary system;
- High quality of information and adoption of strict accounting and disclosure standards;

²¹ See, for example, APF and ADBI (2001) and Jeffrey and Pomerleano (2002).

- The presence of independent risk-rating and other information generating agencies;
- An efficient and reliable clearing and settlement arrangement; and
- Some forms of tax incentives during the initial stage of development.

Moreover, the bond market in Viet Nam is heavily dominated by Government bonds. It is necessary, however, to strengthen the role of the Government as the primary issuer.

With the opening of the economy, full participation in the regional and international bond markets is unavoidable. Viet Nam has been involved in all dimensions of regional financial cooperation, including the regional surveillance system, the Chiang Mai Initiative (CMI), the regional bond market development and monetary policy and ER coordination. However, the effectiveness of such involvement is very limited and obviously depends very much on how the country can effectively develop its domestic bond market. The practical issues of engagement in the ASEAN stock market link and in the regional bond market are basically theoretical now and have yet to be put into practice.

Foreign Capital Inflows ²²

Viet Nam continues to be on the right track for attracting FDI with a more liberal and neutral investment environment. Recently, the Government has moved towards unifying domestic and foreign investment regulations, aiming to establish a level playing field for both domestic and foreign investors. Commitments to the WTO, especially those of the services sector, are quite broad and deep and are in favor of FDI. Major obstacles, however, still exist such as red tape and corruption, an inconsistent and barely transparent system of legal documents and unpredictable policy changes. The recent slow pace of FDI realization²³ has also revealed major bottlenecks in attracting FDI in an efficient manner due to weaknesses in the infrastructure and a shortage of skilled laborers.

ODA inflow has been the result of the gradual strengthening of a set of common commitments between the Vietnamese Government and the donor community in line with the Hanoi Core Statement (HCS) on aid effectiveness (Table 17). In particular, in 2006, the Government issued Decree 131/2006/ND-CP

²² Decree 22/1999/ND-CP is the 1st legal document on the FDI outflows. Since then there has been some relaxation on foreign exchange transactions and borrowings for overseas direct investment purposes.

²³ The realized FDI as a share of the total FDI commitment in 2006 and 2007 was only 41.0% and 37.8%, respectively. These figures are much lower than that in 2005 (84.7%) and the average during 1988-2007 (52.7%).

Table 17. Central Principles of the Hanoi Core Statement

Ownership	The Government is the leader/owner of the development agenda.
Alignment	Donors use plans, systems and procedures of the Government to the best possible extent.
Harmonization	Donors and the Government jointly harmonize ways of aid delivery
Managing for results	The Government adopts results-based management, and donors use frameworks of the Government results wherever possible for measuring success.
Mutual Accountability	Donors and the Government jointly agree to share accountability for aid effectiveness.

Source: PGAE (2005).

(in replacement of Decree 17/2001/ND-CP in 2001) to accelerate decentralization of ODA management and utilization, giving full responsibility to project executing agencies for appraisal, approval and implementation of ODA-financed programs/projects. However, some shortcomings in this field such as the modest effectiveness of anti-corruption programs and the lack of capacity for monitoring and evaluation, especially at local level, necessitate more radical solutions. Last but not least, having transparent and effective public-private partnership (PPP) schemes are still questionable.

Regarding portfolio flows with trade in services, financial liberalization and WTO commitments implementation, FIEs were allowed to be transformed into share-holding companies (since 2004). The Government also provided guidance for purchasing and selling securities by foreigners at the STC. Moreover, the Ordinance on Foreign Exchange Management issued in December 2005 gave permission for individuals to obtain overseas borrowings and domestic economic entities to make overseas lending if they met necessary conditions. Soon after, it led to some uncontrollable problems related to external debt monitoring. As a result, the SBV had to delay issuing a Circular for guiding the implementation of the Ordinance. As a reflection, although the KA is now relatively open for capital inflows, Viet Nam needs to think seriously about the sequencing of full KA liberalization in conjunction with improvements in the financial supervision system.

Macroeconomic Policies

In an economy open to capital inflows, policy consistency over time requires the authorities to have either a very strong commitment to a pegged ER or pursue a flexible ER. However, efforts to maintain macroeconomic policy consistency are constrained by the well-known “impossible trinity” or “impossible

tri-lemma,” which states the impossible coexistence of exchange rate stability, free movement of international capital, and monetary autonomy²⁴. Policymakers can have several macroeconomic policies to respond to capital inflows such as sterilization, revaluation of the nominal exchange rate/greater exchange rate flexibility, and fiscal austerity. Other policy measures such as liberalization of capital outflows, controls on capital inflows, and trade liberalization can also be implemented. The effectiveness of such policies is presented in Appendix C.

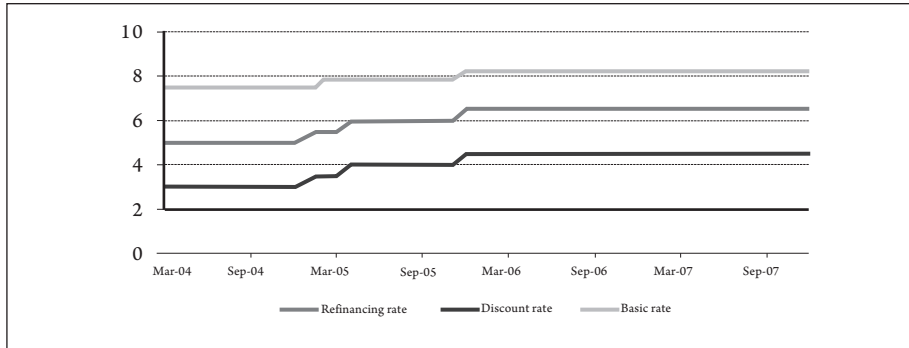
Appendix C shows that not only single possible policy response to a surge in capital inflow is perfect in terms of achieving both goals of macroeconomic stability and economic growth. ER flexibility and appreciation seem to be the best effective response to large capital inflows because it avoids side effects attendant to other policy responses. But it could also create a policy inconsistency that is very much dependent on external conditions, such as the position of the foreign currency the local currency is pegged to. That in turn would encourage short term speculative capital inflows. Sterilization is often costly and ineffective, but remains most the commonly used since policymakers are generally reluctant to allow the exchange rate to appreciate because of fears of undermining export competitiveness and the resulting lower economic growth. Fiscal tightening could be a good option, yet it faces several limitations, especially in terms of approval and action. Moreover, it could lead to lower investment and hence, a lower economic growth rate if public investment still accounts for a large share of total investment.

Recently, SBV’s conduct of monetary policy turned out to be more complicated as it faced two problems, namely, increasing macroeconomic policy inconsistencies (Table 16) and the “impossible trinity” as capital inflows surged, especially in 2007. The SBV has had to consider a trade-off between exchange rate stability and inflation targeting policy. Basically there have been two main arguments to the dilemma facing the SBV. The first is that appreciation can hurt exports and economic growth; yet historically the SBV has pursued a rather weak VND policy in order to promote exports. The second is to let VND appreciate which seems to be in line with macroeconomic fundamentals and foreign exchange behavior of many other East Asian economies and moreover, it could be a sign for the economy that the VND is no longer only in a position of depreciation (JP Morgan 2007). So what is the choice by the SBV in practice?

²⁴ If a country attempts to achieve ER stability and monetary independence, it needs to introduce capital controls. If a country attempts to have full financial integration and monetary independence, it needs to adopt the floating ER regime. If a country attempts to achieve ER stability and full financial integration, the very rigid fixed ER such as a currency board system or a currency union should be considered.

In general, the SBV and the Government are more concerned about the possible negative impact of appreciation on exports and the slowdown of economic growth. In January 2007, the SBV widened the trading band of the VND/USD from $\pm 0.25\%$ to $\pm 0.5\%$ around its daily reference rate. The VND/USD appreciated in nominal terms of only 0.2% for the whole year of 2007. At the same time, the SBV kept all official interest rates such as refinancing, discount and basic rates unchanged since early 2006 in order to provide a stable signal to the market (Figure 19), although the rates set by commercial banks increased slightly (Table 16). While stabilizing the nominal ER, the SBV quickly built up its foreign exchange reserves, which increased from USD 11.5 billion in 2006 to USD 23 billion by the end of 2007.

Figure 19. Evolution of the Interest Rate Policy Set by SBV (% Year)



Source: SBV.

As inflation accelerated in the first half of 2007²⁵, the SBV only attempted to sterilize the excess liquidity through the OMO and the increased reserve requirements. It is reported that the SBV regularly withdrew up to VND 11,000–14,000 billion (USD 688–875 million) per week from circulation since May 2007. At the end of the year, this figure rose to as much as VND 15,000–16,500 billion (USD 938–1.031 million) (World Bank 2007). Since June 2007, the SBV has raised its reserve requirements. For VND deposits under 12 months, the compulsory reserve rate increased from 5% to 10%; for VND deposits between 12 and under 24 months, from 2% to 4%. Correspondingly, rates for foreign currency deposits are from 8% to 10% and from 2% to 4%.

²⁵ During 2007, the price of petroleum increased four times—in January, March, May and November, and decreased one time, in August. As a result, the price/liter increased from VND 10,500 to VND 13,000 (or 23.8%).

But the sterilization was ineffective and costly (CIEM 2008). The money supply (both M2 and domestic credit) expanded sharply in 2007 in comparison with that of previous years since 2003, which was already high (Table 6). The inflation rate jumped from 9.4% in 2004, 8.4% in 2005 and 6.7% in 2006, to 12.6% in 2007. The SBV was recognized by the Government to be “perplexed” in conducting monetary policy, which was considered a major cause, together with cost-push and demand-pull reasons, of higher inflation. Moreover, in the context of the weakening USD and increasing international commodity prices, keeping the stability of the nominal VND/USD also means a significant import of international inflation.

To be more proactive in controlling the money supply, the SBV in the last few months introduced several policy measures:

- By the end of December 2007, the trading band of the VND/USD was cautiously widened to $\pm 0.75\%$ and as a result, the nominal VND/USD appreciated by 0.3% over the first two months of 2008;
- In January, lending restrictions for stock investment changed from 3% of total loans outstanding to 20% of charter capital, which limits potential growth in such investment credit;
- Since 1 February 2008, the rates of compulsory reserve requirements have been raised to 11% (from 10%) for VND and foreign currency deposits under 12 months, and to 5% (from 4%) for those deposits between 12 months and under 24 months;
- Also since 1 February 2008, all official interest rates have been increased, from 6.5% to 7.5% for the refinancing rate, from 4.5% to 6.0% for the discount rate, and from 8.25% to 8.75% for the basic rate; and
- In particular, in the second week of February 2008, the SBV decided to issue by 17 March 2008 365-day-bills worth VND 20,300 billion with a coupon of 7.8% and requested a compulsory purchase by 41 commercial banks.

What can be observed in the following days ahead is that some JSCBs, which have a maturity mismatch problem because a significant proportion of their lending consists of medium and long-term loans (e.g. those going to the real estate market and consumption of durable goods), will not have sufficient liquidity to meet the new policy measures. The inter-bank market became too heated with overnight rates of 25–30%. As a result of the “liquidity chaos,” the SBV was forced to pump out VND 33,000 billion. Those banks were, however, in a difficult position in terms of liquidity because they held T-bills/bills issued by the SBV. They increased their annual VND deposit interest rates to 14.6% to mobi-

lize as many as deposits they could. The race for higher deposit interest rates among commercial banks began. It calmed down only by the end of February 2008 as the SBV-issued directive requested that all commercial banks not raise annual deposit interest rates more than 12% and promise to meet the liquidity of the banking system through the inter-bank market with reasonable rates.

The liquidity chaos once again shows how high the cost could be if the policy of keeping the nominal stability of ER persists in conjunction with the maturity mismatch problem in the banking system or even only in some commercial banks (due to weak supervision) and the inappropriate policy actions leading to more serious macroeconomic policy inconsistencies. The fact that the SBV had to use some administrative measures to control the situation will have higher costs due to distortions in resource allocation. This action, though temporary and necessary, can be seen as a step backward in the process of improving monetary instruments²⁶. The movements of the some key macroeconomic variables in the first two months of 2008 will make the policy option more complicated. Inflation rose by more than 6%²⁷. The rise in deposit interest rates by banks could soften the liquidity problem but it imposes a higher risk for several banks.

Fiscal tightening can be a good response to capital inflows. It contains inflationary pressure and reduces pressure on real appreciation and increases interest rates. However, up to now, Viet Nam has had no serious intention of using fiscal policy as a policy complement to monetary and ER policies in response to capital inflows. For a long time, fiscal policy has followed the “golden rule,” meaning the budget should have savings, i.e. total revenues are higher than current expenditures (Table 18) and the budget deficit cannot be financed by seigniorage.

Room for reducing the budget deficit seems to be small. However, the budget deficit is rather huge. Budget revenue still relies heavily on crude oil exports and import tariffs. The former item has fluctuated much and moreover, because of some technical problems, the volume of crude oil exports will not increase unless new oil resources are found. The latter item has significantly decreased over time due to trade liberalization (Table 18). There is also uncertainty about the impact of tax reforms (e.g. personal income tax, asset tax, etc.) on the budget revenue.

²⁶ Basically, the SBV liberalized foreign currency and VND interest rates in 2001 and 2002.

²⁷ Inflation is often high during the months before and after the Lunar New Year. But inflation at 6% is still high by normal standards. The impact of the most recent monetary measures can be seen later. Note that in January the Government increased again public salaries by 20% and also the petroleum price from VND 13,000/liter to VND 14,500 (or 11.5%).

Table 18. Budget Revenues and Expenditures (2001–2007)

	2001	2002	2003	2004	2005	2006	2007
Proportion of total revenues (%)							
Total revenues	100.0	100.0	100.0	100.0	100.0	100.0	100.0
<i>Crude oil revenues</i>	24.5	21.4	18.6	21.6	27.5	29.5	21.97
<i>Trade taxes (import tariffs)</i>	21.4	25.5	19.6	15.5	17.0	15.7	18.12
Proportion of total expenditures (%)							
Total expenditures	100.0	100.0	100.0	100.0	100.0	100.0	100.0
<i>Investment expenditure</i>	31.0	30.5	28.5	25.8	27.2	27.1	27.6
<i>Current expenditure</i>	55.8	53.1	49.8	44.5	55.8	51.3	55.9
<i>Grants and interest payments</i>	11.5	13.4	13.2	13.4	13.1	12.8	13.4
Ratio in terms of GDP (%)							
Total revenue	22.3	23.1	28.2	31.4	26.8	27.8	27.4
Total expenditure	27.0	27.7	31.4	35.8	31.6	32.8	32.4
Budget balance	-4.7	-4.5	-3.3	-4.3	-4.9	-5.0	-5.0

Note: The IMF's latest Article IV estimated a fiscal deficit of 6.9% in 2007 (Cited from ANZ 2008).

Source: MOF and authors' estimates.

On the expenditure side, the Government is facing increasing pressure on infrastructure development and upward adjustment of salaries for public servants (because of higher inflation rates, the Government was forced to raise public salaries several times, by 10%–20% each, during 2004–2008). Nevertheless, investment expenditure is recognized as inefficient in terms of selecting projects and disbursements (at least 20–30% of investment expenditure can be saved).

V. Policy recommendations

The prospect for Viet Nam's development is bright according to a number of forecasts: the economy will likely continue to grow at an annual rate of 8–9% in coming years. To materialize the slogan "Prosperous people, a forceful country, and an equitable, democratic and civilized society," the major development goals set by the government of Viet Nam reflect its strong determination to develop itself, with significant attention to both the economic and social aspects of people's lives. Specifically, these goals are:

- To sustain high economic growth;
- To shed the status of a poor country by 2010 (there is a possibility that this objective will be realized in 2008); and
- To accelerate the industrialization and modernization process so that by 2020, the country will basically be a modern, industrialized country.

In spite of the recent significant expansion of the financial system, room for financial development remains very large. Viet Nam is still largely bank-based, and the capital markets are only at an early stage of development. Not only does the financial system appear to have a bright future thanks to high economic growth and rapid urbanization, but Viet Nam's population is also very young, of which 60% is under 35 years old. As anecdotal evidence shows, these young people are early adopters of banking and financial services. Access to financial services and activities, however, is still limited. About 50% of household savings is not deposited in banks. The number of personal accounts in banks is just about 8% of the total population and retail banking services account only for 6% to 12% of bank revenues (VinaCapital 2006).

There exist, however, enormous challenges to Viet Nam in achieving its development goals and in realizing its potential for financial development. The country is still in transition, with low income, and needs to strive for industrialization. Weaknesses and vulnerabilities persist in some critical areas, such as the SOEs, the financial system and efficiency of public investment, and others. Private firms have recently flourished, yet very few of them can become leading ones in the field. Furthermore, the infrastructure is still underdeveloped. In particular, infrastructure services and utilities like transportation and electricity remain too expensive and/or inefficient, resulting in a high cost of doing business in Viet Nam. Growth performance in the past few years has been impressive, but to go further, Viet Nam also needs better human resources and institutional capacity. Yet, it seems that the capacity is not yet adequate, which can be mainly attributed to problems of public governance and the quality of the education and training systems. Avoiding wider poverty and income inequality, and reducing social risks and adjustment costs of trade liberalization and international integration are all challenges that Viet Nam needs to resolve on its way to sounder and more sustainable development.

At the same time, the reform process is becoming more complicated as it touches the production factor markets and the large SOEs, which are socio-economic sensitive and related to the concept of socialist orientation. Moreover, macroeconomic instability and financial vulnerabilities are still a threat, and have

Table 19. Signs of Financial Vulnerabilities in Viet Nam’s Economy

Key macroeconomic indicator-based assessment		Asian crisis lessons-based assessment
1. Appreciation of VND	High pressure.	1. The scale of capital flows, especially short-term flows: quite substantial.
2. Trade deficit	Tends to widen.	
3. Private consumption	Some signs of booming in cities.	
4. Fiscal expansion	High budget deficit and high pressure on both investment and current expenditures.	2. Direction/distribution of short-term flows: a large proportion going to real estate and stock markets.
5. External debt	Tends to relatively decline; seems to be sound over medium-term.	3. Degree of macroeconomic policy inconsistency: serious.
6. Domestic savings	Quite high (30–31% GDP), but large and widened S-I gap.	4. Quality of financial supervision and corporate governance: some improvement through “learning by doing” but still weak.
7. Investment efficiency	Declined in the early 2000s, but improved over the last three years, but still concerns of large SOEs and public investment efficiency.	

Source: Authors’ own assessment.

become more apparent as the country integrates the regional economy with the world economy (Table 19). The underlying factor is the mismatch between the lively business reality in relation to new money-making opportunities on the one hand, and weaknesses in the financial institutions’ and firms’ risk management and financial supervision capacity on the other hand.

There are three well-known pillars which are interrelated and reinforced by each other for assuring sustained economic growth and development: (i) strong economic fundamentals; (ii) a sound and healthy financial sector; and (iii) macroeconomic stability. The policy package option for Viet Nam, therefore, should aim at sustaining high economic growth and sound financial development while mitigating financial and macroeconomic risks. Obviously, Viet Nam needs to have a broad approach to economic and financial reform as well as more specific policy measures to deal with the present macroeconomic instability. Followings are some ideas for this policy package option.

Directions for Broader Reforms²⁸

The first and foremost important reform direction for Viet Nam is to continue undertaking a decisive institutional reform—one that will transform the existing state-led economic institutions into efficiency-enhancing institutions. This is not only about making the legal framework more consistent with a market-based economy and international commitments, but more importantly, it is also about reforming the large SOEs and establishing an efficient and effective administrative and enforcement system.

The second is to start moving up along the value chain, while fully utilizing traditional comparative advantages. It is essential for Viet Nam to: (i) diversify export products and strengthen non-price competitiveness; (ii) attract efficient FDI; and (iii) improve infrastructure (especially, the transportation system and electricity supply) and labor and management skills (at both the macro and micro levels) since these two present bottlenecks for development. What Viet Nam needs to do now is to maximize the benefits of efficient FDI inflows. In that sense, improving the overall business environment and creating a playing field are critical. A liberal and neutral environment is much better than financial incentives for attracting efficient FDI. This can be done via institutional improvements, market factors, human resources development and cutting down business costs. While public investment still has an important role in economic development, it should be redirected to areas with significant positive externalities for business activities such as infrastructure and information provision. ODA should be utilized more efficiently and transparently in accordance with the central principles of the Hanoi Core Statement. Institutional and human resources capacity building for Viet Nam is the key as decentralization of ODA management and utilization has been carried out substantially. Increasing participation of foreign and private firms in public projects in a transparent manner is also essential for reducing the burden on state investments.

The third is to strengthen surveillance and financial supervision capacity. This necessitates amendments and improvements of the existing regulatory framework to cope with the new dimensions of financial activities and development²⁹. The financial and BOP statistics are still not accurate and consistent, and they do not conform well to international standards, despite considerable improvements with respect to their collection, processing and dissemination. Unless their quality is improved, early warning systems for detecting vulnerabilities in the financial system cannot be developed and used with high credibility.

The key regulators—namely, the Ministry of Finance, the SSC and the SBV, could be unified into a single body to detect vulnerabilities associated with the financial sector and capital movements. It could be more cost-effective, but its effectiveness is questionable. As stressed in the study by Corbett (2007), there is still no consensus view about whether a multiple or single system works best. Different countries may well need different systems, and the transition from multiple supervisors to a single, integrated supervisor is a complex process that can be costly. A high quality regulatory environment (low cor-

²⁸ Some ideas are taken from Vo et al (2007).

²⁹ Two laws, the SBV Law and Credit Institutions Law, have been substantially revised and amended.

ruption, etc.) that supports private property rights, information transparency and market discipline are more important than the specifics of who regulates what and how. Whatever the case, the SBV should be renovated into a more modern and relatively independent central bank, while the money market should be developed with more monetary instruments available to both the SBV and market participants.

The fourth is to develop a healthy financial system. As the capital markets are only at an early stage of development, having a sound banking system is vital. Together with strengthening financial supervision capacity, there is a pressing need to improve risk management, apply international auditing and accounting standards, recapitalize commercial banks, and enhance human resources capacity. While strengthening rigid conformity to BASEL I, a gradual shift from capital adequacy to risk management-based BASEL II is also needed. Avoiding NPL in coming years is largely dependent on how lending controls and SOE reform progress.

Having a more balanced financial system should be a long-term objective. This contributes not only to enhancing efficient resource allocation and to mitigating financial risks, but also to an effective engagement of Viet Nam in regional financial integration. The key is to lay down all fundamental conditions for the sound development of a capital market. This requires the establishment and/or strengthening of financial institutions, a secondary government bond market, financial regulations, credit rating companies, judicial systems, accounting and disclosure standards, and clearing and settlement arrangements. Development of the securities market also depends on the process of equitization of large SOEs in which their management capacity and business efficiency can be significantly improved. This relates also to the question of how the SCIC can be transparent and competent to fulfill its mandate, and how it can avoid the conflict of interest problem. Currently, it is also important for Viet Nam to properly regulate stock market-related credit to discourage insider trading, and to enhance information disclosure and transparency and the professionalism of individual investors.

Macroeconomic Policy Responses to the Present Macroeconomic Instability

Obviously, the macroeconomic policy option becomes more complex now due to the presence of serious policy inconsistencies (high inflation, high VND nominal interest rates, weakening USD with rather low interest rate, and high pressure on nominal appreciation). In this context, any policy measure response can have an undesirable side effect (Appendix C), and a combination of various macroeconomic policies could be a better, though not perfect option.

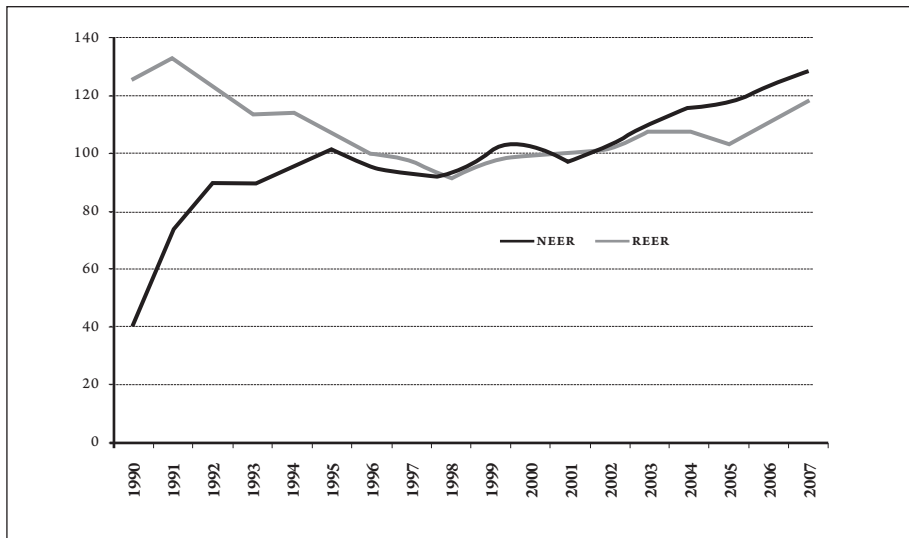
To begin with, a strong commitment to stabilizing the economy should be the focal point in combating high inflation. Macroeconomic stability is a prerequisite for sustaining economic growth. In that sense, stabilization is consistent with the goal of achieving relatively high economic growth. There may be, however, a short-run trade-off between the two. The key risk is that the Government would go for high growth over price stability. Current experience has shown that much concern about a slowdown in economic growth can make policies conducted more inconsistently and in the end, this can slightly change expectations of sustaining high inflation.

As money supply growth was very high over the last four years, and this is associated with inflation, tightening monetary policy is necessary. But it is far from sufficient. Not only is it unsustainable as the ER is kept stable, but also strong monetary policy measures could create a liquidity problem for the whole banking system per se.

A more flexible ER policy needs to be an option. Greater ER flexibility can reduce pressure on monetary intervention and sterilization. More importantly, in the context of a weakening USD, it could significantly constrain the import of international inflation. At first, however, the widening band of ER fluctuation could lead to nominal ER appreciation and hence, encourage short-term speculative activities. But it is not always the case. Rather, it is meant to introduce two-way risks and thereby discourage speculative capital inflows, if the SBV can manipulate policy appropriately, especially when inflation is under control. In principle, a good choice for an exchange rate regime needs to be consistent with sustainable international competitiveness in the exchange rate and have room for exchange rate fluctuations to free up (within limits) domestic monetary policy.

A natural question to be asked then is, is there room for nominal appreciation without posing any serious threat to export competitiveness? To measure the price competitiveness of goods, the real effective exchange rate (REER) is usually used. Despite a relatively high inflation rate, the price competitiveness of Vietnamese exports seems to remain as the REER has depreciated compared to the equilibrium level (Figure 20). This is attributed to the depreciation of the USD compared to currencies of Viet Nam's main trading partners, and to the peg of the VND to the USD.

Figure 10. Evolution of the Real and Nominal Effective Exchange Rate



Note: The calculation is based on IMF's International Financial Statistics (exchange rates and CPI), GSO's trade statistics (trade weights). The base year is 2000. Nineteen largest

trading partners, accounting for 85.65% of Viet Nam's total trade from 2000–2007, were included in partner weights. An upward trend means real depreciation.

Sources: Cited from Dang (2008).

It can be said that permission by the Prime Minister on 3 March 2008 for the SBV to widen the trading band of VND/USD to $\pm 2.0\%$ should be seen as a positive move in making ER more flexible.

Fiscal tightening is another good complementary policy option for some reasons. It may embody inflationary pressure. It can also lessen pressure on real exchange rate appreciation (by limiting increases in the relative price of non-tradable goods) and interest rate hikes. Fiscal policy, however, has several limitations as a response to capital inflows. It requires longer terms for legal approval and action. Moreover, it often has little fiscal flexibility to begin with, especially when there is a lack of political will and determination. For Viet Nam, fiscal tightening can be seen as an opportunity for the Government to make budget expenditures more transparent and to decisively cut back on inefficient public investment projects.

The choice of the scope and scale of policy mix is hardly to be right as asymmetry is inherent in the financial sector and there is a lack of reliable financial information. Therefore, policy manipulation should avoid policy shocks in order to test the market for necessary adjustments.

As policy inconsistencies still exist, which lead to various risky and speculative financial activities, rigorous and prudential screening and supervision based on updated information analysis is definitely necessary. The same work on projects financed by Government investment bonds through lending should also be undertaken. Effective enforcement of new anti-corruption laws to eliminate corruption and prevent the waste of public funds is an integral part of this endeavor.

It is worth noting that policies for the relaxation of capital flows are under consideration by the Government. The impact of this measure depends on whether there is sufficient pent-up demand for foreign assets. If not, making it easier to repatriate funds may even lead to additional net capital inflows. Experience has also shown that financial trouble can follow an inappropriate sequencing of financial and KA liberalization. Therefore, consideration of further liberalization of capital flows, if any, needs to focus first on the relaxation of some conditions for FDI outflows and a possible increase in the proportion of foreign equity investors in manufacturing and some services sectors.

In short, measures to sustain economic growth and sound financial development while mitigating the possible financial risks in Viet Nam are critically dependent upon both longer term reform processes and the implementation of necessary macroeconomic policies. This paper therefore recommends a broad reform package that aims to: (i) tackle persisting bottlenecks in the economy (weaknesses in economic institutions, the infrastructure and human resources); (ii) modernize the SBV; and (iii) strengthen risk management in the banking sector and financial supervision systems. The focus is also on capital market development based on the improvement of its fundamentals and the reform of large SOEs. In particular, this paper suggests the essence of having a firm commitment to combating high inflation and a combination of tightened monetary policy with a more flexible exchange rate policy and tightened fiscal policy. The scope and scale of the macro-policy mix should avoid policy shocks in order to test the market for necessary adjustments. With the evident policy inconsistencies, prudential screening and monitoring should be strengthened to prevent speculative financial activities.

Appendix A. Role of the Non-state and FIE Sectors in Industry (1998 and 2006)

	1998				2006			
	% of total industrial output	By sector (% of a specific industry output)			% of total industrial output	By sector (% of a specific industry output)		
		Total	FDI	SOE		Non-state	FDI	SOE
Total	100.00	34.68	43.38	21.94	100.00	37.16	34.32	28.51
Mining industry	14.57	83.74	12.56	3.69	9.11	71.82	20.42	7.76
Coal mining	1.21	0.74	97.81	1.45	1.44	1.86	96.47	1.67
Petroleum and natural gas	12.20	99.76	0.24	0.00	6.50	99.88	0.12	0.00
Metal ores	0.11	2.72	73.65	23.63	0.16	3.07	45.94	50.99
Stone and other mining	1.04	1.84	50.82	47.35	1.01	1.40	38.88	59.72
Manufacturing	79.23	25.34	47.61	27.05	84.91	35.87	31.45	32.68
Food products and beverages	22.37	21.73	46.02	32.24	20.95	26.51	31.53	41.96

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Tobacco products	2.84	0.50	99.12	0.38	2.57	1.83	97.37	0.80
Textiles	4.97	21.03	54.30	24.67	4.71	30.01	40.94	29.05
Apparel wear	3.09	23.29	33.26	43.45	3.72	38.11	22.59	39.30
Tanning and leather dressing, leather products	4.58	45.25	29.63	25.11	4.58	59.26	12.70	28.04
Wood and wood products	1.88	9.36	20.67	69.97	1.87	18.54	11.80	69.66
Paper and paper products	2.06	12.75	52.23	35.02	2.06	17.18	32.79	50.03
Publishing and recorded media	1.19	1.83	89.49	8.68	0.93	3.24	86.82	9.94
Coke, refined petroleum products	0.06	0.00	0.00	100.00	0.12	43.65	0.00	56.35
Chemical and chemical products	5.74	27.35	62.73	9.92	5.32	41.95	40.58	17.47
Rubber and plastic products	3.22	22.01	34.15	43.84	4.70	29.51	24.79	45.71
Non-metallic mineral products	8.76	19.04	59.73	21.24	9.13	22.83	50.42	26.75
Basic metal	2.96	44.62	44.13	11.25	3.27	30.35	41.38	28.28
Fabricated metal products, except machinery and equipment	2.98	28.45	15.42	56.13	3.75	31.15	11.68	57.17
Machinery and equipment	1.28	23.42	58.72	17.86	1.54	52.23	24.13	23.64
Office, accounting and computing	1.01	98.51	0.00	1.49	0.56	96.15	0.00	3.85
Electrical machinery and apparatus	1.74	33.79	52.10	14.10	2.76	45.69	38.89	15.43
Radio and communications equipment and apparatus	2.37	81.36	17.27	1.37	2.26	78.52	11.80	9.68
Medical, precision, and optical instruments, watches, clocks	0.23	71.39	20.72	7.88	0.20	85.20	6.86	7.94
Motor vehicles	1.09	70.57	15.71	13.73	2.56	82.33	12.21	5.46
Other transport equipment	2.71	69.34	18.68	11.98	3.99	66.89	15.18	17.93
Furniture	2.01	26.75	7.90	65.35	3.26	40.66	5.24	54.11
Recycle	0.08	0.00	0.00	100.00	0.07	1.46	0.00	98.54
Electricity, gas and water supply	6.20	0.36	99.53	0.11	5.98	2.79	96.25	0.96
Electricity and gas	5.63	0.17	99.79	0.03	5.59	2.73	96.41	0.86
Water	0.58	2.19	96.97	0.83	0.39	3.75	93.82	2.43

Note: The choice of the year of 1998 is not only due to data availability, but because this is the year before the 1999-Enterprise Law was approved.

Source: GSO (Various issues) and authors' estimates.

Appendix B. Balance of Payments of Viet Nam (1990–2007)

USD million	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
1. Trade balance	-41	-2345	-2775	-1247	-989	972	377	481	-1054	-2581	-3854	-2439	-2776	-10360
Exports (FOB)	1731	5198	7255	9185	9361	11540	14448	15027	16706	20149	26485	32447	39826	48561
Imports (FOB)	1772	7543	10030	10432	10350	10568	14072	14546	17760	22730	30339	34886	42602	58921
Imports (CIF)											31969	36761	44891	62682
2. Services	55	159	-61	-623	-530	-547	-550	-572	-749	-778	61	-219	-8	-894
Exports	55	2074	2243	2530	2616	2493	2702	2810	2948	3272	3867	4176	5100	6030
Imports	0	1915	2304	3153	3146	3040	3252	3382	3697	4050	3806	4395	5108	6924
Adjusted for F&I												1500	1832	3009
3. Investment income	-411	-236	-384	-543	-677	-429	-451	-477	-721	-811	-891	-1219	-1429	-2168
Receipts	28	96	140	136	127	142	331	318	167	125	188	364	668	1093
Payments	439	332	524	679	804	571	782	795	888	936	1079	1583	2097	3261
Of which														
Scheduled Interest payments	237	262	340	379	303	371	462	345	288	286		443	541	626
(Actual payments)	53	128	281	348	246	276	328	345	288	286		443	541	626
4. Transfer (net)	138	290	1200	885	1122	1181	1732	1250	1921	2239	3093	3380	4049	6430
Private sector	0	140	1050	710	950	1050	1585	1100	1767	2100	2919	3150	3800	6180
Government sector	138	150	150	175	172	131	147	150	154	139	174	230	249	250

A. Current Account (Excluding private transfer)	-259	-2132	-2020	-1528	-1074	1177	1108	682	-603	-1931	-1591	-497	-164	-6992
B. Capital account	121	2360	2624	1944	1129	509	-754	220	1980	2533	2753	3087	3088	18771
S. Foreign direct investment	120	1956	2395	2220	1671	1412	1298	1300	1400	1450	1610	1889	2315	6600
FDI in Viet Nam												1954	2400	6700
Viet Nam FDI abroad												65	85	100
6. Medium and Long-term Loans	-47	93	37	356	228	2	65	139	-51	457	1162	921	1025	2043
Disbursements	233	433	772	1145	952	1036	1348	958	1049	1540	2047	2031	2260	3480
Scheduled Amortization	280	340	735	789	724	1034	1283	819	1100	1083	885	1110	1235	1437
(Actual payments)	166	272	508	639	544	582	979	668	990	1083	885	1110	1235	1437
7. Short- Term Loan	48	311	224	-520	-233	-118	-29	-22	7	26	-54	46	-30	91
Disbursements	338	1381	1747	1006	478	239	333	370	377	418	1001	1046	1070	902
Scheduled Amortization	290	1070	1523	1526	711	357	362	392	370	392	1055	1000	1100	811
(Actual payments)	290	1092	1523	1526	711	357	362	392	370	392	1055	1000	1100	811
8. Portfolio Investments											-	865	1313	7414
9. Currencies and deposits			-32	-112	-537	-787	-2088	-1197	624	1372	35	-634	-1535	2623
C. Errors and omissions	-4	-51	-628	-280	-278	-917	-676	-862	-1020	777	-279	-459	1398	-1611
D. Overall balance	-142	177	-24	137	-224	769	-322	40	357	2151	883	2131	4322	10168
E. Financing	142	-177	24	-137	224	-769	322	-40	-357	-2151	-883	-2131	-4322	-10168
10. Change in NFA, incr	-156	-357	-262	-318	-13	-1317	-116	-191	-467	-2151	-883	-2131	-4322	-10168

Change in NFA (-;incr)	-156	-448	-440	-277	30	-1285	-90	-253	-519	-2097	-810	-2076	-4289	-10143
Use of IMF credit	0	91	178	-41	-43	-32	-26	62	52	-54	-73	-55	-33	-25
Purchases	0	91	178	0	0	0	0	106	106	0	0	0	0	0
Repurchases	0	0		41	43	32	26	44	54	54	73	55	33	25
11. Change in arrears and rescheduling	298	180	286	181	237	548	438	151	110			0	0	0
Change in arrears							0	0	0			0	0	0
Rescheduling							438	151	110			0	0	0
% of GDP	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
1. Trade balance	-0.68	-11.17	-11.10	-4.62	-3.66	3.35	1.22	1.46	-3.01	-6.45	-8.56	-4.60	-4.55	-14.59
4. Transfer (net)	2.30	1.38	4.80	3.28	4.16	4.07	5.59	3.79	5.49	5.60	6.87	6.38	6.64	9.06
Private sector	0.00	0.67	4.20	2.63	3.52	3.62	5.11	3.33	5.05	5.25	6.49	5.94	6.23	8.70
A. CA balance	-4.32	-10.15	-8.08	-5.66	-3.98	4.06	3.57	2.07	-1.72	-4.83	-3.54	-0.94	-0.27	-9.85
B. KA balance	2.02	11.24	10.50	7.20	4.18	1.76	-2.43	0.67	5.66	6.33	6.12	5.82	5.06	26.44
5. FDI (net)	2.00	9.31	9.58	8.22	6.19	4.87	4.19	3.94	4.00	3.63	3.58	3.56	3.80	9.30
6. M-L term Loan (net)	-0.78	0.44	0.15	1.32	0.84	0.01	0.21	0.42	-0.15	1.14	2.58	1.74	1.68	2.88
7. ST Loan (net)	0.80	1.48	0.90	-1.93	-0.86	-0.41	-0.09	-0.07	0.02	0.07	-0.12	0.09	-0.05	0.13
8. Portfolio Investments	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.63	2.15	10.44
C. Errors and omissions	-0.07	-0.24	-2.51	-1.04	-1.03	-3.16	-2.18	-2.61	-2.91	1.94	-0.62	-0.87	2.29	-2.27

Appendix C. Policy Responses to Capital Inflows and Their Effects

Policy measures	Effects and effectiveness
<p>Sterilization (for defending ER stability) <u>Instruments</u>: reserve requirements, sterilization</p>	<ul style="list-style-type: none"> - Using a higher reserve requirement raises the cost of financial intermediation and distorts resource allocations. Sterilization through open market operation (OMO) often leads to increased interest rates inducing further unintended capital inflows and causes significant quasi-fiscal costs. - In either case, sterilization can be self-defeating by raising the level of macroeconomic policy inconsistencies and encouraging further capital inflows. Greater sterilization effectiveness means more limited sustainability. - It may create a liquidity problem if maturity mismatch is present. - Real (effective) ER can be eroded as inflation goes up.
<p>Greater ER flexibility/appreciation- <u>Instruments</u>: widening the band for ER to fluctuate; making ER fluctuation, etc.</p>	<ul style="list-style-type: none"> - Greater exchange rate flexibility can reduce pressure on monetary intervention and sterilization. - It does not always mean nominal exchange rate appreciation. Rather, it is meant to introduce two-way risks and thereby discourage speculative capital inflows. This usually involves, in the context of a de facto peg or a tightly managed float, introducing a wider band of fluctuation. - Expectations of ER appreciation could encourage inflows of short-term speculative capital, while discouraging some inflows by longer-term investors.
<p>Fiscal tightening <u>Instruments</u>: Narrowing budget deficits by increasing revenues and/or reducing current and investment expenditures</p>	<ul style="list-style-type: none"> - Fiscal tightening can contain inflationary pressure and prevent a real appreciation of the currency. In addition, fiscal tightening could also reduce pressure on the real exchange rate (by limiting the increase in the relative price of non-tradable goods) and the increase of interest rate.
<p>Liberalization of capital outflows <u>Instruments</u>: Relaxation of FDI and portfolio investment outflows, and overseas lending conditions</p>	<ul style="list-style-type: none"> - The impact of this measure depends on whether there is a sufficient pent-up demand for foreign assets. If not, making it easier to repatriate funds may even lead to additional net capital inflows.
<p>Capital inflows controls <u>Instruments</u>: e.g. Tobin tax</p>	<ul style="list-style-type: none"> - Their effectiveness is mixed. As such a policy is applied, investors' confidence could collapse and the development of a capital market would be seriously damaged.
<p>Further trade liberalization <u>Instruments</u>: tariff reduction and the like</p>	<ul style="list-style-type: none"> - It can have some effects on downward pressure on inflation. But further trade liberalization could encourage more imports. Over time, however, it may improve export competitiveness by reducing the price of imported inputs and may not contribute much to reducing net imports. - It may also encourage further capital inflows by showing a signal of authorities' commitment to a liberal and open international economic policy regime.

Source: A summary by the authors.

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