Study on Economic Development Policy in the Transition Toward a Market-oriented Economy in Viet Nam (Phase 2)

FINAL REPORT

VOL. 3 Fiscal and Monetary Policy

February 1998

Ministry of Planning and Investment
The Socialist Republic of Viet Nam

Japan International Cooperation Agency

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Foreword

This study entitled "Economic Development Policy in the Transition toward a Market-oriented Economy in Viet Nam" was conducted within the framework of the technical cooperation program of the Government of Japan, in response to a request from the Government of the Socialist Republic of Viet Nam.

The study was carried out as joint research by professionals specializing in economic policy from both Japan and Viet Nam. The research groups headed by Prof. Shigeru Ishikawa, Professor Emeritus of Hitotsubashi University, for the Japanese side, and by Dr. Nguyen Quang Thai, Vice President, Development Strategy Institute, Ministry of Planning and Investment, for the Vietnamese side were set up in each country, assisted by consultant teams consisting of leading research institutes in both countries.

The research groups and consultant teams held a series of discussions, and conducted several field surveys. This report was prepared jointly by the Japanese and Vietnamese research groups based on a mutual understanding.

I hope that the useful suggestions presented in this report will contribute to the formulation of policies for economic transition and sustainable development of Viet Nam, and it would be my great pleasure if the report would be used practically by concerned organizations, officials and experts.

I wish to express my sincere appreciation to Professor Ishikawa, Dr. Thai and each research member for their close cooperation in the study, and to the officials concerned for their valuable opinions.

February 1998

Kimio Fujita
President
Japan International Cooperation Agency

Preface

This Final Report of the project on the Study on Economic Development Policy in the Transition toward a Market-oriented Economy in Viet Nam (Phase 2) aims at collecting all the important reports on the research results and policy suggestions which have been produced on the subjects of the title during September 1996 and November 1997, and thereby concluding the Phase 2 study. Moreover, the Final Report of Phase 2 combines with the Final Report of Phase 1 which was published in August 1996 in five separate volumes, to conclude all the formal research activities of the whole study project. The project itself was decided on April 1995 on the basis of the consultations between the governments of Japan and Viet Nam during 1994 and 1995, and was implemented under the Social Development Studies Program of the Japan International Cooperation Agency (JICA). The project was formally inaugurated in August 1995.

Under the agreement, the project was to be conducted in two phases. The general purpose of Phase 1 was to study the "Five-year Plan for Social and Economic Development in Viet Nam" (1996 - 2000), which was then being drafted for consideration by the Eighth Congress of the Vietnamese Communist Party. The phase 1 was brought to a close by the submission to the government of Viet Nam of a "Summary Report" in June 1996 and a "Final Report"[1] in that August. The general purpose of Phase 2 that followed Phase 1 has been to research the implementation of the "Five-year Plan" and the new issues raised during the course of it.

The agreement also stipulated that this was to be a joint Japanese and Vietnamese project. To accomplish this, research groups consisting of scholars and high-ranking experts were organized and worked under the direction of relevant steering committees on both sides. The general leaders of the research group were Professor Shigeru Ishikawa of Japan and Dr. Nguyen Quang Thai of Viet Nam. The project consisted of Subgroups to research selected priority topics, to which both Japanese and Vietnamese researchers were assigned. Both Phase 1 and Phase 2 had four priority topics, though the topics themselves changed a bit between the phases:

Phase 1:

Macro economic growth and its relationship with inflation and stability

Capital mobilization policies in the fiscal and monetary sectors

Industrial policy and industrialization

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1 Ministry of Planning and Investment, the Socialist Republic of Viet Nam = Japan International Cooperation Agency, "Summary Report — Study on Economic Development Policy in the Transition toward a Market-oriented Economy in Viet Nam Phase 1, Opinions on the Draft New Five-year Plan for Social and Economic Development in Viet Nam (1996-2000)," June 1996, Hanoi and Tokyo.

Agriculture and rural development

Phase 2:

Agriculture and rural development

Participation in AFTA, APEC, and the WTO, and industrial policy

Fiscal and monetary policy

State enterprise

As for the concrete procedures for implementing the joint research, the general leaders from both sides met together for consultations at the start of each phase and draw up minutes of those meetings,[2] thereby ensuring that the project does become a real "joint research."

To ensure that joint research was fruitful, opinions were exchanged, materials and literature provided for each other, joint field studies and interviews conducted, and research findings discussed closely at the overall project level, the subgroup level, and the individual researcher level. At the overall project level there were five workshops held during Phase 1 and three during Phase 2, in either Tokyo or Hanoi.[3]

The results of the joint research can be seen, first and foremost, from the research findings themselves. In many aspects, the Vietnamese economy suffers from a lack of basic data, statistics, and information, which combined with the complexities involved in the transition from a centrally planned economy to a market economy (this overlaps the problems found in the process of rehabilitation and reconstruction from an economy long on a wartime footing) to produce the many inadequacies that remain in our research. But these details aside, during Phase 1 we were able to elucidate four problems in the Vietnamese economy and advise that they be taken note of in the drafting of the Five-year Plan.

The four points we called attention to were: 1) restraining an excessively high growth rate; 2) improving domestic savings rates; 3) recognizing that the development of agriculture and rural economy (including rural industrialization) was a major prerequisite to industrialization; and 4) recognizing that it was desirable to take a dualistic economy approach to industrialization, having a modern industrial sector with modern industrial technology and equipment existing side by side with a small industry sector using traditional technologies and facilities.

The importance of these four points was in no way diminished during Phase 2. However, new conditions that emerged or became apparent in the Vietnamese economy in 1996 and

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2 August 30, 1995, "Minutes on Guiding Principles of Joint Studies"; August 9, 1996, "Minutes on the Conduct of Vietnamese-Japanese Joint Studies for Phase 2."

3 Phase 1: 1) Hanoi Preparatory Meeting (May 1995, Hanoi); 2) First Hanoi Workshop (August 28-29, 1995, Hanoi); 3) Consultations on the work plan for joint research (November 27-28, 1995, Tokyo); 4) First Tokyo Workshop (January 28-29, 1996, Tokyo); 5) Second Hanoi Workshop (March 1-2, 1996, Hanoi).
Phase 2: 1) First Tokyo Workshop (March 22-23, 1997, Tokyo); 2) Consultations on the progress of joint research and announcement of results (May 22-23, 1997, Tokyo); 3) First Hanoi Workshop (June 6-7, 1997, Hanoi).

after resulted in the addition of a new research priority, namely new issues of the Vietnamese economy emerged in its international economic dimension. The priority here was to consider how Viet Nam should draft and implement its trade and investment policies in the circumstance that Viet Nam have joined AFTA and applied for membership in the WTO and APEC. This, by way of conjunction, also raised new issues directly and indirectly in state enterprise reform, industrial policy, fiscal and monetary policy, and agriculture and rural policy.

The second result of the joint research can be found in the evolution of the mechanism for joint research itself. This mechanism was devised experientially as a means of furthering the cooperative relationship between developed and developing countries concerning industrialization for economic development. It was obviously anticipated that there would be many difficulties in the realization of this mechanism, but as a matter of fact, the results outweighed the difficulties. In a word, a relationship of mutual trust has begun to take root between Japan and Viet Nam at all levels of the joint research. In the process of researching topics together, we were able to understand the sincerity and good faith of our counterparts. Naturally, differences of approach sometimes remain regarding analysis and policy options, but both sides understand the arguments behind these differences and indeed the background that has produced them, and from that have developed trust and confidence in one another.

In proceeding with this study project, we have obtained profound support from a wide circle of the people. We would like to acknowledge this with warmest gratitude.

The Japanese side of the joint research project feel extremely fortunate to have been given many opportunities to meet with Secretary-General Do Muoi and other Vietnamese leaders and seek their opinions. These opportunities were instrumental in bringing depth and strength to our findings.

The Vietnamese side of the project expresses sincere thanks to JICA and its Vietnam Office for supporting its research activities particularly in Japan.

In addition to submitting this Final Report to the leaders of Viet Nam, we will be providing it to other interested parties in order to seek comments and opinions.

February 1998, Hanoi and Tokyo

Thai — Shigeru Ishikawa

Nguyen Quang Thai
Vietnamese Cochair of
the Research Group
Doctor of Economics

Shigeru Ishikawa
Japanese Cochair of
the Research Group
Doctor of Economics

1

Introduction

1-A: Reformation of the Fiscal and Financial System in Viet Nam*

Akiyoshi Horiuchi

The University of Tokyo

I. Introduction

This is a summary of the papers we are preparing for the research on the reformation of the Vietnamese fiscal and financial system under the project The Economic Development Policy in the Transition Toward a Market-Oriented Economy in the Socialist Republic of Viet Nam (the 2nd phase).

The first section will briefly overview the performances of Vietnamese economic policies during the first half of the 1990s and will point out a few phenomena which cause our concern. They are (1) the rapid increase in the trade balance deficits observed since 1993, (2) a domestic savings rate substantially lower than the targeted investment rate to be attained under the current Five-year Plan to 2000, and (3) the low level of financial deepening suggesting an inactive banking sector in Viet Nam.

The second section will discuss the consistency of capital import in the current Five-year Plan with the expected trade balance deficits. According to our simple simulation, the trade balance deficits will increase more than the Five-year Plan envisaged. This will make Vietnamese macroeconomic policy management, particularly management of foreign exchange rates, very difficult.

The third section will take up the policy issues of how to increase domestic savings and make the financial system more efficient. Viet Nam will face difficulty in achieving the rapid capital formation the current Five-year Plan projects unless they mobilize domestic savings more efficiently. After briefly discussing the policy of rationalizing the taxation system, we will discuss the current situation of the Vietnamese financial system, particularly the banking system. In our understanding, we should refrain from being too optimistic about the future of the banking sector in Viet Nam. The banking sector has been less active than the rapid economic development would require it to be. However, it may not be easy to vitalize the banking sector soon because the banks are suffering from a shortage of monitoring and intermediating capability. We will propose some policy measures to cope with this difficulty both from the long-run perspective and from the short-run perspective.

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* The original version of this paper was presented at the MPI-JICA Workshop: Viet Nam-Japan Joint Study on the Transitional Economy in Viet Nam, June 6-7, 1997 in Hanoi. The authors of this paper were given a lot of help by the MPI and the State Bank of Viet Nam. The authors also acknowledge many helpful comments from Shigeru Ishikawa, Lai Quang Thuc, Vu Van Hoa, Le Dang Doanh and other participants of the Workshop. Their comments greatly improve this paper.

II. Performances of the Macroeconomy During the First Half of the 1990s

The Vietnamese economy has achieved remarkable performances since the start of economic reformations at the end of the 1980s. The inflation rate was steadily reduced from triple digits to single digits during the first half of the 1990s, while the GDP annual growth rate has been kept at a fairly high level, around 8 percent. The reduction in the relative magnitude of budget deficits has mainly accounted for this success in keeping inflation under control. We have observed a steady reduction in the budget deficit/GDP ratio since the beginning of the 1990s. Thus, the excellent performances of the Vietnamese macroeconomic policy in the first stage of transition to a market-oriented economy should not be underestimated.

1. Our Chief Concerns at the Moment

We should pay proper attention to the fact that Viet Nam has not succeeded in every aspect of economic development. There have been some features suggesting the existence of difficulties to be overcome before pushing economic development forward in the near future.

Expanding trade deficits: First, since around 1993 a rapid expansion of trade deficits has been observed. We are concerned with the issue of whether the trade imbalance accompanying real economic growth will hinder the smooth development expected by the Vietnamese government through the end of this century.

Stagnant domestic savings: Second, according to IMF statistics, the domestic savings rate has not been significantly improving in Viet Nam since the early 1990s. Rather, the statistics show stagnation. With low domestic savings, higher economic growth will be dependent on higher capital import from abroad. The substantial shortage of domestic savings relative to domestic capital formation also implies an identically huge deficit of the current account and/or trade balance. The rapid expansion of the trade balance deficit which we have already observed since 1993 suggests that domestic savings has been too small compared with the large amount of investment in Viet Nam. Thus, we must question from two angles the feasibility of a further development plan which crucially depends on capital import (i.e., whether foreign capital will flow into Viet Nam as much as the original Five-year Plan expects, and whether the trade balance deficit will be kept from expanding).

However, we should note a significant discrepancy between IMF statistics and GSO statistics concerning the savings rate. GSO statistics show a steady increase in the domestic savings rate during the first half of the 1990s, reaching nearly 20% in 1996. If the GSO is nearer to reality than the IMF, we can be more optimistic about the Vietnamese development in the near future. If the domestic savings rate can be sustained at around 20% during the next five years, Viet Nam will not have to depend upon capital imported from abroad as much as the Five-year Plan envisages.

Table 1 Major Macroeconomic Performances of Viet Nam

Year	Real GDP growth rate	Inflation (CPI)	Budget deficit per GDP	Trade balance per GDP	Financial deepening M 2/GDP	Growth rate (M2)
1986		774.7	6.18		0.185	
1987	3.66	231.8	4.74		0.164	324.3
1988	5.90	393.8	7.62		0.167	445.4
1989	8.53	34.7	10.26		0.295	233.8
1990	5.10	67.5	8.03		0.271	32.4
1991	5.96	67.5	3.71	2.9	0.265	78.8
1992	8.65	17.4	3.71	0.4	0.246	33.7
1993	8.07	5.2	6.21	−7.3	0.236	19.0
1994	8.84	14.4	2.61	−11.4	0.253	33.2
1995	9.54	12.7	1.47	−13.4	0.237	22.6
1996	9.34	4.5		−16.6	0.250	22.7

Source International Monetary Fund, "Vietnam: Recent Economic Developments," November 1996, and Japan International Cooperation Agency, "The Economic Development Policy in the Transition Toward a Market-Oriented Economy in the Socialist Republic of Viet Nam: Fiscal and Monetary Policies," June 1996.

Insufficient financial deepening: Third, despite rapid economic growth during the first half of the 1990s, the Vietnamese financial system has not yet sufficiently deepened in terms of the M2/GDP ratio. There is a lot of statistical evidence showing that real economic growth proceeds accompanied by financial deepening at an early stage of economic development. Thus, we think that Viet Nam will have to raise its degree of financial deepening by strengthening the capability of the banking sector. At present, the banking sector has many difficulties which must be resolved in order to develop full-scale intermediation capability.

In a society in transition to a market-oriented economy, like Viet Nam, the banking system plays a pivotal role. First, the banks mobilize domestic savings by offering liquid and safe stores of value to households. Second, the banks promote efficient allocation of funds by examining investment project alternatives and disciplining borrowers (particularly enterprises) to carry out their business prudently. Thus, high capability in the banking system is a precondition for sustaining rapid economic growth in a transitional economy.

2. The Relevancy of "Financial Deepening"

The relevancy of financial deepening represented by M2/GDP is based on the theory of aggregate demand for money (M2). If people regard bank deposits as a trustworthy store of value, they will hold larger bank deposits, relative to their income. Demand of the people for bank deposits is crucially dependent on the level of real interest rates (i.e., nominal interest rates minus the expected rate of inflation). For example, suppose the central bank increases money supply at a triple-digit rate just as the SBV did during the late 1980s. Naturally, the rapid growth in money supply leads to hyper-inflation (triple digit in Viet Nam's case) causing expectations of further inflation. This expectation induces people to economize on their holding of money as much as possible—exchanging money for commodities or any other more credible store of value as soon as possible and sustaining rapid increases in commodity prices.

Thus, the higher growth rate of money will not lead to higher M2/GDP but to lower M2/GDP. At first glance, this may seem to be paradoxical. However, many scholars have proved this to be true of most historical episodes of hyper-inflation. See Cagan (1956). People's demand for bank deposits is dependent not only on the real interest rate, but also on the various conveniences related to usage of bank deposits. If the banks provide depositors with efficient services, people will increase their holding of deposits, leading to higher M2/GDP. On the other hand, high growth in money supply does not necessarily lead to lower M2/GDP if the monetary growth is accompanied by remarkable improvement in people's demand for bank deposits. This was the case in China during the first half of the 1980s. See McKinnon (1992).

III. Feasibility of the Five-year Development Plan to 2000

Under the current Five-year Plan, an accumulated $22 billion of capital will be imported during the five years from 1996 to 2000, of which $8 billion will be dependent on ODA and the remaining $14 billion will be financed through foreign direct investment (FDI) (Table 2). In this section, we discuss the feasibility of this Plan from a few angles.

Table 2 Investment Planning in the Five-year Plan
(in billions of 1995 US dollars)

	1991-1995	1996-2000
Capital formation	18.0	41.0~42.0
State	7.7	15.6
FDI	4.9	14.0
Private	5.4	12.4
Fund sources	18.0	41.0~42.0
ODA	2.0*	8.0
FDI	4.5	14.0
Domestic savings	11.5*	21.0
Investment/GDP ratio (%)	19.1**	30.0

Notes * = based on disbursement ** = based on IMF statistics
Source Japan International Cooperation Agency, "The Economic Development Policy in the Transition Toward a Market-Oriented Economy in the Socialist Republic of Viet Nam: Fiscal and Monetary Policies," June 1996.

1. The Possibility of Net Capital Inflow of $22 billion

Recently, many industrialized countries, including Japan, have been reconsidering the supply of ODA to developing economies because of the degeneration of their budget deficits. Thus, we should refrain from being optimistic about future increases in the ODA supply. However, we do not regard a plan based on the introduction of $8 billion into Viet Nam as too ambitious. During the three years from 1993 to 1995, donor countries pledged ODA grants amounting to $6.2 billion, of which $4.5 billion has not yet been disbursed. Moreover, in December 1996 donor countries agreed to supply an additional $2.4 billion. Thus, an inflow of capital amounting to $6.9 billion has already been promised to Viet Nam.

On the other hand, there is some uncertainty about the prospect of FDI. For the three years 1993-95, the net capital inflow to Viet Nam through FDI amounted to $3.66 billion. In 1996, the inflow of FDI was larger than $8 billion, in terms of approvals, although $3 billion of this came at the end of the year when the Vietnamese government rushed to approve two big projects. We should regard these two projects as exceptions when forecasting the future inflow of FDI in Viet Nam. However, the experience during the first half of the 1990s suggests that it would be possible for Viet Nam to receive a net inflow of $14 billion through FDI during the second half of the 1990s.

Needless to say, the Vietnamese government should be careful in stimulating FDI—constructing an environment favorable to foreign enterprises who are considering joint ventures. First, the government must quicken the process of ODA disbursement. Second, the government should reduce the legal risk for foreign investors by making various rules regarding FDI transparent. Third, the government should strongly discipline Vietnamese commercial banks to follow global standards for international transactions and thereby improve their reputation in global capital markets and reduce cost of fund-raising in international markets.

2. Forecasting Trade Balance Deficits

As far as the requirement of capital import from abroad is concerned, it seems possible for Viet Nam to finance half of its domestic capital formation (i.e., 15% of GDP) by depending on capital imported from abroad. However, we need to examine whether or not the requirement of capital import envisaged by the Five-year Plan is consistent with the trade imbalance that the rapid economic growth is expected to bring forth. As we have already pointed out, the trade balance deficit has been remarkably increasing since the early 1990s. For example, the amount of imports was $11.1 billion compared with exports of $7.1 billion in 1996. The annual rate of increase in imports from 1995 to 1996 was 47.2% whereas exports grew 36.6%.

According to our rough calculation, if exports grow at an annual rate of 28% from 1996 to 2000, the growth rate of imports will have to be around 22% or less in order for a capital import at 15% of GDP to be sufficient to finance the trade balance deficits. We should note that the average growth rate of imports was 34.2% during the five-years from 1991 to 1995 (Table3). Growth of imports at 22% per year is quite a tough target for Viet Nam to attain.

Our rather pessimistic finding based on this calculation neglects investment income and other services. A more optimistic picture may emerge if we consider these items, because Viet Nam is enjoying a large amount of remittance from abroad. However, we should note that the continuation of substantial dependence on capital imports, like that implied by the Five-year Plan, will increase the Vietnamese payment of interest and dividends abroad in the future. Thus, taking the items of investment income and other services into account does not significantly alter the basic message of our calculation regarding the feasibility of the Five-year Plan.

Table 3 Export and Import in the Five-year Plan

Year	Nominal GDP ($ million)	Exports ($ million)	Imports ($ million)	Trade deficit to GDP (%)
1991	8,671 (82.8)	2,042 (18.0)	2,105 (18.8)	0.7
1992	9,872 (44.1)	2,475 (21.2)	2,535 (20.4)	0.6
1993	12,820 (23.6)	2,985 (20.6)	3,532 (39.3)	4.3
1994	15,519 (24.7)	4,054 (35.8)	5,245 (48.5)	7.7
1995	20,178 (30.9)	5,198 (28.2)	7,543 (43.8)	11.6
1996	23,433 (16.1)	7,100 (36.6)	11,100 (47.2)	17.1
1997	27,036 (15.0)	9,088 (28.0)	13,144 (18.4)	15.0
1998	29,470 (15.0)	11,633 (28.0)	16,053 (22.1)	15.0
1999	32,122 (15.0)	14,890 (28.0)	19,708 (22.8)	15.0
2000	35,013 (15.0)	19,059 (28.0)	24,311 (23.4)	15.0

Note Nominal GDP is translated into US dollar terms by making use of the average rate of exchange for each year until 1996. From 1997 to 2000, we assume $1.0=VND11,000.
Source GSO

Thus, we are skeptical about consistency between the requirement of capital import and the trade balance deficits under the current framework of the Five-year Plan. More specifically, we fear that promoting economic growth without improving the domestic savings rate will widen the trade imbalance, thereby expanding the requirement for capital import beyond the level explicitly envisaged by the Five-year Plan. If Viet Nam does not succeed in managing trade balance deficits, a shortage of capital inflow will soon surface, exerting strong downward pressure on the exchange rate of the VND. The degree of currency substitution (between dong and the US dollar) is still high in Viet Nam (Table 4), although it has been mildly decreasing since the early 1990s. (While deposits denominated in foreign currencies have been decreasing, bank loans denominated in foreign currencies have been significantly increasing since the early 1990s. This contrast is arising from the fact that the interest rates in terms of the VND have been substantially higher than the interest rates in terms of foreign currencies.)

The successful management of Vietnamese macroeconomic policy would be threatened with downward pressure on the exchange rate of the VND. Any significant devaluation of the VND would likely lead to rapid shifts from dong to US dollars in portfolios of Vietnamese people, forcing further devaluation. The spiraling process of devaluation would be, needless to say, quite destructive in Viet Nam. Therefore, the government will have to continue careful management of exchange rates.

Table 4 Relative Importance of Foreign Currency Deposits and Loans
(in trillion VND: %)

Year	Total deposits	Total loans
1991	13.6 (61.5)	10.1 (18.6)
1992	16.3 (50.4)	15.1 (26.3)
1993	18.0 (41.2)	23.2 (32.0)
1994	24.3 (39.2)	30.6 (34.6)
1995	33.0 (33.5)	43.1 (38.0)
1996	41.4 (31.7)	50.7 (39.2)

Note Figures in parentheses show percentage of foreign-currency-denominated deposits and loans.
Source State Bank of Viet Nam

The recent difficulty surrounding the baht clearly teaches us how it is difficult for a developing country heavily depending on capital imports to sustain a high growth rate. The Thai baht has been a target of downward speculation since this spring, being forced to abandon its long de facto linkage to the US dollar. Thailand was able to keep the annual rate of real GDP at higher than 8% during the five years from 1992 to 1996. However, this remarkable economic growth was accompanied by huge trade and current account deficits. For example, the current account deficit to GDP has been no less than 5% from the beginning of the 1990s. The balance of payment statistics indicate that this huge current account deficit was mainly supported by portfolio investment and bank loans from abroad. It is reported that one part of these capital inflows did lead to growth in Thailand's production capacity, but others inflated a bubble in property development and stimulated consumer expenditures. The bubble in the property sector, supported by loans from banks and finance companies, has resulted in the bad loan problem in the Thai financial sector. Capital import is almost indispensable to developing countries in their early stages. However, unless the imported capital is directed to sectors which help to expand production capacity, particularly exporting industries, the huge dependence on capital import will cause a collapse of confidence in the exchange rate, leading to speculation against the currency. We regard the sterile nature of imported capital as the fundamental cause of the baht's problem this year. Viet Nam should carefully study this experience of Thailand when reconsidering the feasibility of her own development plan.

3. How to Manage the Trade Balance Deficits

The Vietnamese government seems to have recognized the danger of trade balance deficits. First, the exchange rate of the VND was allowed to depreciate from VND11,155 per US dollar in December 1996 to VND11,650 per US dollar in March 1997. This depreciation accompanied the SBV's decision to broaden permissible fluctuations in the VND from 1% to 5% in February 1997. The recent depreciation of the VND suggests the government's desire to check the expansion of trade deficits. The government also started a policy of suppressing imports, particularly the import of consumption goods, in 1996 by means of direct controls. In addition, since June 1996, SBV has ordered that when commercial banks issue letters of credit to enterprises, banks are to require a deposit equivalent to 80 percent of the value of the L/C to suppress increases in imports financed by L/Cs. The government reportedly succeeded in reducing the trade deficit to $900 million during the period of January to April 1997 from the huge amount of $4 billion during the same period in 1996. (According to Professor Vu Van Hoa, 1997, while Vietnamese exports were recorded at $3.36 billion during the first five months of 1997, its imports amounted to just $4.5 billion.)

However, we should note that the direct suppression of imports implies a policy of subsidizing import-substitute industries in Viet Nam. In other words, the policy of suppressing imports will reallocate domestic resources from export-oriented industries to import-substitute industries. From the long-term perspective, this policy would make the Vietnamese economy vulnerable to international competition. We believe the policy of gradually devaluating the VND is preferable to the direct suppression of imports, because the former would promote development of traded-good industries, particularly those of producing export goods, albeit at the expense of non-traded-good industries.

We think that the best way for the Vietnamese government to cope with this difficulty (i.e., the inconsistency between the economic development and the trade deficits), is to increase domestic savings through fundamental reform of the fiscal and financial system. However, it will take a long time to realize the reformation needed to mobilize domestic saving. Thus, the Viet Nam government may slow the speed of economic growth to some extent for the time being before strengthening their capability of mobilizing domestic savings.

Ⅳ. How to Increase Domestic Savings and Achieve Efficient Financial Allocation

In order to make the Five-year Development Plan more feasible, the Viet Nam government should take effective measures to increase domestic savings. In our understanding, there are two ways to mobilize domestic savings. One is to reform the taxation system to increase the government savings (or to decrease budget deficits). Another is to reform the banking system to strengthen the capability of bank intermediation between savers and investing enterprises. These measures of fiscal-financial reformation will be more important for the Vietnamese economic development from the long-term perspective. The fundamental reformation with long-term perspectives should be started by the government as soon as possible. However, it will take a long time before they can effectively mobilize domestic savings and attain efficient fund allocation. We need to take stopgap measures to deal with urgent issues caused by the inefficient or immature financial system. We will discuss this point at the end of this section.

1. Reformation of Fiscal Management

(1) Reform of the tax system

Viet Nam embarked on major tax reform in 1991 and introduced the laws on such essential taxes as the export-import tax, the turnover tax and the profit tax. Though not in the form of laws, various other tax ordinances and government decrees were introduced in this first stage of the reform process to frame tax administration into a more transparent form.

These series of efforts that have been put toward modernizing the tax system and strengthening tax collection have led to an increase in tax revenue. In fact, the progress has been significant enough to push the revenue-to-GDP ratio up above twenty percent. Fiscal management efforts, and a loan on State Bank money issuance to finance fiscal deficits, have contributed to stabilizing the economy in Viet Nam.

Good achievements on the macro-economic front, however, have left some structural problems in fiscal policies. In a sense, one may say that the fiscal issues of Viet Nam are getting to be more intrinsic and tax reform requires structural changes other than mere frame constructions. So far the bulk of Vietnamese revenue has been coming from the SOEs in profit or turnover taxes, export-import taxes and non-tax revenues from oil. This excessive dependence on a handful of taxes will be inefficient for mobilizing domestic resources to attain a versatile market economy in Viet Nam.

In this regard the second-phase tax reform is overdue, and the recent efforts in this direction are a welcome sign. The Value-Added Tax (VAT) and the Business Income Tax (BIT) are the focal issues of this process. Reform in personal income tax is also necessary, but raising it concurrently with the introduction of the VAT would be too much, in both administrative and tax-burden perspectives.

Our diagnosis of the coming tax reform has been prepared in a separate paper entitled "A Note on Major Issues of the 1997 Tax Reform in Viet Nam: the Value-Added Tax and the Business Income Tax" (prepared by request of Dr. Lai Quang Thuc at the MPI). Our messages in the Note are the following.

VAT: Utilizing VAT, signals should be sent more clearly about the basic nature of the taxation; that is, VAT is a tax on consumption, therefore intermediate costs, including capital investment, must be fully deducted, and the zero rate must be fully applied to exports. For any country implementing the VAT, these issues are important, however, they are especially so in Viet Nam.

The reason for this stems from the tax environment in Viet Nam in which taxes have historically been collected by local governments and some of the provinces have been endowed with the entire tax proceeds. In this kind of system, intermediate-stage VAT can be retained and used by the place where the tax is collected. That means that the sources of tax rebates (i.e., the input taxes) are taken away at preceding stages and that they are gone when they are supposed to be paid out to succeeding stage producers.

This problem would be most important for export rebates. Since the zero rate is applied to their products, exporters can recoup all the taxes paid to their inputs at preceding stages. These rebates can be very big, since exporting is the final stage of production and the VAT paid up to that point have accumulated greatly. And yet, one of the most important features of the VAT is that, unlike the turnover tax, it is a tax on domestic consumption. Therefore, export rebates must be strictly guaranteed by the government to every exporter, foreign as well as domestic.

BIT: The profit tax is replaced by the Business Income Tax and a uniform tax rate will be applied to every firm. In view of the present highly distorted profit tax structure, setting the tax rate at a uniform level is a major step forward in the transition to a market economy. The very wide range in profit-tax rates, makes it understandable that enterprises that have been paying the lowest tax rates have the most to lose, and therefore, are very reluctant to the reform. Thus, for successful implementation of the BIT, gradual transition to a uniform profit-tax regime would be unavoidable.

A surprising feature of the proposed law is that the supplementary tax on excess profits is still in place. The only rationalization for this is that the high income, made possible by the "excess" profits, cannot be properly taxed. However, it is also a fact that the costs of this tax are very high, since the profits, if left with producers, could have been put into investment. This would apply to both SOEs and private enterprises that have suffered from limited access to financial markets.

FDI: As for taxes on FDI, we have emphasized the importance of receiving more FDI and have suggested a risk of pushing it to other countries if Viet Nam starts raising the taxes on it. Our suggestion seems to have been well taken by the legislators, and at the final draft of the BIT the profit tax rate for FDI was set at the rate specified under the Foreign Investment Law. This seems to us an inevitable choice for Viet Nam; moreover, more simplification, like the elimination of foreign remittance tax, is the next step that deserves serious attention.

(2) Fiscal relations between the localities, and reform of the pension system

Finally, but just as important, are a couple of fiscal areas that need more reform and examination so that better resource allocation and higher economic growth can be achieved. They are the fiscal relations between the central government and the localities, especially provinces, and the mobilizing of savings through the funded pension system.

Budget Law: The Budget Law, enacted in 1996, is the first legal arrangement that has outlined the scope of revenue and expenditure of the four levels of government: the center, provinces, districts and communes. The year-by-year budget negotiation at the Ministry of Finance in Hanoi has consumed enormous time and efforts of key people in financial affairs both centrally and locally. The new Budget Law, by temporarily stabilizing the fiscal arrangement for three to five years, settles the dust from the long hours that have been put to budget bargaining. Given the previous situation this looks like progress; however, it goes without saying that more commitment on the part of the government is needed to make the fiscal arrangement between the center and localities transparent. Thus, the Budget Law most properly should not be viewed as an achievement, but as a call to begin setting up rules among various levels of government.

Pension System: The importance of the funded pension system cannot be emphasized enough in Viet Nam, where they suffer a severe shortage of savings. Presently the Vietnamese social security system is the Pay-As-You-Go type transfer system from the young to the old. One of the most important resources in Viet Nam is its young people, and the funded pension will help increase savings which will then be mobilized by mandatorily shifting part of income from the young to capital investment. The financial market, that has been so belated in coming into being, will also be very much stimulated by the development of the funded social security system. Singapore's Central Providence Funds are just one example of this sort of pension system. More recent pension reform in Chile and Mexico might apply better to Viet Nam. In any event, the focus of discussion should be against spending the pension contributions on state bonds for financing budget deficits, and to connect this important scarce resource to more productive ventures.

2. Reformation of the Financial System

We believe that an efficient financial system, particularly an efficient banking system, would contribute to increasing domestic savings in Viet Nam. Many things remain to be done to make the banking sector more efficient. A more efficient system for fund-transfer and settlement between banks and the SBV will make bank deposits more convenient for households, thereby effectively mobilizing small-scale savings scattered around local areas. Increasing the number of branches of commercial banks will be useful for mobilizing regional savings in Viet Nam (Vu Van Hoa, 1997). We strongly recommend that the government rationalize the payment network in Viet Nam as soon as possible.

(1) Strengthening bank intermediation capabilities

We would like to emphasize that the banking sector is not only important as an instrument of savings mobilization. The banking sector is also important as a social device for monitoring and disciplining the management of borrowing firms in the market-oriented economy. In a market-based economy, the banking sector should be in charge of determining a major part of fund allocation and of monitoring fund-raisers to ensure the efficient use of allocated funds. However, without sufficient capabilities in monitoring and disciplining, banks incur difficulties such as inefficient management and misallocation of resources on the side of enterprises — causing an accumulation of non-performing loans in their balance sheets. At present, the Vietnamese economy requires more active intermediation by commercial banks to promote industrial development. However, it is quite dangerous to activate banks' credit supplies without strengthening their ability to monitor borrowers. It is urgently required that the commercial banks in Viet Nam strengthen their intermediation capability as soon as possible. The government should help commercial banks improve their financial capability by introducing an effective accounting system following global standards.

The collateral system: The collateral system can be used by commercial banks to compensate for immature monitoring capabilities, because borrowers are disciplined by fear of yielding their assets to lenders. However, there exist some difficulties with the collateral system. Above all, owners of assets which can be used as collateral are not necessarily promising entrepreneurs, while many enterprises with hopeful investment projects may lack suitable collateral. In particular, the current system allowing only state-owned enterprises to collateralize tenancy of land for bank credit may be distorting resource allocation in that private enterprises are thereby unfavorably treated. Foreign banks and joint venture banks are not allowed to take out mortgages on borrowers' tenancy of land. This regulation also distorts financial intermediation in the immature Vietnamese banking sector. Generally speaking, collateral is important as the complement to efficient loan supply when commercial banks lack effective monitoring ability. In the short term, therefore, the government needs to wipe out ambiguity regarding the system of collateral in the business sector.

Commercial bills: Professor Vu Van Hoa (1997) argues for the necessity of introducing a system of commercial bills into the Vietnamese financial system. We agree with him. Commercial bills would supplement the commercial banks' capability of financial intermediation, because the bills, backed up by real commodities, would work as security for bank loans. Moreover, rediscounting commercial bills has traditionally been one of the most important ways for the central bank to supply additional base money to the banking sector. The central bank could specify the eligibility of commercial bills for rediscounting, and could determine the level of the rediscount rate. The rediscount of commercial bills would develop interbank trade of those bills, thereby promoting a money market. The rediscount rate determined by the central bank would be an important instrument for controlling money market interest rates. In sum, the introduction of commercial bills into the Vietnamese financial system is not only good for strengthening commercial bank intermediation, but also for developing an interbank money market and diversifying the SBV's methods of monetary control.

The importance of SBV supervision: Needless to say, the SBV is responsible for monitoring managerial performances of individual commercial banks. Thus, the SBV must strengthen its own monitoring capability based on clear-cut rules of accounting for banking business.

(2) Coordinating financial and SOE reformations

Improvement in commercial bank intermediation would not directly lead to an increase in credit supply to the enterprise sector. To the contrary, if prudential regulation on bank management is strengthened, and if managerial efficiency in the enterprise sector remains unimproved, commercial banks would be conservative in extending credit to enterprises. The commercial banks in Viet Nam have reportedly become conservative, responding to reinforced SBV supervision. This reflects the imperfect nature of enterprise management rather than malfunctioning commercial banks. Thus, the government should be careful about forcing banks to increase credit to enterprises without significant improvement in borrower enterprise management.

In May 1997, the government reportedly began to allow commercial banks to extend credit to SOEs without collateral. This order seems to have been issued for the purpose of mitigating SOE difficulty in raising funds. However, we are afraid this policy will impose a severe burden on the commercial banks' inspection capabilities, which are still under-developed. We are skeptical that this policy is good for promoting efficient banking in Viet Nam.

It is obvious that disciplined and responsible management on the side of borrower enterprises is indispensable for efficient bank intermediation. For example, although many enterprises desire additional bank credit, their capital bases seem to be, in general, very fragile. In this situation, a rapid increase in bank loans to enterprises would incur financial disorder, and default on bank loans in the near future. Thus, the managerial reformation of the enterprises (particularly the SOEs) must proceed in parallel with the reformation of the banking sector. We would like to recommend that the government set up a joint committee which is responsible for making a blueprint for reforming the banking and SOE sectors and coordinating one with the other.

(3) A proposal for a system of long-term credit banks

Recently, the Vietnamese banking sector appears to have supplied a relatively large amount of long-term credit to businesses. However, many enterprises are complaining about a shortage of long-term credit from commercial banks. There is a wide discrepancy between bank supply of and enterprise demand for long-term credit. It should also be noted that rather wide maturity-mismatches exist between assets and liabilities of individual commercial banks. Table 5 shows that BIDV concentrates primarily on supplying long-term credit and the share of its funds raised by issuing debentures is very small (less than 10%). On the other hand, Agribank issues a large amount of debentures (more than 40 percent) compared with its deposit liabilities. However, Agribank does not supply so much long-term credit (only a little higher than 30 percent).

There is some limitation on bank maturity-transformation. In developing countries like Viet Nam, most savers desire to hold their savings in the form of liquid and short-term assets such as short-term bank deposits. On the other hand, enterprises must invest in equipment and factories with long gestation periods. Thus, early stage economic development requires a rather extreme degree of maturity-transformation. We recommend introducing a system of long-term credit banks where commercial banks with liabilities of short-term deposits will cooperate with a few long-term credit banks which specialize in long-term credit and issue bank debentures with longer maturities than those of deposits. A long-term credit bank system will be able to mitigate the limitation on maturity-transformation in the banking sector.

(The appendix to this summary briefly explains how a system of long-term credit will be able to overcome the limitation on maturity-transformation.)

Table 5 Relative Importance of Long-term Credit for Vietnamese Banks
(The percentage of medium and long-term credit in total credit: %)

	1991	1992	1993	1994	1995	1996
Vietcombank	10.3 (0.0)	12.1 (0.0)	19.8 (0.0)	34.2 (2.5)	32.9 (4.6)	26.7 (3.7)
Agribank	6.5 (0.4)	6.9 (9.4)	26.4 (42.1)	29.4 (42.9)	31.3 (51.3)	32.2 (42.8)
BIDV	73.8 (1.7)	76.7 (2.9)	75.8 (0.6)	70.8 (9.4)	55.6 (12.6)	53.3 (9.1)
Incombank	3.8 (4.1)	6.3 (0.3)	13.5 (22.0)	16.1 (30.5)	18.6 (25.9)	20.1 (26.2)
Private Banks	0.0 (0.0)	1.0 (0.0)	4.4 (0.0)	19.5 (0.0)	18.1 (0.0)	23.4 (0.0)
Total	16.7 (0.9)	18.3 (1.7)	29.8 (15.4)	37.0 (21.7)	34.2 (23.8)	32.4 (21.2)

Note The figures in parentheses indicate the ratios of the bank's funds raised by issuing bank debentures to the total amount of deposits and bond-issue.
Source State Bank of Viet Nam

3. Are There Any Measures to Quickly Improve Bank Capability?

We are concerned with the present situation of the Vietnamese banking sector. Although there is statistical ambiguity, the banks are holding a large amount of non-performing loans in their balance sheets (Table 6). Some people point out that the amount of non-performing loans is still increasing and undermining the viability of bank management. On the other hand, there is some circumstantial evidence that many enterprises are suffering from want of long-term credit. If these are true, the commercial banks are failing to accomplish efficient intermediation. The true nature of the problem is that commercial banks have not yet fully developed their capability of monitoring and disciplining borrower enterprises. So, we have already recommended a program of improving the intermediation capability of commercial banks. The State Bank of Viet Nam also will have to improve its ability to effectively monitor commercial bank to ensure prudent management.

However, it will take a rather long time to establish a banking sector with full-scale monitoring power in Viet Nam. Moreover, the banks' capabilities in monitoring are crucially dependent on the corporate governance of borrower firms, particularly that of SOEs. Thus, for the time being, Viet Nam must find ways to issue sufficient credit to enterprises through an inefficient banking sector. This is a difficult problem. In our understanding, there are two ways to cope with it.

Table 6 Non-performing Loans in the Banking Sector
(The ratio of non-performing loans per total loans: %)

	1994	1995	1996*
Vietcombank	16.5 (18.0)	8.7 (10.2)	9.6 (9.1)
Agribank	14.3 (13.6)	13.9 (13.3)	16.6 (17.8)
BIDV	3.0 (2.9)	3.3 (3.1)	5.2 (5.0)
Incombank	7.7 (8.7)	9.3 (6.3)	12.1 (8.2)
Others	3.6 (6.1)	3.0 (2.5)	3.1 (3.0)
Total	9.6 (9.7)	7.7 (6.6)	9.1 (7.5)

Note The figures in parentheses show the ratio of state-owned enterprise loans that are non-performing.
Source State Bank of Viet Nam

The possibility of syndicated loans: One possibility is to utilize the capability of BIDV more intensively in supplying credit to enterprises. In our opinion, BIDV has accumulated expertise in inspecting investment projects; therefore, its ability of monitoring is considered higher than that of other commercial banks. For efficient intermediation, the system of long-term credit banks, which we have already explained, should be centered on BIDV. At the same time, building up a sort of syndicated loan system centered on the most reliable bank (say BIDV) will be instrumental in economizing the capacity of information production in the banking sector. Under this system, a core bank like BIDV is responsible for examining and monitoring borrower enterprises, but the bank provides only part of the total loans to a specific borrower. The remainder is supplied by other commercial banks which are allowed to free-ride on the core bank's information production via examining and monitoring. This system will to some extent economize on financial intermediation capabilities in the immature banking sector.

Capacity of foreign and joint-venture banks: Another way to strengthen bank intermediation is to utilize the capacity of foreign banks. They came to Viet Nam with the sophisticated ability to monitor borrowers. As Table 7 shows, the relative share of both foreign banks and joint venture banks is still very low, although it has been increasing since the mid-1990s. At present, their activity in Viet Nam is severely limited. We think that foreign banks should be allowed to penetrate domestic markets more deeply. Of course, the Vietnamese government may desire to prevent them from creaming off the best borrowers from domestic markets but this may be difficult.

However, if foreign banks are given favorable conditions for establishing joint-venture banks with Vietnamese bankers and are allowed to be engaged in full-line businesses equivalent to those of domestic banks, their incentives to commit themselves to domestic financing will be substantially increased. We hope that joint ventures of foreign banks with domestic bankers will stimulate the spread of sophisticated banking know-how to the Vietnamese banks rather quickly. The Vietnamese banks will improve their abilities in monitoring and intermediating before long. Until then, we believe the Vietnamese banking sector should increase dependence on foreign banks in order to keep stability in the financial system.

Table 7 Deposit and Loan Shares of the Banking Sector (%)

	1993	1994	1995	1996
Total deposits	100	100	100	100
SOCB	91	88	80	76
Agribank	27	26	23	22
Incombank	27	24	20	20
BIDV	16	22	19	18
Vietcombank	21	16	18	16
Joint stock banks	6	8	9	10
Joint venture banks	1	2	3	3
Foreign banks (branches)	2	2	8	11
Total loans	100	100	100	100
SOCB	89	85	75	74
Agribank	18	18	17	17
Incombank	29	33	31	25
BIDV	6	4	3	8
Vietcombank	36	30	24	24
Joint stock banks	7	11	15	14
Joint venture banks	1	2	3	5
Foreign banks (branches)	3	2	7	7

Source State Bank of Viet Nam

V. Concluding Remarks

The performances of the Vietnamese macroeconomy were excellent during the first half of the 1990s from many perspectives. In this paper our interest has been whether or not Viet Nam will be able to continue those good performances during the latter half of the 1990s and in the next century. We think that the fiscal and financial system must be drastically reformed in order to sustain rapid economic growth in the near future. The market-oriented economy needs an efficient mechanism for monitoring and disciplining enterprise management. The financial system, particularly the banking system, should play an important role in monitoring borrower firms. However, the banking system with insufficient intermediation will endanger the working of the market economy by unduly extending credit to inefficient enterprises and/or by unduly excluding promising businesses from the credit market. Thus it is urgent that banks' monitoring and intermediating be strengthened in order for the Vietnamese economy to continue developing.

The government should build up infrastructure as much as possible, such as (1) an effective accounting standard for both nonfinancial enterprises, and for banking and other financial businesses, (2) the SBV's system of supervising commercial banks, (3) a clear-cut and rational rule on collateral, (4) explicit rules for dealing with insolvent borrowers, and (5) a system of deposit insurance. In particular, we advise the introduction of a system of long-term credit banks.

At any rate, there is no need for Viet Nam to introduce any financial reform schemes particularly different from other countries which want to rationalize their financial systems. The World Bank, IMF and other agents have already proposed reformation plans which are similar in nature. We agree with them almost totally. However, we must recognize that it will take a long time before this infrastructure becomes truly effective in bringing forth efficient intermediation by the banking sector. Thus, Viet Nam is expected to struggle with an inefficient banking sector for the time being. The government should continue careful supervision of commercial bank behavior. At the same time, as we have recommended, the government should endeavor to involve foreign banks in domestic financial business as much as possible to supplement financial intermediation in Viet Nam.

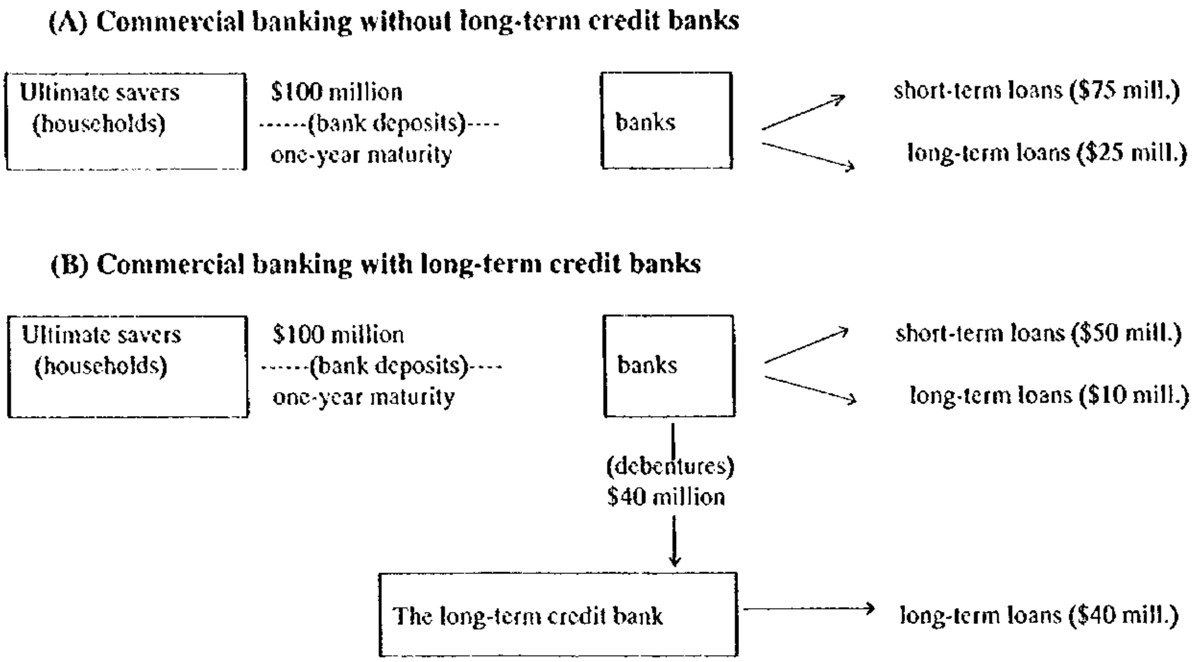
Appendix: Why are long-term credit banks useful?

This appendix briefly explains the mechanism of the long-term credit bank system we are proposing. Assume that ultimate savers (households) want to hold only bank deposits with one-year maturities. They so strongly value liquidity in their stores of value that they do not consider any assets with maturities longer than one year. On the other hand, every bank is assumed to have limited ability in maturity-transformation in the sense that the average maturity of its assets (loans to businesses) must be less than the average maturity of its deposit liabilities multiplied by a fixed coefficient. In the following, we assume the value of the coefficient as two. In other words, the average maturity of every bank's assets must not be more than double the average maturity of its deposit liabilities. Furthermore, for simplicity, there exist only two maturities for bank loans. One is a short-term loan with a one-year maturity, another is a long-term loan with a five-year maturity.

Banks cannot issue debentures directly to ultimate savers, because of our assumption. If banks can issue deposits worth $100 million with a one-year maturity, the maximum amount of long-term credit will be $25 million. This is because the average maturity of the banks assets is two years (0.75 * (one year)+0.25 * (five-years)).

Let us introduce a long-term credit bank that issues debentures with a maturity of 2.5 years to other commercial banks and specializes in supplying long-term loans (five-year maturity) to businesses. It should be noted that the coefficient of maturity-transformation is just equal to two. Now, suppose the commercial banks issue deposits of $100 million as before, and invest $40 million into debentures issued by the long-term credit banks. In order to keep the average asset maturity at two years, the commercial banks have to supply $10 million in long-term loans (maturity of five-years) and $50 million in short-term loans (maturity of one year) to businesses. By assumption, the long-term credit bank automatically supplies $40 million in the form of long-term loans, the total supply of long-term credit can be $50 million. It is apparent that long-term credit banks are useful in increasing the capability of maturity-transformation in the banking sector.

Chart 1 Commercial Banking vs. Long-term Banking



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1-B: Direction for the Improvement of Taxation System and Monetary Policies in Viet Nam in the Period of 1996-2000

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I. Policies on Taxation

1. Brief Review of the Current Taxation System in Viet Nam

Since 1990, the tax system in Viet Nam is comprised of the main types of taxes as follows:
- Turnover tax
- Special Consumption tax
- Import and Export tax
- Profit tax
- Agricultural tax, in 1994, renamed as Tax on the Use of Agricultural Land
- Personal Income tax
- Housing Land tax
- Tax on Transfer of Land Use Rights

Besides the above taxes, there are several taxes with characteristic charges such as: License tax, Slaughter tax; a number of charges for Registration, Transportation, Airport, Ratifying, and Passing Fees for bridges, vessels, roads and airways . . .

With regard to enterprises regulated by the foreign investment law, they have to pay the same types of taxes as a domestic enterprise does. Nevertheless, a certain number of taxes are levied specifically for those enterprises:

- For the Profit Tax, there is one mutual rate of 25%, but for each preferential project there is a respectively lower rate (10% - 15% or 20%). With regard to the enterprises operating in the field of gas or other precious and rare resources exploitation, the Profit Tax rates are defined in the Law on Petroleum, and other relevant laws.
- Remittances of profit abroad are taxed at either 5%, 7%, or 10%, according to the preference of each case.

Enterprises that have foreign capital invested have to pay rents to the Budget for the Land and Water and Sea Surface they rent. Tax on the Use of Agricultural Land and Housing Land Tax is not applied in this case.

During the time of implementation, the taxation policies are continuously amended to meet the requirements of economic renovation in each period. As a result, recently, certain improvements with positive effects have been recorded:
- Annual Budget receipts grew steadily
- An equal footing play ground for fair competition between economic sectors has been created contributing to economic development. Over the past five years, the GDP has increased at an average

annual growth rate of 8.2%.

- Development investment has been encouraged:
  + The resource mobilization from agricultural sectors has been lowered.
  + Incentives are provided for foreign investment.
  + Investments in problematic areas are preferential.
  + Reinvestment of profit is encouraged.
- Enterprises are urged to rearrange their management and production.

Economic accountancy is being continuously enhanced.

- A unified system of taxes is applied for all economic sectors to provide equalities in obligations to the Budget.
- Taxes are issued in the forms of Laws and Ordinances and thus have higher juridical power.
- The implementation of tax laws is being improved and the professional skills of the taxation authorities and cadres are enhanced.

However, at the outset of a new period of development, the current taxation system has revealed certain shortcomings:

- There are still double calculations, especially for the turnover tax, that have badly affected the production and circulation of commodities.
- Bearing too many functions at the same time(creating sources of receipts for the Budget, playing a macroeconomic managing and regulation role, and supporting many social policies . . .) makes the taxation system complex with many tax rates.
- The current system has not covered all the sources of receipts, such as interests on deposit money, transfer of shares, stocks trading . . .
- Some taxes are combinations of several kinds of taxes, creating an impression of heavy taxes(the Import Taxes on several commodities are high due to the inclusion of Special Consumption Tax)
- The tax policies are not stable and thus make the tax payers doubtful.
- There is no clear differentiation between tax and fee.
- The management of tax collection suffered from many shortcomings (the Ordinance on static works and accounting is not strictly implemented, coordination between economic branches in tax collection is weak)
- The mechanism of taxation is not completely organized, with poor facilities and a large share of untrained tax officials (30%).

2. Direction for Improvement.

(1) Objectives

Each kind of tax has to:

- be an important source of revenue for the budget.
- serve as an instrument for macroeconomic management, and a guiding light for economic development.
- ensure equality between economic sectors and society.
- be clear and simple; easy to understand, implement, and manage.

(2) Direction for Improvement for each Type of Tax:

1) Replacing Turnover tax with VAT

+ Target: All production and circulation activities of goods and services, including imports and exports of goods and services. In the coming period, VAT is not going to be applied for certain fields: agricultural production, production and trading of salt, credit activities ,financial and banking services, health care, film production, education, vocational training, passenger-bus transportation, . . .

+ Method of calculating:

Payable amount = Tax on Output - Tax on Input

(With regard to production and business units that have systems of accountancy)

With regard to other units:

Tax amount is to be paid = Value Added(x)Tax rate

With regard to imports:

Amount to be paid = Import Volume(x)Tax rate

+ Tax base: taxable price and tax rate.

- With regard to goods and services consumed domestically, taxable prices are the selling prices that have not been taxed and are written in the bill of trading.

- With regard to goods and services imported, taxable prices are the import value at the border plus Import tax.

- With regard to goods processing, taxable prices are the prices of processing.

- With regard to purchases of goods on credit (payments are carried out in a number of times), taxable prices are the prices of goods that have not born VAT at the selling point of time, that is, the taxing is not base on the periodical payments of this kind of purchase.

- Besides the zero rate applied for production and processing of export goods, there are expectedly 3 rates for VAT which are 5%, 10% and 20%.

2) Enterprise Income tax

- Applied for all types of enterprises in different economic sectors, including enterprises that have foreign capital invested. Enterprise income tax was promulgated to substitute for the Profit tax. Only for food producing enterprises that sell their own products (planting food crops like rice, maize, sweet potato or manioc), the Enterprise Income tax is not applicable.

- Clearly determine the costs of production: Materials, wages, depreciation, and other costs with a simple method of calculating that puts all the cost into a certain percentage over the total amount of taxable profit.

- Apply one unified rate to all types of production, and carry out a number of preferential rates for a certain period of time for certain fields of production and services.

3) Import and Export tax

The direction for improvement is to only levy Export taxes on the number of products that is necessary and possible for collection; for other products, Export taxes are fully eliminated to encourage exports. With respect to Import tax, the number of tax rates will be reduced, but the tax range will expand. The maximum import rate does not exceed 60% of the original price at the border. Commodities that now bear tax rates higher than this will be regulated by the special consumption tax.

4) Personal Income tax

The approach is to develop this kind of tax to become one important tax. All Vietnamese citizens (including people working overseas) and foreigners who live in Viet Nam that receive an income must pay Personal Income tax. There need to be further considerations to complete the draft of Personal Income tax law. The immediate task is to amend the Ordinance on Personal Income tax in two areas: The minimum level of income that is taxed, and the tax on irregular income.

5) Natural Resource Tax

There is going to be a Law on Natural Resource Tax in the coming period.

6) Other taxes are also going to be amended to the economic development.

3. Some Notable Points in the Process of Drafting the Law on VAT and the Law on Enterprise Income Tax

In the 11th session scheduled in April,1997, of the 9th National Assembly of the Socialist Republic of Viet Nam, these two tax laws are going to be passed. However, in order to gain practical and useful opinions to contribute to these two tax Laws on VAT and Enterprise Income tax, we would like to mention some issues for us to discuss. We would like to hear your valuable comments.

(1) About the Law on VAT

- with respect to the target of this law, the draft law holds that other countries do not levy VAT on small businesses. Other opinions say that there should not be a difference between large and small business, and that all businesses that have permanent operation grounds, shops or offices, are objects of the Law on VAT.
- There are 4 tax rates in the draft (0%, 5%, 10% and 20%). However, some people say there should only be a single tax rate (except 0%) to make it easier for the tax register and the determination of the amount of tax to be discounted . . .
- There may be certain problems when applying VAT (prices may be pushed up, heavier taxes, decrease in the Budget revenue . . .)

(2) About the Law on Enterprise Income Tax

- How to define rational and legitimate costs is still a controversial matter in Viet Nam. Some opinions say that the calculation of the taxable profit based on planned turnover and the average rate of profit is a sound method. This method helps to avoid cost disputation and encourage enterprises to reduce production costs.
- Many enterprises maintain that applying other countries' experiences for Viet Nam is not practical. Enterprises in other countries have had growth and the ability to develop strongly, while those in Viet Nam are still too weak to bear a tax rate of as much as 32%.

II . Monetary Policy

To meet the requirement for capital and inflation control, monetary policies in the period of 1996-2000 can be sketched as follows:

1. Policies on Capital Mobilization and Lending

1) Carrying out a general strategy for capital mobilization to serve industrialization, modernization and economic development.

- Improving and varying the forms of capital mobilization.
  + Widely applying personal accounts
  + Minimize wage payments in cash
  + Expanding the application of automatic machines for paying and with drawing money, as well as the use of credit cards.
  + Studying and developing forms of deposits with various terms
  + Promoting the issuance of bonds, stocks for different echelons and enterprises.
  + Step by step, issuing commercial bank's bonds to the international market.
  + Improving the mechanism for attracting foreign resources.
  + Encouraging the development of investment funds.

2) Carrying out a strategy for investment through the banking system:

- Expanding the volume of credit to meet the demand of economic growth.
- Developing medium and long-term lending to make the of medium-and long-term lending a larger share compared with the short-term lending in the total outstanding credit.
- Improving the quality of credit and reducing the percentage of overdue debts to below 3% of the total outstanding loans in the year 2000.
- Varying the forms of lending, including leasing activities, providing guaranty, . . . combine lending with consultant services for customers contributing to the upgrading of credit quality.

2. Interest Rate Policy

- Gradually liberalizing interest rates
- In the coming period, controlling only the ceiling rate of lending and abolishing the current control on discrepancy between deposit rate and lending rates.
- Setting the medium-and long-term lending rates higher than the short-term rates.
- Narrowing the gap between the rates for dong and foreign currencies, and going further to lend in VND only.
- Step by step development of instruments with regulating roles, like rediscount rates, open market operation . . .
- Encouraging fair competition among commercial banks.

3. Foreign Exchange Management, Regulation on Exchange Rate and the Balance of Payment

- Pursuing the objective "in the territory of Viet Nam, only using VND", The State Bank of Viet Nam needs to promulgate policies that restrict the use of foreign currencies.
- Increasing the foreign exchange reserve of the government to 13 import weeks.
- Boosting exports, reducing deficit in the trade balance.
- Abolishing the use of government's foreign exchange reserves for the financing of the Budget deficit.
- Commercial banks must develop foreign exchange trading in the global market.
- Issuing high face-value bank notes to facilitate payment requirements.
- Prohibiting price quotations in USD in shops, and paying wages for Vietnamese in VND
- Strengthen the interbank foreign exchange market to gather information for determination of a sound exchange rate.
- Managing exchange rates in accordance with the market signals, creating favorable conditions for promoting exports, with careful consideration of the import price, to serve the development of domestic production.

4. Budgetary Policy

- Ensuring good coordination between monetary policy and budgetary policy during their implementation, especially with interest rates and the volume of domestic and foreign capital mobilization.
- Strictly implementing the rule of not printing money for the financing budget deficit. The budget can receive loans from the State bank when necessary, but has to repay the loan within the fiscal year.

- Establishing and developing a well-functioning treasury bills market.
- Borrowing from abroad for financing the budget deficit is only for development investment purposes.

5. Developing Instruments of Monetary Policy

(1) Direct Instruments

- Credit ceiling
- Control on lending interest rate for the economy
- Reserve requirement

(2) Indirect Instruments:

- Rediscount window
- Open market operations

(3) Development of Banking System and Financial Institutions

- Developing a rational network
- Building a multi-functional banking system
- Varying other financial activities: investment funds, stocks trading companies, stock brokerage . . .
- Enlarging the self-generated capital of banks to ensure safety and credibility

6. Conditions for Banking Operation

- Promulgating Laws on banking activities and other Laws such as Trade laws, Law on Mortgage, . . .
- Intensifying inspection and supervision of the State Bank of Viet Nam.

1-C: Monetary Policy and its Relation to the National Financial Policy in Viet Nam

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I . Monetary Policy and its Objectives in a Market Economy

At a certain stage of socio-economic development, policy framework for each field in society will be determined. Monetary policy would only be fully determined when the market economy have bee established.

In our view, monetary policy is a set of strategic guidelines and ad hoc solutions of the government with the aim of stabilizing money and achieving planned socio-economic targets of the national economy. Therefore, there are three important points we should pay attention, to which are:

- Each country has its own monetary policy depending on its stage of development. There is not one fixed model of monetary policy for all countries.
- A monetary policy is considered a sound policy if it provides conditions and factors that support economic development.
- Monetary policies, when formed, should still maintain their flexibility depending on actual social and economic development, and avoid being too rigid with predetermined ideas.

Monetary policy plays a crucial role in the national economy. First, it has wide and deep impact on various socio-economic fields. Through monetary policy, we could promote or restrain investment, and thus influence the level of unemployment. Second, monetary policy influences the circulation of money in the economy, and its position and prestige in the international market.

Objectives of monetary policy:

The objectives of monetary policy are to smooth the monetary circulation at present and in the future, and to improve purchasing power of domestic money so that in the near future the VND could become a convertible currency.

Monetary policy in Viet Nam has the same objectives as in other countries. However, being a economy that just stepped out of economic crisis and hyperinflation, Viet Nam faces many difficulties in achieving those objectives.

In our view, if the monetary policy reaches the above objectives, other achievements of the economic could also be gained. They are:

- achieving desired rates of economic growth,
- stabilizing interest rates,
- stabilizing the foreign exchange market,
- promoting investment and generating more job opportunities.

Those consequences, if achieved, are conditions for the success of national financial policy.

Nevertheless, caution should be used with aspects of monetary policy that when implementing, could be in harmony as well as conflict with each other. If there are conflicts among the objectives, then the solution is to focus on the most important ones. For examples, rising interest rates in the period of 1989-1990 to contain inflation clearly conflicts with investment and employment objectives. However, the major objective of stabilizing monetary circulation was achieved in that period.

II. Initial Achievements and Unsettled Problems in the Formation and Implementation of Monetary Policy in Viet Nam

We would like at this point, to present our view on the monetary policy in Viet Nam during the past few years.

1. Policy Determination and Implementation

It could be said that monetary policy in the strict sense has been set up since 1990 when Viet Nam was in its fast transformation to a market economy. That does not mean Viet Nam did not have a monetary policy before 1990, but the so called monetary policy in the period before 1990 was very partial, and only managed temporary tasks of the government for each specific historical period. That policy could not serve as a monetary policy with new functions in a market economy.

The main components of current monetary policy are:

1) Mobilizing and allocating capital

This objective is aiming at providing adequate capital for the industrialization and modernization of the economy. To achieve this objective, the banking sector should:

- Verify and improve the capital mobilization both in short-and long-term. Generate a mechanism for mobilization of foreign capital.
- Establish a strategy for investment through the lending function of the banking sector. This strategy must provide various methods of lending that are suitable for the conditions of enterprises in Viet Nam, and benchmarks for credit increase in line with the needs of economic development.
- Implement a flexible interest rate policy based on economic growth. Interest rates should promote both capital mobilization and investment needed for the emerging market economy in Viet Nam.

2) Foreign exchange management and exchange rate regulation

Objectives are: boosting export and forex earning, prudently utilizing the national foreign exchange reserve, and strengthening the circulation of VND, for step-by-step implementation of the policy in Viet Nam of using only VND.

The government should reduce and then fully eliminate the unorganized foreign exchange market and replace it with a strong official one.

Measures to be carry this out may be:

- Developing a strong foreign exchange reserve for foreign exchange stabilization.
- Implementing a flexible foreign exchange rate in favour of export promotion and import control.
- Establishing a strong foreign exchange market regulated by SBVN.
- Implementing active measures to adjust the Bop to enable favorable international transactions for Viet Nam.

3) Policy concerning the government budget

Monetary policy should be such a crucial part of national financial policy that its implementation should be in the direction as follows:

- Not issuing money to finance a budget deficit. The financing should be carried out through operation of the monetary market and the security market.
- Developing a strong market for treasury bills as a solution for the temporary deficit in the government budget and for stable monetary circulation.

- If foreign borrowing is used to finance the deficit, then those borrowing should do so only for the purpose of developing our infrastructure.

4) Developing and improving the banking system and financial intermediations.

Our point of view is:

- The commercial banks should operate multi-functionally, not monopolistically specializing in their own particular economic fields as at present. However, for the particular fields of capital mobilization and extending long-term and medium-term credits, the Bank for Investment and Development of Viet Nam should keep its sole role.
- To build a huge State-owned commercial bank, which is capable enough to compete with other commercial banks, including foreign commercial banks. At the same time, this bank will support other domestic commercial banks. Presently, the average capital of a commercial bank in Viet Nam is about USD 20,000,000 (VND 200 billion equivalent), which is considered very low. Whereas, the capital of the Daiichi Bank (Japan), as an example, including equity and mobilizing capital, amounts to 472 billion USD.
- To expand the banking network to provide several services to meet the people's requirements. In 2000,the target of 15,000 habitants per branch should be achieved (Thailand 12,000 people per blanch; Germany: 4,000 people per branch).
- To establish finance-credit organizations to meet the people's requirements of banking services; to facilitate the development of the monetary market and the securities market.
- To improve organizational structure from the State bank to the system of commercial banks and financial intermediations. Local state banks should be established instead of provincial Branches of State Bank as present.

5) To study and improve the tools for implementation of monetary policies.

These tools are:

- The required reserve ratio of the commercial banks.
- The discount rate.
- Open market operations.

Though the above contents of monetary policies were planned, there are some unsuitable points during the implementing process. It is possible that, in fact, the market economy in Viet Nam will develop faster than the progress of management skills and planned policies.

2. Performance of Monetary Policies in Viet Nam Recently

a. To evaluate performance of a policy, especially one which influences every socio-economic field as monetary policy does, is not simple task. However, in our personal understanding, the performance of monetary policy has been shown by two points as follows:

1) The Government implemented monetary policy in the right orientation and appropriate, flexible way. These are:

- The inflation rate was reduced from three digits in 1986-1989 (410.9%) to a single digit (4.5%) by 1996.
- The deposit interest rate was reduced from 12%/month (1989) to approximately 1%/month (1996).

b. To facilitate the stability of monetary circulation:

2) Promulgated the "Ordinance on State Banksm," "Ordinance on Banks, Credit Cooperatives and Financial Companies" - 5/1990.

- Bank system of two hierarchies, commercial banks and state bank, has been established.
- To distinguish the state management of banks and banking operations of commercial banks.

3. Remaining Problems of Planning and Implementing Monetary Policy

The remaining problems that could be seen clearly are:

- The planning policies and promulgating policies are not consistent, so the management process and implementation face many difficulties.
  - There is no strategic policies, so it is impossible to have tactical solutions.
  - The laws on money management are insufficient. Moreover, the banking law has not been issued.

The distinction between monetary management and monetary operation is not clearly defined between MOF and SBV.

- The conditions and environment necessary for implementing monetary policy are inadequate and very bad.
  - Commercial credit is not recognized: thus, one type of monetary base is completely out of circulation, i.e., commercial bills.
  - Though there have been many proposed projects, the securities market still has not sufficient conditions to open and operate.
  - Monetary market is not complete; lack of debt securities market.
  - Interest rate is unstable.
- Infrastructure of banking sector is too backward compared with some regional countries and the world: technical equipment and technology of banking are bad; the capacity and quality of banking staffs are very bad. Moreover, the independence of SBV in determining, planning, and implementing monetary policies is not enough.

4. Some Proposals

- Completing organization of monetary market.
- Launching the securities market step-by-step.
- The Government should recognize commercial credit as soon as soon as possible so that commercial bills can be put into circulation.
- Promulgating Banking Law into socio-economic life.
- To upgrade banking technology and infrastructure.
- To create favorable economic environment to implement monetary policies.

III. The Relationship between National Monetary and Financial Policies

1. The Unity and Independence of the Two Policies

The monetary and financial policies are both in the financial-credit area. This is the widest and also most complicated area within the socio-economic life of any nation.

Each policy has its own targets.

The target of the monetary policy (briefly speaking) is to maintain the stability of monetary circulation by issuing policies and measures during certain times.

The target of the financial policy is to exploit, mobilize, and utilize efficiently all the available resources of society, and to ensure the development of all socio-economic areas following the expected plans.

In our opinion, the difference between the two mentioned policies is the two organic elements of a unique economic policy in our nation.

The independence of the two policies is only relative, because their targets are of two different state management fields. The unity of the two targets support each other to achieve the highest target of the economy: a stable and a firmly growing economy; the consistence between planning and implementing the two policies. The unity is expressed as follows:

- The State Bank will not have stable revenues, will not stimulate investment, will not create more jobs, will not stabilize the interest rates . . . and neither will achieve the expected growth rate if monetary circulation is instable, inflation is seriously high, and the purchasing power parity (PPP) of currency declines.

Therefore, the relationship between the monetary and fiscal policies is that of causes and effects in terms of a unique economic policy.

2. The Remaining Problems in Moderately Settling the Relationships between the Two Policies

In fact, the following remaining problems can be seen:

1) The distinction of loans management is not clearly defined between the State Bank and Ministry of Finance.

In our opinion, all the investment capital sources in an economy, without any distinction between sources, should be managed by the MOF if they are not reimbursable, and should be managed by the SBV if they are reimbursable (including loans on basis of interest or non-interest funds). Therefore, we propose:

- Reconsider the management units of project 327
- Infrastructure development loans.
- Anti-poverty loans . . .

2) The conditions and fundamentals between mortages and collateral loans are not clearly defined:

This is expressed as follows:

- State-owned enterprises are allowed to use the State's assets as mortages to borrow money from State-owned commercial banks.
- Unsecured loans are extended from time to time, i.e., loans without mortages and/or collateral.
- The conditions based on that enterprises can borrow money from banks are not concretized.

As a result, with capital lost, bad debts all finally become a burden to the State's budget. The people will have to bear the consequences.

3) There is no unified management of domestic borrowing by government:

Treasury bills, when issued, are not very attractive to the commercial banks for bidding. Even the insurance companies, who have large unused capital, are not very active in this matter. This contributes to the conditions where expenditure requirements of the government budget are high, and difficult to satisfy, while there is idle capital in the commercial banks and insurance companies that is not used for lending.

4) Benchmarks and responsibility of capital investment, as well as lending are not regulated or instructed clearly in accordance with the current conditions in Viet Nam. This is one of the reasons for the money glut in the banking system.

3. Orientation for the Relation between Monetary Policy and the National Financial Policy

As mentioned above, financial policy and monetary policy are the two elements of national economic policy of one country. In order to maintain a steady economic growth rate, monetary stability, and increasing purchasing power of VND, orientation for the relationship between the two policies should be that:

1) The monetary policy should support the objectives of the national financial policy

- In the coming period, the implementation of monetary policy should be in harmony with the "policy for the government budget" The SBVN should by active measures satisfy the short term expenditure requirements of the government budget, but not by printing more money (in normal economic conditions).

- In the future, when the SBVN has its independence in the formation and implementation of monetary policy, the SBVN should still hold the objectives of national financial policy as the objectives for monetary policy. Conflicts between the two policies should be completely avoided.

2) Monetary policy should be considered as a component of the national financial policy

That is, objectives of the monetary policy should be reflected in the national financial policy at both macro and micro levels.

JICA-MPI PROJECT
Some remarks on:
"Reformation of Fiscal and Financial System in Viet Nam"
by Prof. Akiyoshi Horiuchi

Vu Van Hoa

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By reading the report entitled as above by Prof. Akiyoshi Horiuchi, firstly, it must be said that Prof. A. Horiuchi has relatively good insight into Vietnamese economy, and its general and monetary and financial field in particular. Especially, the Prof. has kept track of the progress and renovation progress of financial and fiscal reform in the context that Viet Nam is approaching gradually to a market economy.

Secondly, in the report, Prof. A. Horiuchi sets forth the drawbacks in dealing with economic relationships in Viet Nam over time. The Prof. really concerns himself with correlation of the Vietnamese economic ratio which would give impact on the steady development of Vietnamese economy in the future. With his Japanese experience and research into the history of economic development of many nations, Prof. Horiuchi's opinions on the Vietnamese economy are noteworthy. Moreover, as a foreigner, after studying and surveying the Vietnamese economy, Prof. Horiuchi has come up with objective, sincere opinions, and constructive advice. As a Vietnamese, with some certain knowledge of finance and money, I sincerely thank Prof. Horiuchi for his lofty sentiment toward Viet Nam, our Motherland. I am sure others also share my impression after having a chance to read his writing.

The following are my supplementary opinions on your report that I would like to share with you if permitted.

First, in regard to the trade balance deficit.

According to statistics by the IMF, Viet Nam's trade balance has kept a deficit for 3 consecutive years: 1994, 1995, 1996; at the rate of 11.4%,13.4%,and 16.6%, respectively by GDP (say, in 1996, imports are of 11.1 billion USD against exports of 7.1 billion USD). Provided that these statistics are correct, your concern about our economic growth rate, imported capital, foreign exchange control . . . is absolutely realistic. The above figures are made by the Payment and Refund Agreements between the Vietnamese government and other nations' governments. Presently, Viet Nam has trade relations with 43 nations (1996):

- Asia	16 countries
- Europe	20 countries
- America	3 countries
- Africa	2 countries
- Australia	2 countries

Other than the data on the above-mentioned official trade balance, the IMF fails to control statistics:

- Minor-quota-trading between Viet Nam and border countries and regional countries, especially China, Laos, Cambodia, Thailand, Hong Kong . . . keeps increasing. Foreign currency input is not an inconsiderable figure.

- Foreign currency input from tourism is not included in the statistics.
- Foreign currency input from other channels, notably remittances. This source, unsurprisingly, keeps a high profile in Viet Nam at present.

In case the data on trade balance deficit is an official, the cirumstances we explained above should help to relieve your doubts about consistency between imported capital requirements and trade balance deficit.

However, it is noted that in our case, the country was devastated by wars lasting 30 years running, and recently recovered from crises and inflation, so a trade balance deficit is not unusual. Yet Viet Nam is cutting this rate.

By the way I, also want to tell Prof. Horiuchi that import-export data of the first 5 months in 1997 shows that:

Export: total turnover reached 3.36 billion USD, increase by 31.8% compared to the first 5 months in 1996, of which coffee made the increase of 99.6%, textile and garment 39%, rice 47% . . .

Import: estimated as 4.5 billion USD, import turnover increased modestly by 1.5% in comparison with the first 5 months in 1996.

(Source Bulletin of "Finance-market" issued no.127, dated 30 May, 1997)

The above figures should be considered an encouragement for us and an ease to your concern.

Secondly, the accumulated rate of internal capital against our investment target.

According to the IMF report, the accumulated rate of internal capital in Viet Nam in the early 90s was measured as very low, even at standstill. Prof. Horiuchi expresses his anxiety that with the low accumulated rate of internal capital (20% in 1996) compared with relatively high economic growth rate in other regional countries (1995, Viet Nam-9.5%, ASEAN-8.2%. 1996, Viet Nam-9.38%, ASEAN-7.8%), Viet Nam is more dependent on external capital. If just looking at the above figures, your concern is very reasonable.

Regarding this, we would like to help you have a better understanding.

- As told above, Viet Nam has gone through lengthy wars. The Vietnamese have suffered hardship and lost much. It has been nearly 20 years of peace, even though healing the war is far from complete. Therefore, the Viet Nam Communist Party and the Viet Nam State intend to "save people force," delay calling for the rapid-rate-accumulation of internal capital. This intention definitely meets the people's desire. It is not meant that we are unconscious of the inconsistency of accumulation of internal capital at a slower pace than GDP growth rate being disadvantageous to the economy in the future.
- After many years of devastating wars, peace is brought about, the demand for capital for war healing, economic recovery and new construction is extremely great. Owing to the low rate of accumulating internal capital in Viet Nam, external debts in the beginning stage are likely to grow. It is a natural trend, and your country, Japan, may have been influenced, to some extent, after the Second World War.
- It would be a great mistake if we forget to explain to you further about our government's viewpoint and intention to invest in the economy on the principle as "The State and People's Sharing work." This principle has been realised briskly, resulting in a tremendous economic basis and infrastructure, which are bearing fruit without capital from either our State budget or from foreign investment.

For example:

- People themselves invest capital in dwelling construction
between 1991 and 1995
  + In Hanoi: 700,000 m^2

+ In Ho Chi Minh City: 3,805,062 m^2

- Between 1993-1996 agricultural infrastructure construction

+ By State Budget: 2,000 billion VND

+ By other sectors: 17,000 billion VND

- Buy bills and bonds from people

1992: 330 billion VND

1993: 3,640 billion VND

1994: 5,036.6 billion VND

1995: 10,000 billion VND

Used as investment in 500KV electric transmission lines

In addition: by issuing bonds, fund is available for investment in construction wholly or partly:

+ Nguyen Tat Thanh Road (Ho Chi Minh City)

+ Hoang Thach Cement Plant (Contribute 44.45 billion VND)

+ Anh Son Cement Plant (contribute 7.65 billion VND)

These figures are not big, though they prove appropriation of the intention. On the other side, it is also a good explanation for the fact that, despite the small rate of internal accumulated capital, our growth rate is still high. However, we must say that Viet Nam's foreign debts stay at a great sum and it is extremely difficult to resolve.

Thirdly, promote the capability of our financial system.

Prof. Horiuchi assesses the capability of our financial system by looking at the rate of M2/GDP. In our opinion, this is both a theoretical and practical matter.

If we agree on the point that the rate of M2/GDP reflects financial capability of the economy and banking industry, we suppose that measuring M2 volume must be done under the following circumstances:

1. Stable monetary flow; inflation rate, if any must be as low as single-figure.

2. Adequate statistics on the "ingredients" and relatively accurate accounting of the means making up the aggregated M2 at a given time

3. Put the nominal money volume generated by financial-banking system to flow into the account.

If we come to an agreement of looking at M2 under these circumstances, I would like to discuss with Prof. Horiuchi as follows:

- It is not advisable to assess a nation's financial and banking capability by weighing the volume of issued bank notes. In Table 1, the data you set forth was that in the years 1987, 1988, and 1989, Viet Nam's M2 growth rate was at the climax as 324.3, 445.4, and 233.8, respectively. It was the time when Viet Nam experienced its worst inflation; our economy was at crisis. It is correct to say that according to the data, Viet Nam was boasting of its greatest financial capability in those years. Our opinion is the opposite. Viet Nam's financial capability was in the worst shape in those years. Since 1990 up to now, in spite of the data illustrated in Table 1 which shows unsteady even decreasing, M2 growth rate, Viet Nam's financial capability enjoyed record highs (the highest since 1975). As you know, market prices are quite stable, in early 1997. For a certain month, consumer prices even went down by 0.5% against the same period in 1996. Therefore, the data in table 1 does not correctly tell the actual economic situation.
- If the IMF statistic method is applied, they must be missing a volume of M2 in Viet Nam's market, that is:

- According to ADB estimation, there are about 700-1,000 million USD "floating" on Viet Nam's market out of control of banks.

- Minor-quota-import-export system with the foreign currency inflow which the State and banking system fail to account for.

- In the Asian people's habit, the Vietnamese keep gold as a "risky" provision. As a modest-minded estimation, each Vietnamese individual keeps gold provisions amounting to 1 tael (3.75 gr.). The present circulation is made up by up to 76 million tael, which is a very useful means of trading. At the present price of 500,000 VND/tael, it makes trading in gold worth 40,000 billion VND.

The means which are forgotten by the IMF can never lose their roles of M2 in Viet Nam's market.

- Commercial banks and other sectors involved in money generation, the previous money volume should also be taken as component of money.

Therefore, the statistics of M2 Volume cannot merely be based on accounts of the State Bank, but also estimations and other related factors. Among these, people's accumulated assets which are convertible, and can never left out of consideration.

I would like to emphasize that to evaluate the capability of the financial system, especially that of banking system, we should not base our data only on their owned capital. As compared to State-owned commercial Banks, at present, capital declared at SOCB's charter is very small.

- State-owned commercial bank: 200 billion VND.
- Joint-stock commercial bank
  + in Hanoi 50 billion VND
  + in Ho Chi Minh City 70 billion VND
  + others 20 billion VND

(Decision 233/OD-NH5 dated Nov. 27,1993 by governor of State Bank of Viet Nam on the minimum regulatory capital requirement)

With capital this size, it is difficult to compete with regional commercial banks. Thus, your concern about the capability of financial system is the focus of attention.

The last point I want to share with you is, that in order to develop our economy, capital is surely put as the top priority, is always steadfast. This view is again re-emphasized in the decision by the 8th Viet Nam Communist Party Congress: regarding domestically, accumulated capital as the key factor for industrialization and modernization, but external capital is treated as supplementary. Thus, we are not optimistic about calling for ODA in the future, as you advise.

With the encouragement and assistance of our friend nations, Vietnamese people have attained a lot of achievements. Surely, in the process of industrialization and modernization, by receiving your assistance and encouragement, Viet Nam will succeed in shaping its economy and become an event-maker who is worth paying attention to in the early half of the 21st century, as predicted 100 years ago (1891) by the late U.S. Foreign Affairs Minister, William Seward (President Lincoln's administration): "the Pacific Ocean and its islands will become a great theatre which is rich in world events in the coming time."

Many nations in the Pacific, Japan is one on these, have become "Great Theatres." Viet Nam is going to be such a great theatre in two or three decades.

1-D: Financial Policies - Problems and Solutions

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Ⅰ. Viet Nam's Actual Financial Situation Since the Adoption of Doi Moi Policy

For the past few years, the Doi Moi cause has gained initial remarkable achievements in many fields. There is rapid progress in monetary and financial sectors, the taxation system is in place and has been working uniformly in all economic sectors, the share of domestically mobilized funds is larger and larger over years, from 14.2% GDP in 1991 up to 21-22% in 1995, 1996 respectively of which taxes and fee amounts have become the main revenue sources. Investment is therefore on the rise; total investment reached to 15-16 billion USD. for 1991-1995 period, of which the State share accounted for 43% (including investment as an item of state budget expenditures, and investments made by State-owned enterprises themselves). The increasingly growing size of investment is one decisive determinant of the annual high economic growth rate of 8.3% (as compared to the targeted rate of 5.5-6.5%); namely, the growth rate was 9.5% in 1995 and 1996.

Viet Nam has curbed galloping inflation and kept inflation under control, which is considered to be one of the most remarkable achievements, given the ongoing transformation of economic structure and the unfavorably changing external environment. Inflation rates are 77.4%, 67.1%, 67.5%, 17.5%, 5.3%, 14.4%, 12.7%, 4.5%, in the years 1986, 1990, 1991, 1992, 1993, 1994, 1995, 1996, respectively. This achievement has contributed a lot to stabilization of our socio-economy, consolidation of people's trust in the Doi Moi cause, helped attract more and more foreign investors and improved the public image of Viet Nam in the world.

In the 1986-1995 period, the state budget changed greatly from one reliant on external aids, and characterized by the chronic situation of revenue failing to meet regular expenditure requirements (e.g., revenue amount met only 85% of expenditure requirements), to one of domestic receipts' meeting regular expenditures and internal accumulation, and formation of domestic investment development capital. The budget deficit tends to decrease as a share of GDP, from 7.7% (1986-1990) to 4.3% (1991-1995). Since 1991, the State no longer issues more money, but borrows domestically and uses external loans(ODA) to finance budget deficits. The deficit spent for investment and development has been used mainly for socio-economic infrastructural facilities. The subsidy mechanism no longer exists as expenditures are increasingly met by funds raised by people and socio-economic organizations.

As per enterprises, several policies have been adopted to encourage enterprises of all economic sectors with a view to ensuring enterprises' business rights stipulated by laws, and accountability of business owners, equity in formation, mobilization of funds and equal tax treatment. SOEs are re-organized, merged, Integrated; ownership form is replaced in loss-making enterprises; the former subsidy system from state budget to SOEs has been replaced with a credit system, expansion of businesses by creating joint-ventures, borrowing domestically and externally to finance production and trading activities; removal of capital granting system in the public sector.

These financial policies and mechanisms have helped with promoting enterprises to reorganize their production activities and improve technological levels, and product quality. As a result, a remarkable number of enterprises have continued to grow with a stronger foothold in the competitive internal and external market environment. However, the financial sector is still facing big challenges and there are several constraints to implementation of financial policies:

First, the system of financial policies and mechanisms has not been uniformly changed while moving towards a market economy.

Second, natural resources and all other state-owned assets, especially land, houses and mineral resources, have not been priced by market principles, which should have been the main determinants of management regulation of those public assets with a view to minimizing losses and waste. As these national resources are being used pervasively and wastefully, and the state loses control over them, the national financial sector is suffering huge losses.

Third, as the state budget is fed by stable sources of revenues associated with a large budget deficit with few, reserve and a low accumulation level, the state is always in difficulty meeting the requirements of account balancing. The budget is heavily reliant on export-import duties and revenue from oil export, notwithstanding domestic production activities with huge revenue losses. The budget amount is being used wastefully with very low rate of return; loose control of budget expenditures associated with lack of uniform management of budget activities, and the state budget characterized by chronic low, balance, pervasiveness, and scatteredness. Moreover, the budget management decentralization from the central level to the local one is not clearly defined or stable in place, resulting in the state budget not bring into, full play local accountability.

Fourth, the efficiency of the public financial sector is very low. It is still enjoying a number of state subsidies in the forms of low-priced fixed assets, and in most cases land is not valued in the right way; low amounts of social insurance premiums are given, so there is a huge coverage amount. Though SOEs are holding a large amount of capital and assets at their disposal, accounting for 88.4% of the total enterprises' capital, these resources are being used wastefully with low rates of return.

Fifth, weaknesses in financial inspection and control. A lot of funds out of the state budget have not been monitored appropriately, from the granting of funds to the final usage of funds extended, not to mention lack of compulsory regulation on auditing practices and publicity of financial statements. Not only is Viet Nam lacking consistent financial regulations, but it is unable to make these regulations and rules enforceable.

II. Tasks and Directions

1. Capital Mobilization Policy

As planned, the total investment capital must reach about 41-42 billion USD, for the 1996-2000 period, given the targeted annual growth rate of 9-10%.

The capital mobilization policy should help exploit greatest extent domestic and external capital sources meeting the needs for capital in the budget and economic sectors, and help meet the targeted socio-economic objectives by the year 2000. The policy should be formulated from point of view that the domestic resources are decisive and the external ones important, with a view to increasing the share of domestic resources gradually, in order to strengthening the nation's financial sector.

Searching for and providing greater access to resources, and economization will help maintain an annual investment of 27% of GDP and up to 30-35% by the year 2000. The State should also restructure mobilized and used funds, with emphasis placed on long-term and medium-term investment and development.

The policies for domestic capital mobilization include encouragement of economization on consumptions to raise more funds for production and trading through tax policies, investment promotion, capital preservation, macroeconomic environment stabilization, keeping inflation rates under control, and uniform implementation of policy in multisector development. The State should diversify measures to mobilize funds especially issue bonds and shares at different levels of government, locality, enterprise; expand and develop of intermediary financial institutions, such as financial companies, insurance firms, investment and development funds, mutual assistance funds, pension funds, social welfare funds . . . further develop medium-term, long-term and short-term forms of mobilizing funds.

The State should promote mobilization of external funds especially FDI as one of the main external sources. However, it is necessary to increase the Vietnamese share in order to gain more influence on JVs, and at the same time bring in more benefits to Viet Nam. The policy should also fully list priority areas calling for FDI, given the target of moving the country towards modernization and industrialization. The capital mobilization policy must conform with the master plan for all economic sectors and industries, and the economic strategy for national security. The State continues complete policy, regulation, and administrative reform in order to create an enabling environment for FDI.

Regarding ODA, it is necessary to take into account economic and repayment capacity for external loans in order to identify levels of external borrowing in the state budget for certain periods of time; borrowing activities should be monitored to ensure effective use of external loans; ODA loans first are to be spent for infrastructural building and upgrading projects, environmental and social projects; there is no need for commercial borrowings to invest in infrastructure on non-profit projects. One part of ODA can be spent for production and trading development projects through loans made by enterprises on the basis of effectively using loan capital and recouping of loans to fulfill repayment obligations.

Issue of international bonds-commercial borrowing at high interest rates-should be under thorough consideration in terms of borrowing conditions and repayment capacity; the State should allow enterprises to borrow abroad on the principle of self-borrowing and self-repayment with a bank guaranty. Local authorities are not allowed to borrow abroad so as to avoid pervasiveness of borrowing activities; i.e., government borrowing should be centralized under state plans and programs.

Financial markets should be further developed depending on the size of the national economy, aiming at facilitating fund exchanges and shortening cycles and minimizing costs. Attention should be paid to developing short-term and long-term capital markets, monetary markets, inter-bank domestic and foreign currency markets, treasury bond markets . . . in order to create momentum for mobilization of funds among people, and conditions for development of the stock market.

Creating necessary conditions for the stock market for the time to come: first, commodities should be produced (bonds, shares) diversified forms of mobilizing shares to raise more funds, selling stakes, developing shares to be traded freely in markets; issuing government bonds (including compulsory bonds) in order to expand primary markets and develop secondary markets; and simultaneously developing intermediary financial institutions such as investment funds, assistance funds, aid funds, insurance funds, commercial banks, mortgages, collateral funds, etc.

2. State Budget

The State budget is mobilized to the greatest extent all domestic and external resources to help fulfill strategic socio-economic development; the State should reconcile the relationship between a target of creating great financial strength enabling the state to undertake strategic change and the nee to accumulate capital among enterprises and among people for the purpose of expanding production and trading activities with bigger and bigger accumulated funds.

Given the open-door policy adopted in Viet Nam now, and as Viet Nam has joined AFTA and is now a would-be member of WTO, it seems that with the share of revenue from export-import duties, it is necessary to increase domestic revenue by improving performance and competitiveness of enterprises. For the 1996-2000 period, the contribution ratio of GDP in the state budget should be maintained at 21-22%; revenue will be raised by higher economic growth rate and minimizing losses.

State budget allocation should be carried out on the principle of economization of production and trading, consumption with emphasis placed on development investment; ensuring the growth of increased expenditures for development investment outpaces that of regular expenditures; domestic revenues should meet regular expenditure requirements and debt repayment, but also meet investment development needs.

Reorganizing and reforming the state budget expenditure structure should promote centralization and higher efficiency of usage of expenditure items.

Expenditures for investment and development focus on socio-economic infrastructural facilities. One part is spent on significant projects such as acknowledged government lending or state-owned stakes in the enterprise.

State budget expenditures also focus on areas of healthcare, education, culture, and other such national programs ensuring integrating objectives of high economic growth rate with human resource strategy. The State budget must help fulfill the task of state management in order to improve efficiency on the state mechanism.

For the coming time, the state should better adjust the relationship between the central budget and the local one, as stipulated in the state budget law on the principle of democracy; the central budget is to help fulfill national strategic tasks, while local budgets are given more accountability to be active in implementing their own tasks given a united institutional framework. The revenue-spending tasks are to be undertaken for period of 3-5 years, to enable local authorities to work out plans and take advantage of their own potential to increase revenues.

The State budget should follow the principle of sustainable account balancing: between needs and capacity, saving and consumption, accumulation and concentration, external and internal capital; while ensuring that the State budget must have reserves to be active in every stage of the process; gradual removal of residual budget subsidies to be replaced by other forms of financing if necessary.

3. Tax Policies

The State should stabilize the contribution ratio from taxation, charges and fees to the state budget at about 22% of GDP. Renovation of tax policy should be carried out by expanding the range of taxpayer fees and adjusting the rates of some taxes; some of them should be raised and others decreased, given the unchanged contribution ratio.

Tax policies should move towards gradually separating them from social policies and uniformly adopting tax policies on goods and products, regardless of users or objectives, in order to reduce the cases of exemptions, and to expand the range of taxpayers and the overall tax base.

Rearranging taxes by the characteristics of each tax, expanding the excise tax base, adjusting levies on some consumers' goods, and uniformly imposing these new tax rates on both domestically produced goods and imports. Timely adjusting the import tax to better conform with export-import policy, properly protecting domestic production, adjusting consumption structure, and increasing state budget revenue, encouraging technological transfer, renovating domestic technology, expanding the export market, and attracting foreign investment, given the commitments Viet Nam has already made to ASEAN (AFTA), APEC, and WTO.

Introduction of Value added tax (VAT) requires several conditions, such as accounting standards, system of bills and invoices in trading goods and services. The State should be active in creating such necessary conditions, as well as keeping tight control over implementation in order to effectively imposing VAT (effective date: 01 January 1999).

We are moving gradually to contracting and uniformly imposing tax rates on business profits of domestic enterprises and foreign-invested enterprises; businesses' income tax instead of profit tax.

Preparing and introducing an individual income tax law, instead of taxing high income level people.

Reforming tax administration by changing to a system whereby a taxpayer will declare and pay a tax amount directly to the State Treasury; strengthening control, monitoring activities, and encouraging people's fulfillment of tax obligations, minimizing tax evasion; preventing road smuggling, border smuggling, and waterway or sea smuggling.

4. Enterprise Financial Policies

Enterprise financial policy should continue encouraging and improving enterprise to accumulate capital, expand investment, increase efficiency in using capital, contributing more to GNP and national financial resources, and promoting production in the direction of industrialization and modernization of our country.

The State implements favorable tax policies for enterprises who use their profits for laborers, or for mobilizing profit for the laborers, or for reinvestment. The State issues regulations on using most of (at least 70%) after tax profits for maintaining and expanding business (especially for state owned enterprises).

The State enables enterprises to mobilize idle public capital for business purposes by issuing of shares, bonds, creating joint ventures, and adopt in equitization, internal and external cooperation policy and appropriate credit policy to encourage enterprises to borrow and effectively use loans to intensify investment and expand business activities.

The State continues to reorganize the state sector for the purposes of getting out of the current pervasive situation and increasing economic efficiency and national economic strength, to diversify forms of ownership with more emphasis on state capitalist ownership, and to accelerate equitization of state-owned enterprises that no longer need be 100% state owned.

The state removes capital subsidies for state-owned enterprises, simultaneously expands and diversifies channels and forms of capital mobilization for enterprises, especially by issue of company shares and bonds. Enterprises are allowed to borrow abroad and from ODA, and they have to effectively use and repay the debt.

The State grants supplementary capital to other enterprises after giving favorable treatment to profitable enterprises; they should be strengthened to stay firm in a competitive market; at the same time, abolishes all other forms of subsidies or unreasonable advantages (especially for those enterprises that are considered special public utilities). Bankruptcy Law is released to put pressure on these enterprises to improve their operations.

A system of dominant state ownership in management of SOEs is set up to replace the one of direct intervention by state agencies, moving toward removal of "administrative management" over SOEs.

As per public utility enterprises, the State will apply the form of "target contract" for the period of 3-5 years, or purchase a contract to buy back utility services provided by enterprises of different economic sectors and resell to consumers at state prices, enabling enterprises in different economic sectors to take on some types of public service through bidding.

Table 1 Some basic macro-economic indicators

Year	Annual growth rate of GDP(%)	Inflation(CPI)(%)	Budget Deficit (% GDP)
1986		77.4	6.18
1987	3.66	223.1	4.74
1988	5.9	393.8	7.62
1989	8.53	34.5	10.26
1990	5.1	67.4	8.03
1991	6.0	67.5	3.8
1992	8.6	17.5	3.75
1993	8.1	5.2	6.53
1994	8.8	14.4	4.91
1995	9.5	12.7	3.83
1996	9.38	4.5	

Table 2 Investment programme in 5-year plan (USD billion-1995 price)

Norms	1991-1995	1996-2000
Investment channel	18.26	41.0-42.0
Budget	7.62	15.6
FDI	5.24	14.0
Individual	5.4	12.4
Resources	18.26	41.0-42.0
ODA	2.11	8.0
FDI	4.55	14.0
Domestic savings	11.6	21.0
Investment/GDP(%)	19.1	30.0

Sources
1) General Statictis Office
2) Ministry of Planning and Investment

Table 3 Mobilizing national income for the state budget (%)

Year	86-90	1991	1992	1993	1994	1995	91-95	1996	1997
Total	14.2	13.1	19.0	23.6	24.3	22.7	22.1	23.1	22.0
Taxes and Fees	13.2	12.8	16.8	21.4	22.1	22.1	21.5	20.9	20.9

Table 4 State budget revenue structure (%)

	86-90	91-95	1996	1997
Total SB revenue	100	100	100	100
-Public sector	38.8	28.4	26.4	26.2
-JV	10.5	16.1	16.4	17.1
-Industrial commercial tax	10.4	9.3	9.0	10.3
-Agricultural tax	6.0	3.8	3.0	2.8
-Import-export duties	9.9	20.2	26.8	26.1
-Charges and Fees		4.7	6.6	7.0

Table 5 State budget structural expenditure (of GDP) (%)

Year	86-90	1991	1992	1993	1994	1995	91-95	1996	1997
Total Expenditure of State budget	21.9	15.9	22	30.1	29.2	28.1	26.4	26.4	25.8
-Developing Investment	6.5	3.5	7.4	8.7	6.0	6.2	6.4	5.8	5.8
-Debt repayment	2.0	1.8	2.4	4.3	5.0	4.5	3.9	4.6	3.9
-Current expenditure	13.4	10.5	12.3	17.1	18.2	18.2	16.0	15.4	14.5
-Budget deficit	7.4	2.4	3.0	6.5	4.9	4.3	4.42	3.2	3.8

1-E: Development of Policies on Financial Relationships Among Authority Levels in Viet Nam

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The financial relationships among authority levels depend a great deal on mandates and functions of different levels of authorities. In Viet Nam, the national administrative network is made of central level administrative agencies (Ministry, Ministry-equivalent bodies and government agencies) and the local ones (people's committees).

In terms of role in the State mechanism, any local people's council is a representative of its local people and has its jurisdiction as stipulated by law in accordance with the principle of territory and a local self-administrated decision-maker who deals with local matters.

A local people's council is not considered a legislative agency in that locality, as it the National Assembly that takes on all the legislative jurisdiction; the National Assembly, therefore, has the highest-level or supreme jurisdiction over legislation.

As stipulated in Viet Nam's Constitution and Laws, in principle, the Central State is empowered in a complete manner. In a given period of socio-economic development, the State delegates power to local authorities, namely local people's councils, in a so-called decentralization system and/or "scattering power system" on the principles of democracy and concentration. Thus, the nature of mandates and functions of the people's council is to bring into force state laws and regulations in its process of decision making on assigned matters in its geographical area.

In a centrally-planned economy, the national administrative system is characterized by features of a centrally-planned bureaucratic mechanism.

The first characteristic is that all locally-based revenue sources were to be paid into the central-treasury, and most local expenditures used to be met by the central budget.

Until 1967, provinces and cities were acting as estimating units of the state budget. Since 1967, and particularly 1983, provinces and cities have been classified as one level of the state budget, and the local budget comprises provincial, district, and commune-level budgets.

Resolution No.138 of the Government in 1983 has made some changes to the budget control mechanism and power delegation to local authorities over the state budget. This Resolution served to ensure unified and consistent state control over financial policies, budget revenue, spending system, and revenue sources gathering up in the central-level budget. Furthermore the Resolution helps to emphasize the role of local authorities in mobilizing local financial sources to raise funds for economic and cultural development in the localities respectively.

One difference is that the local spending amount is no longer determined by the expenditure limit set by the state, but the revenue amount actually earned in that locality and in the state adjustment rate. In case the local revenue amount is in excess of the targeted amount of revenue from taxes, and from SOEs' profits, the locality is entitled to extract a portion of the revenue earned to be added to the local budget in accordance with the "adjustment rate" per item and retains 30-50% of the excess revenue as an award. In order to strengthen liabilities over local economic development, the state creates more revenue sources namely revenue in the form of supplies of agricultural products and fund contributed by local people.

At the local level, spending for capital construction is covered by two sources:

1) capital construction funds out of the state budget released upon submission of projects by objective;

2) capital construction funds locally raised from construction lotteries, government debentures, and budget balances from previous years. However, owing to different geographical, natural and economic features among various areas, some cities and provinces are getting affluent with increasing budget surpluses, whereas some others are facing larger and larger budgetary deficits resulting from limited revenue sources given large spending demands. As the state is unable to "reconcile" the two opposite facts by getting the deficit financed by the surplus, in the end it has to issue more money to subsidize those who are in deficit, and as a result is facing galloping inflation rates.

At the commune level, in fact, the commune budget is controlled on the principle of budget balancing and subsides to cover differences between the revenue amount and the spending amount. Thus, only the subsidies or grants are reflected in "other spending items" of the local budget to be aggregated to the state budget.

Since 1989, the delegation of power over budget to authority levels has been governed by Resolution No.186/HDBT. Under this Resolution, more revenue sources that are to be retained by 100% of the local budget are created. A stipulation that some types of revenue from locally-owned enterprises are transferred to local budget has helped get the local authorities more concerned about the operation of state enterprises located in its area. In this regard, more revenue sources of this type created: payment for afforestation, transportation fees, trade license taxes, animal slaughtering taxes, registration taxes.

Also, some new adjusted revenue sources to be added to the local budget are state enterprises' and SOEs' profits (excluding profits from enterprises that conduct accounting in the entire branch); locally-based SOEs' gross profit (price margins, profit from trading activities included), agricultural taxes (including the amount retained by the commune authority to be paid to the commune budget), and industrial and commercial taxes (excluding trade license tax, and registration taxes that are to be paid in full the local budget, animal slaughtering tax, and the commune budget).

According to the recently-released regulation, the spending mechanism is changed somewhat. For example, two categories of capital construction funds as an item of the local budget are grouped together and must be included in the local budget at the beginning of the fiscal year. The state has assigned more spending tasks to the local budget as spending items for social-economic development, such as spending for local master planning, for regular and contingency allowances to local staff (laborers), and spending for management of land, etc.

It is envisaged that, in case the local authority is still unable to meet its assigned spending requirements given a full (complete) applied adjustment rate, it will be entitled to a grant out of the central budget. A uniform and consistent application of the adjustment rate to revenues from enterprises, regardless of different levels of authority own that enterprise, has served as an incentive to provinces and cities for expanding sources of budget revenue.

The budget mechanism applied in reality for the past few years was both of a bureaucratic and a pervasive nature. i.e., the central budget was tasked with balancing the local budget, which resulted in the passive role that the local budget was playing in controlling its budget with a view to self-balancing the local budget. Moreover, a consistent system of norms and criteria for budget expenditures was not in place, but an individual one set up by branches/sectors, and therefore unevenly/pervasiveness was inevitably weakening the State finance.

The changeable allocation of liabilities over budget control among authorities made it difficult to foresee the budgetary process for the following periods. Dispersed or pervasive revenue spending tasks, and the roles of different budget levels are not emphasized, and an absence of incentives to localities to invest more in expanding revenue sources and to rationalize spending tasks with a view to facilitating the process of budget self-balancing also interfered.

Budget Law on 20 Mar. 1996 is an important step in the process of establishing a legal framework for budget control in a market economy.

Budget Law is based on the principle of concentration and democracy, given the requirement of unified management of the national financial sector. Regimes, policies on budget revenue expenditures, and approaches of budget control are, released by the State; powers and liabilities of different authority levels are clearly defined with a view to providing greater accountability and creativeness to local authorities over the budget.

In the State Budget system, the central budget plays the key role, with major revenue sources to meet spending tasks of great significance to national development, like spending for investment in establishing infrastructure facilities, economic transformation, industrialization, and modernization of the country. The Central Budget is also to act as a coordinator among local budgets to ensure an efficient, appropriate and equal economic structure throughout the country.

Local budgets are tasked with norms and criteria for budget revenue and expenditures fixed for a period of several years, so as to enable the authorities at different levels to be active in fulfilling mandates and functions in conformity with state rules and regulations.

The state budget comprises the Central Budget and the budgets of local authorities at various levels. The Central Budget is established to fund operation of the Government, Ministries, and government agencies in fulfilling their national tasks, whereas the lower level budgets will fund activities of People's Committees and local level line agencies. At each level, budget revenue collecting and spending tasks are determined by managerial capacity. The district and precinct authorities are allocated with some revenue sources, and one part is transferred from the provincial and municipal budget to spend for specific purposes, mainly spending-for operations of administrative agencies, socio-economic and cultural development. At the provincial and town level, the authorities are provided with some revenue sources to ensure meeting of all special spending requirements; spending amount of wards, as an inner-city administrative units, are mainly covered out of the higher level budget.

As per allocation of responsibilities over budget, the Law stated the principle of assigning revenue collection and spending tasks for every 3-5 year period; long enough for local authorities to make socio-economic development plans and prepare budget estimations associated with them, while encouraging local authorities' creativity in bringing into full play local advantages and potentials.

Allocation of spending tasks and revenue sources to local governments at various levels is done on the following principles:

- Clear determination and identification of budgetary mandates and functions to be assigned to each level, to assign responsibilities in association with powers.

- The Central Budget plays the key role, and is allotted to with managerial efficiency (principle of assigning tasks by level of efficiency), regular tasks (to undertake for a long period of time) or tasks with large social or public objectives assigned to local governments, depending on their positions in the management hierarchy.

Regarding adjusted revenue sources, state budget revenue sources are categorized into three types: Central Budget revenue sources to be collected by 100%, local budget revenue sources to be collected by 100%, and pro rata revenue sources to be paid into both central and local budgets. The State Budget Law states that:

- National irregular revenue sources arisen locally are to be paid in full (100%) to the Central Budget in order to meet spending requirements of the entire country are: import and export duties, special sales tax (excise tax), revenue from petroleum operations, profit tax paid by businesses that conduct accounting in the entire branch, fees and charges imposed by the Central government.

- Revenues to be collected by 100% and paid to the local budget are those directly associated with governance of local governments: agricultural land use money, land use right transfer money, fees on land use right granting; revenue from construction lottery operation, registration fees, money from leasing and selling houses owned by the State, land lease money, fees and charges imposed by the local governments.

- Revenues to be divided by percentage between the Central Budget and the local budget are those that should be under the control of both central and local governments, including turnover tax, profit tax, income tax, natural resources tax, and revenue from the use of budget capital.

In case provinces are still unable to meet their spending requirements if their revenue sources are exploited to the largest possible extent, they will get subsidies from the Central Budget. Thus, the Central Budget has to meet "national" spending requirements, and ensure equal regional development by transferring funds from those in surplus to those in deficit.

The main changes to allocation of budget revenue collection and spending tasks to authorities at various levels are as follows:

- Narrow the range of revenues to be paid in full to the Central Budget, i.e., revenues from indirect taxes, and revenues arisen irregularly, such as revenues from import and export duties, special sales tax (excise tax), revenue from petroleum operations, profit tax by businesses that conduct accounting in the entire branch, fees and charges imposed by the Central government.

- Introduce more revenues to be paid in full to the local budgets, such as revenues from land and housing operations, to help local governments tighten their control over land and housing, and make the best use of revenue sources of this type to spend on investments in infrastructure improvement and setting up local housing funds.

Create more revenues to be divided by percentage among different level budgets: turnover tax, profit tax, natural resources tax, and revenue from the use of budget capital, resident income tax, with a view to emphasizing the role of local government in managing and using revenue sources and to increasing revenue to achieve the objective of local budget self balancing.

- Expenditures for developing investment: assign to the local government with infrastructural projects that have a close link with that local government's socio-economic management task in order to maintain the sustainability of its revenue collection and spending tasks.

The Central government is supposed to invest in major projects or to invest in adjustment or economic structure, and to invest in enterprise through granting of capital construction funds (if any), working capital, price subsidies and reserves.

- Regular expenditures: clear determination of spending tasks to be assigned to the Central Budget and the local budget in terms of expenditures for health care, education, wages and salaries. It is impossible to use revenue from one budget to meet requirements assigned to another. In case the higher level state management agency to carry out a specific task that is assigned to the former itself, funds must be transferred from the former's budget to the latter's for it to fulfill the spending task.

Commune and town level budgets:

- As each town or commune has its own revenue collection and spending tasks, given its specific mandates and functions in a given period of time, the town commune government is permitted to set up an investment mobilization fund, on the voluntary principle, with released breakdown of revenue and expenditure items, and subject to inspection and check. These funds will be used to spend for public activities undertaken by the community (hamlets, villages, etc.)

- Given the characteristics of cities and the necessity of facilitating urban development, the Law stipulates additional spending tasks undertaken by municipal budgets, such as spending for investment in building the social infrastructural system (inner-city transport system, water drainage, etc.) spending for public welfare, urban lighting, sanitation system.

Also, other revenues are introduced, like adjusted turnover taxes, registration fees, and revenues from supplies of urban facilities, such as sanitation fees, electricity surcharges, water surcharges, telephone surcharges, in accordance with the government rules and regulations and provincial peoples' councils.

- Prefectures and wards are administrative units characterized by some features different from communes and districts, i.e., they are mainly tasked with state management responsibility; social and cultural functions as a component of the overall function of the cities should not be discarded into specific pieces of works to assign to precincts. In this regard, while assigning some revenue sources to wards, the Law also stipulates that a portion will be extracted from the city budget to transfer to the prefectures; most spending requirements at the ward level are met with funds out of the higher level budget.

As stipulated in the Law, levels of authorities take control of specific revenue sources to be divided by percentage as follows:

- Between the Central government and provinces and cities under direct control of central authority: turnover tax, profit tax, income tax, natural resources tax, revenue from the usage of budget capital.

Between provinces and cities under direct control of central authority and districts, towns under control of provincial authority: turnover tax, profit tax, agricultural land use money, taxes on land use right transfer, revenue from granting of land use right, housing use money.

In addition, the local government is allowed to impose charges and surcharges in accordance with state rules and regulations. The provincial and city authorities are permitted to mobilize domestic funds for capital construction within their own jurisdiction and set up financial reserves funds to fulfill other budgetary tasks.

People's councils and people's committees have the right to make decisions on their budgets, given the 3-5 year budget implementation period, and the expansion or greater empowerment of people's council and people's committees should be considered as renovative changes in order to encourage governments at various levels to bring into full play existing potential to sustain and increase revenues and work out better local budgetary implementation plans, in the overall unified budgetary regimes set up by the central government.

1-F: Basic Features of Foreign Exchange, Foreign Exchange Rate and Gold Management Policies in Viet Nam over the Years of Renovation

Duong Thu Huong
State Bank of Viet Nam

As in other developing countries, foreign currencies and gold still play important roles in the economy of Viet Nam. The reasons why foreign currencies and gold play important roles are:

- Viet Nam is a country lacking foreign currencies. The current account is often in deficit; demand for foreign currencies for the economy is still very high, but the supply of foreign currencies is limited.
- Despite being controlled at a lower rate as compared to the beginning years of renovation, the inflation rate is still high in comparison with that of other countries in the region, and is not really stable. Thus the producers, as well as the consumers, psychologically prefer to hold foreign currencies and gold to preserve their savings.
- The fluctuations of foreign exchange rates and prices of gold make a big impact on implementation of State Bank of Viet Nam monetary policy objectives of reining inflation, and stabilizing the value of Viet Nam dong.

Therefore, foreign exchange management policy, foreign exchange rate, and foreign exchange rate management policy are considered the most important contents of monetary policy of the State Bank of Viet Nam. In accordance with the development of the banking system of Viet Nam in the renovation period, the foreign exchange and foreign exchange rate management policies in Viet Nam have gradually been amended and perfected to meet the requirements of a market economy and to contribute importantly to the implementation of the objectives of monetary policy.

I . Foreign Exchange Management Policy of Viet Nam

Derived from the above-mentioned role of foreign currencies and gold, the guiding point of view in foreign exchange management policy in Viet Nam is:

- tight control over foreign currencies outflows.
- Expansion and maximum attraction of the foreign currencies influx by using appropriate measures, such as encouraging direct foreign investment in Viet Nam; encouraging Vietnamese enterprises to use foreign loans effectively; expanding remittance services from abroad; encouraging overseas relatives to send money to help families; encouraging foreigners and foreign institutions to bring gold into Viet Nam to process and reexport.
- Reaching the goal that only Vietnamese dong is to be spent in Vietnamese territory, limiting the utilization scope of "Vietnamese dong" replace by "foreign currencies."
- Increasing State foreign currency reserves through the banking system.

Since 1990, the foreign exchange management policy has been adjusted to meet the requirements of the market economy, and effectively facilitate the process of implementation of monetary policy objectives. The prevailing Decision 396/TTg, issued by the Prime Minister on 4 August 1994, is a document which has been altered and adjusted to meet the requirements of foreign exchange management in the new situation.

The main content of foreign exchange management policy based on Decision 396/TTg is as follows:

- The enterprises are permitted to open foreign currency deposit accounts at commercial banks and conduct trade in foreign currencies. The outstanding balance of the deposit account is allowed to be maintained at a sufficient level to ensure production-business operations (after achieving agreement with the State Bank). The still-unused foreign currencies must be sold to the banks, and to financial companies having a license to conduct foreign currency trading transactions.

- The enterprises (except for banks and financial companies having the right to trade foreign currencies) are not allowed to directly provide loans, payments, trading, or transferring transactions in foreign currencies among them selves. All activities of trade, payment, or transfer in foreign currencies must be carried out through banks or financial companies having the right to trade foreign currencies.

- The local business and service institutions are permitted to have only receipts in Vietnamese dong, except for duty free shops and service units at the airports and seaports. They are allowed to accept foreign currencies based on the State Bank of Viet Nam licences. Establish a wide, convenient system of exchange bureaus in economic centers, big cities, and in the places needed to serve customers having foreign currencies to exchange into Vietnamese dong.

- Restrict the institutions permitted to open foreign currencies deposit accounts abroad to the 4 following types of enterprises:

1) Qualified commercial banks and financial companies.

2) Enterprises of airlines, sea shipping, posts, insurance are allowed to open foreign currencies accounts abroad to conduct online receipts and expenditures and make clearing payments with partners.

3) Foreign-invested factories are allowed to open foreign currency accounts to borrow foreign funds according to the Foreign Investment Law.

4) Vietnamese economic entities are permitted to establish offices abroad to produce and run business.

- Increase the value of foreign currencies outflows which are not to be under customs declaration and licence up to USD 7,000 from November 1994.

Thus the issuance of Decision 396/TTg on foreign exchange management has already had effects on:

- Controlling the foreign currency deposit accounts of enterprises, especially the foreign currency deposit accounts of enterprises abroad.

- Limiting, to some extent, the balance of foreign currency deposit accounts of enterprises and institutions having receipts in foreign currencies.

- Enhancing, to some extent, the ability to manage and steer foreign currencies under Government control.

- Concentrating more effectively all payment and trading services in foreign currencies in the Banking system; restricting and then removing free transactions in foreign currencies among the enterprises.

However, the foreign exchange management policy of Viet Nam still has some limitations:

- Not having ability of managing the foreign currencies of individuals.

- Still having foreign currency deposit accounts and payment transactions in foreign currencies among enterprises; between commercial banks and enterprises in the Viet Nam territory, credit transactions in foreign currencies still exist. The existence of credit relationships in foreign currencies has led to the existence of a foreign currency lending interest rate and an unreasonable discrepancy between the Vietnamese dong lending interest rate and foreign currency lending interest rate, leading to taking advantage of interest rate discrepancy by some enterprises, and difficulty in managing the utilization of borrowed foreign currencies of these enterprises by the banks.

II. Foreign Exchange Rate Management Policy

In Viet Nam, the foreign exchange rate has played an important role in ensuring the stability of the Vietnamese dong's value. In the Viet Nam territory, Vietnamese dong is not used exclusively, as the citizens and economic institutions still have the right to keep foreign currencies. If the foreign exchange rate is not rationally defined or effectively managed, this will cause speculation on foreign currencies, instability in foreign exchange market and lead to spontaneous breaches of macroeconomics objectives and other macroeconomics equilibriums.

Under the subsided mechanism, the foreign exchange rate was stabilized over a long period. In that period, the foreign exchange rate was mainly related to the rate of Vietnamese dong against Rubles and partially the rate of Vietnamese dong against the US dollar. The foreign exchange rate in that period was defined subjectively by the 2 Governments to be used for conducting payment transactions between Viet Nam and the former Soviet Union and Eastern Europe.

In the beginning years of renovation, due to the changes in trading and payment transaction relationships, Viet Nam was no longer to make payment transactions in Rubles, but all payment transactions were carried out in US dollars. Thus, the foreign exchange rate relationship was mainly related to the rate of Vietnamese dong to US dollars.

- Before 1990, the Government of Viet Nam maintained a policy of 2 types of foreign exchange rates: the foreign exchange rate defined by the Government, and the foreign exchange rate of the free market. With the 2 types of foreign exchange rates and scarcity of hard foreign currencies, speculation on foreign currencies and depreciation of the Vietnamese dong developed rapidly. The Government had no ability to manage foreign exchange, or to keep foreign currency reserves.

In September 1990, the Government assigned the State Bank to define and announce the official foreign exchange rate of Vietnamese dong against US dollars and other convertible foreign currencies in consistence with market foreign exchange rates.

It was a turning point in the process of renovating banking operations toward the market mechanism with the purpose of removing the system of 2 foreign exchange rate types ,and the subsidied systems through the foreign exchange rate, to help remove speculation and the monopoly in foreign currencies for taking advantage of a discrepancy between the Government-defined foreign exchange rate and the free market rate.

Since 1991, the foreign exchange rate of Vietnamese dong has been managed in accordance with the market mechanism, with Government intervention. In principle, the foreign exchange rate has been formulated in conformity with the relationship of supply and demand for foreign currencies in the market. The State Bank of Viet Nam has intervened promptly when foreign exchange rates fluctuated significantly, making negative impact on the economy and the control of inflation in Viet Nam. The timely intervention of the State Bank of Viet Nam in the foreign exchange market is aimed at keeping appropriate, stable foreign exchange rates to help ensure macroeconomic stability for producers and foreign investors, so that they are not worried about investing in production and business development; defining a rational, stable foreign exchange rate aimed at encouraging exports, controlling imports and protecting the rights of local manufacturers. The stability of the foreign exchange rate is not synonymous with fixity of the foreign exchange rate. The foreign exchange rate is to be managed according to the relationship of supply and demand for foreign currencies in the market with Government intervention.

To measure the market foreign exchange rate, the State Bank has gradually established and improved the foreign exchange market. The first form of the market was the transaction division of the foreign exchange market. The following form was the establishment of foreign exchange transaction centers in 2 big cities: Hanoi and Ho Chi Minh City. Over approximately 3 years of operations, the foreign currency interbank market has substituted the 2 foreign exchange transaction centers. The establishment of the foreign currency interbank market is a first step paving the way for making foreign currency transactions in the orbit of the market economy.

In fact, during the past 5 years, while the foreign exchange rate was relatively stable, ranging from VND 10,500/USD to VND 11,000/USD, the economy of Viet Nam still obtained good outcomes: average annual economic growth rate was 8.2%, the average annual growth rate of industry was 13%, that of agriculture was 4.5%, that of export was between 25% and 30%, and the foreign currency reserve of the Government was sufficient for ensuring approximately 10 weeks of imports.

However, in 1996, while the economic growth rate was 9.5%, inflation was controlled at the rate of 4.5%-the lowest rate in the 5-year period of renovation, and there was an excessive trade deficit. While in the 5-year period 1991-1995, the average growth rate of exports was 20% per annum, that of imports was 22% per annum; in 1996, the growth rate of exports was 40% per annum and of imports was 38% per annum.

In the circumstances of a "very rapidly" increasing trade deficit, there have been various arguments on foreign exchange and foreign exchange rate management policy in Viet Nam.

The first type of argument said that, despite inflation, the appreciation of Vietnamese dong against US dollars was not rational. This could make negative impact on production, especially exports. Thus to develop production, and encourage exports, Viet Nam should take the initiative of devaluing the Vietnamese dong.

The second type of argument said that the current management method of the foreign exchange rate in Viet Nam was appropriate-the current outcomes of economic growth, controlling inflation and increasing exports were acceptable; it was not necessary to take the initiative of devaluing the Vietnamese dong.

The arguments still discussed by scientists. But with the objective of facilitating economic growth, controlling inflation at reasonable rates to encourage exports and control over imports, the State Bank of Viet Nam has taken the initiative of not devaluing the Vietnamese dong, and is continuing to manage the foreign exchange rate based on the relationship of supply and demand toward encouraging exports, controlling imports and ensuring macroeconomic stability.

The State Bank of Viet Nam is not passive before the spontaneous establishment of supply and demand relationship in the market, but is active in making policies of assisting the increase of foreign currency supply to the economy, while simultaneously making policies of reducing demand for foreign currencies to ensure the balance of payment.

III. Policy of Gold Management

As with foreign currencies, gold has played a considerable role in Viet Nam, because citizens have been psychologically influenced by a traditional preference of keeping gold as a reserve. The fluctuations of price of gold have partially influenced the price of goods in Viet Nam. Thus, aiming at maintaining the stability of the price of gold and not causing psychological unrest among the public, the policy of gold management in Viet Nam is also focused on achieving the following main goals:

- The State Bank of Viet Nam is an organization for managing exports and imports of gold, and precious metals. The exports and imports of gold, and precious metals are licensed by the State Bank of Viet Nam.
- Vietnamese and foreigners are allowed to bring a limited amount of precious metals into Viet Nam without being subject to taxation.
- The State Bank of Viet Nam is to control the amount of precious metals while The Ministry of Trade control gems brought out of Viet Nam.

It is prohibited to use gold in any form to make payments for traded goods or services at borders and migration ports.

Viet Nam is entering into a Five-year Plan period (1996-2000), of new development of the Vietnamese economy; a period of intensive economic market development, of industrialization and modernization, so the State Bank of Viet Nam is suggesting steps of further development in the foreign exchange, foreign exchange rate and gold management policies, with the main objective of using only Vietnamese dong in Viet Nam territory, by carrying out economic measures to manage foreign exchange; to limit the scope of foreign currency utilization in Viet Nam of driving foreign currencies mainly into the hands of the Government, increasing foreign reserves of the Government; developing the foreign exchange market to serve foreign currency transactions quickly and flexibly, actually managing the foreign exchange rate based on market mechanisms with Government intervention, being integrated with the foreign currency markets in the region and in the world.

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