# 1-G: Brief Introduction to the Current Situation of Financial and Tax Reform Process in Viet Nam


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Following the process of renovation based upon the Resolution of the 6th Congress of the Communist Party of Viet Nam on shifting the Vietnamese economy from a centrally planned one to a market oriented economy in a socialist mode with State management, the financial and tax systems in Viet Nam have been significantly reformed. However, renovation is a process taking place everywhere, from abstract theory to practice, and having been improved on a step-by-step basis, with every result obtained and every experience learnt taken into account to improve itself to a higher level for a better appropriateness to the current situation, and to respond to requirements of each stage of development of the country. According to the results obtained and current status and goals of socio-economic development described in the Party's Resolutions, the process of financial and tax reforms in Viet Nam can be divided into two stages: the starting stage (1986-1995) and the stage of renovation for modernization and industrialization of the country (beginning in 1996).

The starting stage (1986-1995) had as its main task to renew the financial mechanism and tax system to overcome the crisis and depression period.

Before that stage, the economy had been controlled by a centrally planned mechanism. The Government had been conduction socio-economic programs by making administrative orders. All economic activities (including production, distribution, trading and consumption) were carried out in accordance with State plans. State Budget revenue came mainly from the public sector in the form of SOE turnover revenue and profit contributions determined by the Government based on the principle of enough revenue collection for expenditure. During that time, the role of taxation as a tool for macroeconomic management was very limited, both in quality and quantity. Budget revenue was always shorted for current expenditure, and the inflation rate was very high, while the standard of living was very low.

In accordance with the policy of economic renovation with the development of a multi-sectoral and market-oriented economy, the law on Foreign Investment in Viet Nam was passed by the National Assembly in 1987. The economic structure of the agricultural sector was reformed; the management mechanism of SOEs was restructured with more business and financial freedoms given to them. International trade was also expanded to open up the economy to the world. In the financial and monetary sector, price controls and subsidies, and the quantitative distribution mechanism were eliminated. Fixed assets of SOEs were reevaluated for deprecation purposes and the salary system was reformed. Prices of power, fuel, and water supplies were raised to express real value of inputs of production. Associated with the renovation of SOEs structure, a policy of capital grants was designed for them, together with a responsibility for capital preservation. In 1990, the system of tax policies was first reformed with the introduction of laws and ordinances on different taxes uniformly applied to all sectors of the economy. The 1990 tax system includes the following taxes: turnover tax, profits tax, excise tax, export-import duties, agricultural land use tax, land and housing tax, royalties, business licensing tax, slaughter tax, capital user fees, and several other charges. The attributable feature of this stage in financial and tax systems is the fact that the government management has been carried out by the means of law, creating a legal framework for business activities to be run in an equitable market environment. Central planning has been removed, giving SOEs more freedom and making them more adaptable to a competitive market economy and creating favorable conditions for all sectors of the economy to develop.

In line with the improvement of the socio-economic situation in the country, the financial and tax reforms have made significant contributions to sustainable and stable growth, and to overcoming the economic crisis. The economy has gotten over depression and started to develop at a rapid pace. For the first time, all planned economic indicators had been achieved in the period of 1991-1995. Economic structures of different sectors and areas have been moved into a better direction with establishment of a multi-sectoral economy. International trade has also been expanded, with a broader international market and increased amount of FDI. Progress has been made in financial and monetary sectors as well. Budget revenue has got its main source from our domestic market, providing enough budget for current expenditures, with a certain part of it saved for development investment and debt payment. The size of development investment has increased and the standard of living has been improved.

With the achievements made over the last 10 years, Viet Nam is ready to walk into a new era of development, focusing on modernization and industrialization of the country. The starting point is the 5-year plan of 1996-2000. The main requirements of this period are sustainable and stable growth rate and better economic efficiency. Maximum capital mobilization is the key deciding factor for development. Improving competitiveness of the economy is the key factor for Viet Nam to integrate into the region's and world's economy.

The above-mentioned socio-economic objectives are requiring further improvement of financial and tax systems for socio-economic development.

Following the resolutions of the 8th Congress of the Communist Party, the National Financial Policy has been designed to focus on the following 8 areas:

① Capital mobilization and capital market development
② State budget
③ Tax system
④ Financial policy for enterprises
⑤ External finance policy
⑥ Policy on economy
⑦ Financial audit and control
⑧ Improvement of efficiency and capability of personnel in management and operation of the financial mechanism.

Based on the above-mentioned areas, the following works have been carried out:

- The Law on SOE was passed not long ago, and the rules on depreciation, and financial management in SOE were promulgated on Jan. 1st, 1997, in accordance with it. The rules on public enterprises and private sectors are to be introduced very soon.
- The Budget law was passed last year and has come into effect since 1st Jan. 1997.
- The rules on Governmental management and guarantees over foreign loans are being considered for amendment.
- New regulations on accounting standards were passed to be applied to all accounting companies and the state auditing authority.
- In order to prepare for establishment of a stock market in Viet Nam, regulations on a financial mechanism are to be passed to create a legal framework for establishment and development of

intermediate financial institutions such as insurance companies, other financial institutions, investment funds, mutual funds, pension funds, and social security funds, to expand convertible bonds and accelerate the process of privatization of SOEs. New forms of overseas capital mobilization are being developed with a focus on FDI as the main objective.

- The Government encourages all organizations and individuals to increase their savings for developing investment. The Ordinance on economization and the Ordinance on capital mobilization for infrastructure development are being draft for consideration by the Standing Committee of the National Assembly.

The following is a briefing on the current tax system in Viet Nam and the content of tax reform:

The achievements of the last 10 years in Viet Nam have created conditions for a new era of development of the country focusing on modernization and industrialization. The starting point is the Five-year Plan of 1996-2000.

The target of socio-economic development and expansion if international economic relations requires the tax system to be reformed in order to overcome its constraints in terms of narrow base, too many objectives for one tax, non-transparency, complexity, tax regulations stipulated outside of tax laws, incompatibility with international practice, etc.

Main objectives of tax reform:

- To overcome the constraints of the current tax system, taking advantage of taxation as a tool for revenue mobilization for the budget, and for the process of economic development and modernization and industrialization of the country.
- To make the Vietnamese tax system compatible with international practices, and to create more favorable conditions for international economic cooperation with the region and the world as well.
- To establish a transparent, equitable, stable tax system favorable for economic development.

The 2nd step of tax reform covers:

+ Introduction of VAT to replace the turnover tax (TT)
+ Amending the Law on export-import duties toward elimination of export duties and tariff reduction.
+ Introduction of Business Income Tax to replace the Profits Tax.
+ Introduction of Personal Income Tax to replace the Income Tax on High Income Earners.
+ Amending the Ordinance on Royalties and introducing a law on Royalties.
+ Introduction of a Law on Land Use tax to replace the Ordinance on Land and Housing tax and the Law on Agricultural Land Use tax.
+ Introduction of a Property tax.
+ Introduction of an Ordinance on Charges.
+ Introduction of a Law on Business Licensing tax associated with the regulations on business registration.

It takes time to fulfill the designed program of new tax introductions. On the other hand, to avoid any damage to business activities and budget revenue, each new tax is to be introduced in accordance with relevant circumstances and the capacity of the country. In the coming period, it is necessary to reform the most troublesome and important taxes.

There also is needed a transitional period from old to new taxes in order not to put the economy in any shock.

Upon the request of the Government, the 1996 program included submission of the Bills on VAT to replace TT, on Business Income tax to replace the Profits tax and Personal Income tax to replace the income tax on High Income Earners.

Following the decision, those Bills on VAT, Business Income and Personal Income tax were submitted for consideration at the 10th Session of the 9th National Assembly in late 1996.

After receiving suggestions from National Assembly members, the Government decided that the Bill on Personal Income tax needed further improvement to be more compatible with the situation in Viet Nam. Therefore, for now, only few changes have been made, which are: the threshold has been raised to 2 mil/month, and the provision for a tax on gifts in form of cash from overseas has been removed. The amendment was passed by the standing Committee on Feb. 20th, 1997.

The following is the main content of the Bills on VAT and Business Income tax which will be considered at the 11th session of the 9th National Assembly in April, 1997:

## Ⅰ. Bill on Value Added Tax (VAT)

### 1. Taxpayers

The VAT is to be introduced to replace the current Turnover tax; therefore, persons subject to VAT will be the same as Turnover taxpayers. They include business entities engaged in production of and trade in goods, provision of services, and importation of goods and services. However, to make it more appropriate to the socio-economic situation in Viet Nam, inheriting several provisions of the current Law on Turnover tax, the VAT is designed to provide temporary exemption to agricultural activities, production and trade in salt, transfer of land use right, credit activities, financial and banking services, medical care, movie production, education and professional training, passenger bus transportation, and irrigation services to farmers.

### 2. Methods of Tax Computation

As a general principle, VAT is imposed on the value added on goods and services during the process of production, distribution and consumption. According to current practice, the following methods of tax computation are stipulated in the Bill on VAT:

- Indirect subtraction method is applied to business entities with proper bookkeeping and invoice issuance. According to this method the tax due = output tax − input tax.
- Direct subtraction method is applied to other taxpayers. According to this method, the tax due = tax rate × (Output − Input)
- For imports, VAT due = taxable price × tax rate.

### 3. Basis for Tax Computation

The basis for tax computation is taxable price and tax rate.

+ Taxable price:
  - For domestic goods and services, taxable price is invoice selling price exclusive of VAT.
  - For imported goods and services, taxable price is import price plus import duties.
  - For processing activities, taxable price is commissions.
  - For goods sold on credit, taxable price is not installments, but the total price of each item at the time of supply.

+ Tax rate:

In addition to the rate of 0% applied to exported goods and services and processed goods for export, there are three rates of 5%, 10% and 20% proposed to replace the 11 rates of the current Turnover tax.

It is suggested that business activities and essential goods currently subject to lower TT rates will be taxed at the rate of 5% under the VAT; the rate of 10% will be applicable to activities and goods subject to middle TT rates or lower rates, but having high potential to develop; high TT rate activities and goods, or those not encouraged for consumption, will be taxed at the rate of 20%. VAT is paid on a monthly basis.

### 4. Input Tax Credit

Input tax credit is granted to taxpayers subject to indirect method of VAT computation, under which VAT due = Output Tax − Input tax. Input tax arising in a tax month is immediately credited against the output tax of the month. If the result is negative, the excess is carried forward to the next tax period. Input tax of capital goods is credited along their depreciation period.

Taxpayers buying agricultural, forestry and other products from nontaxpayers are entitled to credit their input tax equivalent to from 1% to 5% of input value. The Government is responsible to make detailed provisions on this issue.

### 5. Tax Refund

The tax paid is refunded by tax authorities in the following cases:

- Entities engaged in export activities and regularly having their input tax higher than their output tax.
- Pledge, liquidation, or bankruptcy, provided that the finalization statement of tax liability shows an excess payment.

### 6. Consideration for Tax Reduction

To make it more flexible in the transitional period from TT to VAT, the Government will consider to provide tax reductions of up to 50% for a period of up to 3 years from the time of VAT introduction to enterprises involved in production, transportation, and construction industries, and making losses due to the fact that their VAT payable is higher than their current TT.

The same treatment is granted to enterprises importing materials and making losses due to the new VAT imposed on imports.

## II. Bill on Business Income Tax

### 1. Name of the Law

At the 10th Session of the 9th National Assembly, the Cabinet submitted the Bill on Corporate Income Tax and the Bill on Personal Income Tax. After considering National Assembly members' suggestions, the Corporate Income Tax was renamed as Business Income Tax to be more compatible with the current situation in Viet Nam and to cover all kinds of business institutions established and operating in Viet Nam. The Law on Business Income Tax will also include several provisions of the current Law on Profits Tax to make it clearer, more equitable, and uniform all over the country, and to respond to the development policy of multi-sectoral economy in Viet Nam.

## 2. Taxpayers

The law on Business Income Tax is introduced to replace the Law on Profits Tax, and because the Law on Personal Income Tax has not been approved, in general, business income taxpayers will be those subject to the current Profits tax, including all organizations and individuals doing business in production, trade and service provision (hereinafter referred to as business establishment) deriving income. However, in current circumstances and with consideration of the Profits tax, farmers deriving income from selling grains of their own production will be exempt from Business Income tax. Grains are rice, maize, potatoes of all kinds, and cassava.

From the time of introduction, the Business Income tax is uniformly applied to all business entities, including foreign-invested enterprises, but not to those with investment licenses issued before the day this Law comes into effect. They will pay their Profits tax and Withholding tax stated in their licenses in accordance with the provisions of the Law on Foreign Investment in Viet Nam.

## 3. Basis for Tax Computation

Basis for tax computation are total taxable income and tax rate.

- Taxable income of a business includes income from production, trading activities and service provision (equivalent to the total revenue minus legal expenses) and other incomes, such as interest, provisional reserves, dividends, capital gains from securities, and other financial benefits.

- Tax rate: Business income tax rate is 32% applied on total taxable income of a business entity.

Inheriting several provisions of the current Law on Profits Tax and the Law on Foreign Investment in Viet Nam, there are provisions in the Bill on Business Income Tax on different rates, as follows.

+ A higher rate could be applied to enterprises involved in oil and gas industry and exploitation of precious natural resources, but not higher than 50%.

+ Preferential rates of 15%, 20%, and 25% are applied to projects newly invested in encouragible economic areas and sectors for a period of up to 60 months from the time of income derivation. The standard rate of 32% is applied afterward.

+ An additional income tax of 25% is applied to after-tax income of enterprises enjoying preferential conditions.

## 4. Tax Payment

To make it relevant to the current situation in the country, tax payment is stipulated as follows.

- Enterprises with proper bookkeeping and invoice issuance pay the tax on a quarterly basis and make finalization of their tax liability on a yearly basis at the end of each fiscal year.

+ Each year, based on its business results of the previous and the business plan of the current year, a business entity declares its revenue, expenses and taxable income, fills in a tax return provided by its tax authority, and files it with the tax authority not later than Jan. 25th of the year. The tax authority checks the tax return, estimates the taxpayer's tax liability of the year and informs the taxpayer about the amount of its quarterly tax payment. Any change in the business plan is to be informed to the tax authority for correction of tax liability of the taxpayer.

- Business individuals and households or other business entities without proper bookkeeping and invoice issuance pay the tax upon tax notes issued by their tax authorities on a monthly basis. The tax due is assessed based on monthly taxable income. Taxable income is determined by using a certain percentage of the value added subject to VAT. This percentage is determined by tax authorities after conducting a survey to make it relevant to each industry and sector. This group of taxpayers is not responsible for making a finalization statement of tax liability by the end of each fiscal year.

Mobile traders pay their tax on a case-by-case basis at the place of purchase before transportation of goods.

Viet Nam-sourced income of foreign companies without a permanent establishment in Viet Nam is taxed at the source, and withheld by income payers at the time of payment, and at a certain rate fixed by the Ministry of Finance.

## 5. Tax Reduction and Exemption

Business income tax is a direct tax imposed on the income of business entities. Therefore, certain provisions on tax reduction and exemption are required.

Inheriting the provisions of the Law on Profits tax, the Law on Encouragement of Domestic Investment and the Law on Foreign Investment in Viet Nam, and based on the current situation in Viet Nam, the Law on Business Income Tax includes the following provisions on tax reduction and exemption to be more equitable for income redistribution.

- Tax reduction and exemption are granted to newly established enterprises:

+ Newly established production enterprises enjoy tax exemption for 2 years from the time of income derivation and 50% tax reduction for the 2 following years. Tax reduction for up to 4 years is granted to newly established enterprises operating in mountainous and remote areas.

+ Newly established enterprises of encouragible investment projects enjoy 2 year tax exemption and 50% reduction for 4 following years. Those operating in mountainous and remote areas enjoy 4 year tax exemption and 9 year tax reduction.

Trading and service providing companies newly established within the framework of encouragible investment projects enjoy tax reduction for 1 or 2 years from the time of income derivation. Those operating in mountainous and remote areas enjoy 1 or 2 year tax exemption and 50% tax reduction for from 1 to 5 following years.

- Manufacturing, trading, and service-providing enterprises reinvesting to expand their size, improve their technology and production capacity, are tax exempt to the extent of the income received from new investment.

- Manufacturing, trading, and service-providing enterprises moving to mountainous and remote areas are tax exempt for 3 years from the year of income derivation in the new place.

Tax exemption is also granted to some other cases, such as:

+ Income derived from scientific research contracts.

+ Income derived from contracts on providing technical services to agriculture.

+ Income of business entities where disabled people work.

+ Income derived from professional training provided to disabled, motherless children, small ethnic groups, or disadvantaged people, at labor centers or training services provided at home.

The above-mentioned provisions on tax exemption and reduction are applied only to enterprises with proper bookkeeping and invoice issuance, and not to taxpayers subject to tax payment on presumptive method or withholding method.

# 1-H: Current Developments of the Monetary and Payment System Reform in Viet Nam

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As of the end of 1996, the Vietnamese economy has undergone 11 years of renovation with prominent achievements: high rate of economic growth-average annual rate in the 5-year period (1991-1995) was 8.2% (compared with the planned rate of 5.5%-6.5% per year). The economic structure has already shifted: the proportion of industry and construction in GDP was 22.6% in 1991, up to 29.1% in 1995; that of service was 38.6% and 41.9% respectively; the average growth rate of export value was 20% per annum. The economy has just had internal savings; the proportion of investment funds for development was 15.8% GDP in 1990, up to 27.4% in 1995(in which domestic investment accounted for 16.4% GDP). The policy of the Communist Party of Viet Nam was to continue to encourage the development of a multi-sector economy, and to mobilize all resources for economic development, thus liberate a substantial work force, and create much employment.

Inflation was pushed back and controlled at the two digit level in 1993, and at the one-digit level in 1996.

The achievements of economic growth and macro-economic environmental stability have affirmed the very important contributions of the following victories of the current monetary and payment system reform course in Viet Nam:

## I . Overall Outcomes of the Monetary and Payment System Reform in Viet Nam

Monetary reform course in Viet Nam was considered as the breakthrough step which paved the way for the transformation of the economic management mechanism from the centrally planned, subsidized bureaucratic mechanism to the socialist-oriented market economic mechanism with State management. The start for this course was a shift of some State Bank branches (which used to belong to the former mono banking system) to business units, then official establishment of two-tier banking system was defined by 2 Banking Decree-Laws promulgated in May 1990.

Over 6 years of implementing 2 Banking Decree-Laws, the relatively complete 2-tier banking system has been established.

- The State Bank has played a role of a central bank, assuming functions of state management on money, credit, foreign exchange, implementation of monetary policy, and supervision of the operations of credit institutions.
- The credit institutions have carried out the functions of trading on money, giving credit, and providing banking services in the newly-competitive environment.

It was very fundamental reform which made the banking system adapted to the market economic mechanism, strongly develop trading and banking service types to serve economic growth, and simultaneously ensure gradual stabilization of macro-economic environment through stability of internal and external value of the domestic currency.

The monetary and payment system reform have achieved the following considerable outcomes:

1) Success in formulating and implementing monetary policy through implementation of a real positive interest rate system, and adjusting the foreign exchange rate relevant to the market price and making it flexibly managed to create strong momentum for success in fighting inflation in Viet Nam.

Special emphasis was given to monetary and inflation control by the Government. Besides implementing a tight monetary policy, the Vietnamese Government has carried out a set of big integrated measures: setting up and implementing an active, practical plan of budget receipts and expenditures; increasing funds for goods management; applying price stabilization funds; setting an overall program of long-term fighting against inflation. As a result, inflation was reigned at the 2-digit level and had a gradual decreasing tendency over the past 5 years, from 67.1% in 1991 down to 14.4% in 1994; then 12.7% in 1995 and 4.5% in 1996. The State Bank has gradually become flexible, and sensitive in using monetary instruments aimed at inflation control.

The next step in the overall strategy of interest rate reform was gradually decreasing the interest rate in conformity with stabilizing and decreasing the inflation rate. Up to now, after several adjustments, the interest rate went down from 35% per year (in 1991) to 15% per year (in 1996) and has been consistent with the international practice; medium-, long-term interest is higher than short-term lending interest; the gap between the domestic currency lending interest rate and foreign currency lending interest rate has been gradually narrowed.

Despite the interest rate of Viet Nam being higher than that of other countries of the ASEAN group, it is still noteworthy that reducing the interest rate without reeruption of inflation was the success of an appropriate, flexible monetary policy. In addition, appropriate steps in adjusting interest rates created momentum to help the strategy of funds mobilization achieve encouraging outcomes, the average growth rate of mobilizing funds by the banking system in the 5-year period (from 1991 to 1995) was 24.3% per year.

The above-mentioned decisions and outcomes were all in the framework of the monetary policy of the State Bank of Viet Nam, which showed integration and relatively appropriate steps in the process of shifting to a market mechanism. Thus, monetary reform has reined in and pushed back inflation, created macroeconomic stability, enhanced public confidence in the banking system, helped encourage all resources for economic development, and improved incomes of the laborers, and social life.

2) The legal framework for banking operations has been established and improved step-by-step. Following the issuance of 2 Banking Decree Laws in May 1990, a number of legal documents and policy decisions were promulgated by the Central Bank to be applied universally to credit institutions. In the process of implementation, they have been regularly adjusted and amended to meet requirements of the real situation, which gradually helped make banking operations be in order and consistent with the principles of the legislation.

3) Monetary markets, in turn, have been set up and come into operation, such as the domestic currency and foreign currency interbank markets and the Treasury Bills auctions market. The operations of monetary market were at the primary stage, but still helped the Central Bank grasp and forecast some signals of the economy and set up some rational monetary solutions aimed at reaching the objectives of the monetary policy, meeting the requirements for development of credit institutions.

4) Ceasing currency issuance for budget expenditures led to big success with managing monetary

policy, and facilitated mastery of the Central Bank in supplying money to the economy in conformity with the objectives of economic growth and reigning inflation at the allowed rate.

5) The policy of foreign exchange management has been made and improved step-by-step toward the goals of using Vietnamese dong only in Viet Nam territory; increasing foreign currency reserves, and making Vietnamese currency become convertible in the future.

6) A system of monetary policy instruments (interest rates, reserve requirements, credit limits, foreign exchange rate, etc.) has been established and used in accordance with the situation in Viet Nam.

At first, mostly direct instruments were used; but the current tendency is towards a gradual shift, to utilization of indirect instruments. The monetary policy instruments have been used flexibly and effectively in conformity with signals from the economy, so that its objectives can be achieved.

7) The banks had initiatives in their credit operations, and the collateral forms of real estate, and the warehouse of borrowers was legitimated. The banks have shifted considerably to giving credit to the non-state owned economic sector, which drastically changed the structure of outstanding credit for investments of the economic sectors. The State funds for aiding development were provided through a system of the Bank for Investment and Development; the Government funds for fighting against famine and poverty, and for job creation projects, were provided through a system of the Bank for the Poor, and partially through a system of the State Treasury. Medium- and long-term credit has accounted for an increasing proportion of total outstanding credit to the economy. However, credit has not met demand for development. In general, credit quality has been still bad, while risks in lending activities by credit institutions have been at high rate.

8) Over the past 6 years (1991-1996), the banking system structure has drastically changed various types of banking organization and ownership.

Up to the end of 1996, there have been:

- 4 state-owned commercial banks (Industry and Commercial Bank, Bank for Agriculture, Bank for Investment & Development, Bank for Foreign Trade) and Bank for the Poor
- 23 foreign banks' branches
- 4 joint-venture banks
- 53 rural and urban joint stock banks
- 2 financial companies
- About 1,000 People Credit Funds in substantial rural zones throughout the country.

The banking network has reached populated areas. The Government has settled the issue of bad debts of enterprises owed to banks, which helped make the banking system and enterprises in the economy be healthy.

The presence of foreign banks' branches, joint-venture banks (between Vietnamese and foreign banks) and some representative offices of foreign banks in Viet Nam reflected the sense of opening Government policy in the banking field. This has significantly contributed to success in attracting foreign investment for economic development of the country.

Permitting the foreign banks to operate in Viet Nam has created competition and helped local banks rapidly approach modern technology, and step-by-step be integrated with financial systems in the region and in the world.

9) Paved the way and rapidly developed relations with international financial and monetary institutions (IMF, WB, ADB), and became a member of the international financial community, thus Viet Nam could borrow considerable funds for economic development (from ODA, FDI, etc.).

10) The emphasis was given to fairly comprehensive renovation of the payment system in 4 aspects: legal framework for making payments through the banks; diversifying payment; types,

especially intrabank payment and clearing; the payment technology to gradually modernize and spread the payment network has been to populated areas; the speed of payment transactions have been considerably expedited.

- Although the Law on Cheques has not been promulgated, as international practice, Viet Nam has a firm legal framework for this issue by assuming Government Decision 30/CP from on 9 May 1996, on Cheque payments.

- Began to apply electronic payments, completed upgrade of the clearing centers in provinces, cities, and then expanded to the zones; conducted automatic transactions through ATM, a link to the international payment network (SWIFT); helped expedite payment speed in the economy, and saved money.

- Providing equipment to serve operations of the banking system of Viet Nam has already made progress in terms of speed. So far, the Vietnamese banking system has had above 9,000 PC, and many systems have been linked, which helped rapid information processing, reduced payment processing time, and enhanced the ability to steer savings under the management of the commercial banks.

Besides the payment system through the banks, there has been a rapid payment system of the corporation of Posts and Telecoms of Viet Nam, which has operated very actively and been a competitor to help develop the payment system through the banks.

However, the development of a payment system in Viet Nam still is lacking. This was obviously showed by the small volume of non-cash payments in comparison with developing countries; cash based payment is fairly popular (cash accounted for above a third of total liquidity). The number of settlement accounts and payment transactions among the population through the banks were still small, and the population was not familiar with opening accounts or making payment transactions.

The interbank payment system has been not firmly developed and has a lot of drawbacks. Thus, transmitting money from one locality to another locality which is not under the same bank, still faces some difficulties. This requires further development of the active interaction between the banks through the interbank system, and development of clearing system in there areas, then of the nationwide clearing system (electronic clearing), and of a modern and appropriate accounting system.

11) The banking supervision system has been enhanced and its effectiveness has been improved. Now the banks are under the supervision of the State Bank and Ministry of Finance.

Emphasis has been given to establishment of the State Bank Supervision Department. Periodically, (monthly, quarterly, annually) the State Bank Supervision has gathered data, so as to carry out remote supervision and on-line supervision programs. However, the effectiveness of the banking supervision activities have been considered low due to the delay in discovering and timely preventing of violations of regulations on banking operations.

## II. Orientations of Further Development and the Issues of Monetary and Payment System Reform in Viet Nam

The outcomes of the monetary and payment system reform have been encouraging, which affirmed the correctness and appropriateness of the strategy and the steps in the framework of banking system reform. However, in the next period, the new tasks of the economy and their objective are achieving high and stable growth with macroeconomic stability, i.e., controlling inflation at the one-digit rate with a narrow ranging band. Ensuring the relationship between the objectives of rapid growth and stability of the economy is placed before the big challenge of the possibility of being far backward in comparison with other industrial countries in the region and in the world. Therefore the monetary and payment system reform course in Viet Nam faces many new challenges:

- It should be rapidly integrated with and be affiliated to the financial community in the region and in the world. Foreign economists have commented that there has been a wide gap between the banking field in Viet Nam and that around the world in terms of qualification.

- With the requirements of rapid development of the economy, the key task of the current period, as especially defined, is enhancing the industrialization and modernization course of the country. The demand for funds for economic growth is very big, and it is necessary to have solutions in the circumstances requiring regular preventing and correct settling of the hidden factors causing inflation.

- The financial markets of Viet Nam have been underdeveloped.

- Domestic savings and investment have not met the requirements of rapid economic growth.

Thus, it is noteworthy defining that the monetary and payment system reform course in Viet Nam has to solve many issues and focus on the following key issues:

- Rapid developing of the financial-monetary environment, increasing savings and investments.

- Continuing to formulate and complete appropriate legal structure to meet the requirements of international cooperation and competition in the finance and banking field.

- Defining rational and flexible relationships among the foreign exchange rate, tariffs, interest rates and other monetary variables to ensure a healthy, fair business environment for all subjects.

- Ensuring that the monetary reform be integrated with other macropolicies reforms, especially financial and fiscal policies reforms.

- Enhancing competitiveness of the local banks and financial institutions, and regarding that as fundamental condition for ensuring equality and mutual benefits in relation with foreign partners.

With regard to key tasks and issues of the monetary and payment system reform course in Viet Nam to be solved in the next period, some detailed programs to be implemented can be defined as follows:

First, formulation of an integrated and complete legal system which will be appropriate to the new stage of the economy-Upgrading 2 Banking Decree Laws to a set of Banking Laws, improving and amending the economic laws concerned, such as Law on Trade, Law on Land, the stipulations on collateral, mortgages and real estate business.

Second, completing the monetary policy of the State Bank, shifting from mainly utilizating direct instruments to utilizating indirect instruments to manage monetary policy.

Third, promoting mobilization of both domestic and foreign funds by the banking system, strongly developing the money markets and the capital market. Encouraging increase in medium-and long-term credit for investment to serve economic restructuring and investment more, as for all economic sectors.

Special emphasis is to be given to completing the credit mechanism: credit insurance, deposit insurance, minimizing risks, improving funds, and system safety.

Fourth, making the foreign exchange management policy consistent with the development tendency of Vietnamese economy, then consistent with international practice and the stipulations of the international organizations and groups of which Viet Nam is a member (IMF, ASEAN, etc.), facilitating expansion of international financial relationships and gradually participating in the international financial market.

Fifth, perfecting the supervision mechanism over the operations of banks and financial institutions to ensure the system and create fair competition among the banks.

Sixth, gradual standardization of the accounting system of the banks in conformity with international norms, rapid implementation of banking technology modernization program which has a core of modernization, automation of payment system based on the projects funded by international financial organizations, strongly developing the payment system in the populated areas toward providing home banking services.

Seventh, continuing to perfect the organizational model of the banks and financial institutions, enhancing training and improving the knowledge of qualified staff with good behaviour who have regularly upgraded their marketing and professional knowledge to be able to fulfil the new tasks of the banking system at this new stage of country development.

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# Economic Reform and Fiscal Management of Viet Nam

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## I. Introduction

Viet Nam started its economic reform toward market in the middle of the 1980s in the midst of turmoil on both political and economic fronts. The war with China, and the succeeding collapse of the Soviet Union which terminated the life-support assistance to Viet Nam pushed the country to the reform, and the severe budget deficits due to heavy price subsidies granted to state owned enterprises and farmers put the economy under chronic three digit-inflation. Viet Nam officially declared its serious reform package at its Sixth National Congress in 1986, which was dubbed "Doi Moi" (the renovation). However, the fact would rather be that the country had no other option but to invite market mechanism to get rid of the vicious circle of subsidies and rampant inflation.

The reform seemed to be a success in controlling the inflation and guided the economy to the unprecedented growth rates which have never been realized in Viet Nam. However, another side of this good news would be that it has given the government a leeway to rethink of its reform package, and the progress toward the market seems to have stalled. The long-awaited financial market has never come into being and the private sector has not been emerging as an engine for the next stage of development. The restriction even toward foreign companies doing business in Viet Nam has not been much liberalized; much worse, as the recent statistics on the disbursement of the FDI (Foreign Direct Investment) shows, foreign partners have been getting reluctant to investing in Viet Nam.

What has been going on in Viet Nam behind the mist of seemingly good macro-economic achievements? And how has the government been managing its fiscal policies on both revenue and expenditure sides? The purpose of this paper is to deal with these problems using as much data as possible, and to draw the course of development that Viet Nam has undergone since it began its multi-sector and market-oriented reforms.

The research on Vietnamese fiscal management so far has been almost dominated by the works done regularly (as in publications of the country report) or with special purposes by foreign assistance-related organizations, both multilateral and bilateral: the World Bank (1992, 1995a, 1995b, 1995c, 1996), the IMF, the Asian Development Bank, the United Nations Development Program, The Japanese Overseas Economic Cooperation Funds (1995). Spoorner (1988) is an exception and discussed the state finance under Viet Nam's socialist period and estimated the magnitude of budget deficits. However, the research on the fiscal policy in Viet Nam over the reform period has been as much scarce as the pre-reform era and may be said to be long overdue. This paper attempts to examine this open field and seeks to contribute to conceptualizing the nature of the public finance problems in

Viet Nam in its transition to a market economy.

The paper proceeds in the following manner. The second section starts with reviewing the Eighth National Congress in 1996 and locates the way the Communist Party (the Party, hereinafter) views the role of state sector for economic development. The review goes on to show how the Party regards the problems in fiscal policy. With this as a prelude to understanding the reform strategy of the government, the Vietnamese economy over the reform period will be overlooked. The third section traces the development of fiscal management over the reform period: macro-economic review of revenue collection will be our first agenda; and structural, or more intrinsic, characteristics of Vietnamese tax system will follow.

The fourth section turns to the intergovernmental fiscal relations and shows that the country has been heading more toward centralization than decentralization. While this itself is a descriptive statistics on Vietnamese fiscal policy, the paper goes a step further to test how the state investment, i.e., a critical source for development in this capital deficient economy, has been determined over provinces. The fifth section will do this job, and will show that the investment allocation has been influenced significantly by regional balances, and thus, being able to grow faster has not guaranteed more investment in Viet Nam.

The last section concludes the paper by conceptualizing the nature of the government in Viet Nam. The messages here would be as follows: too much emphasis of the government on the state sector has ended up with the fragile revenue sources, and too much concern with regional balances has dispersed investment over the country and discouraged the fiscal efforts of local governments. In Viet Nam, to grow faster and to become bigger is rather difficult; private businesses have to be in balance with the state businesses, and provinces have to be treated equal in every respect. A question that the government of Viet Nam will have to answer soon is whether it can proceed the path toward market having everything this much in balance.

## II. The Economy of Viet Nam Over the Reform Period

### 1. How Does the Party View the State Sector?

In its political report at the Central Committee (Communist Party of Viet Nam, 1996), the Party has defined its multi-sector economy. Let us start this section with receiving the resolution of the Party; we will go first to the state sector.[1]

Simply put, the state sector will be assigned all the power to manage the economy. And it will be playing a leading role for it. Then, where will be its main playing fields?[2]

The playing fields naturally are restricted to the "vital branches". However, the branches that have been defined by the Party are very wide and far reaching, encompassing, in fact, every field of economic activities including baking, "important production" and even service sectors. Under the

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[1] To continue renewing and delivering effectively the *State Economy* to make it play its leading role well: to serve as a lever for rapid economic growth and settlement of social issues; pave the way for, guide and support other sectors to develop along; serve as the material force for the State to perform its macro-level regulatory and managerial functions; and lay the foundation for the new social regime. (p. 51)

[2] To concentrate resources on developing the State economy in such vital branches and areas as social and economic infrastructures, financial system, banking, insurance, important production, trade and service establishments, and a number of enterprises undertaking tasks related to national defense and security. State enterprises in general shall be medium or large sized, equipped with advanced technology, run with efficiently and able to generate large budget surplus. (p. 51)

presence of these wide-raging activities of the state sector, how will individuals and small owners be treated?[3]

Small players can join the game, but what the Party is saying to them amounts to this: When you grow big, you are a part of us. Granting that political resolutions may not reflect economic dynamics, we still have to note that the Vietnamese multi-sector policy is not enhancing competition among its participants, and that the state sector is offered a reserved seat in the process of reform toward market.

With the path toward market thus defined, the Party discusses the 1996-2000 five-year plan. Various weaknesses and shortcomings of the economy are examined, and in a section headed by "Financial and monetary situation remains unstable and unhealthy," the weaknesses of the fiscal policies are pointed out:[4]

Candid as they may, self examinations here are rather unorganized; in fact, every aspect of public finance in Viet Nam looks weak, ranging from the budget, the tax system, the local finance and the finacial situation of state enterprises. An important question to be raised here would be whether the enumerated difficulties are mutually independent, or rather they have come from the same source and, therefore, they are closely interrelated. The rest of the paper will be devoted to answering this question.

## 2. Three Characteristics of the Economy Over the Reform Period

Given the strong determination of the Party for strengthening the state economy, we would like to portray the real economy. We will do this from three perspectives: the magnitude and growth rates of the state sector, the process of capital formation and the macro imbalances sneaking from rising imports. The picture we draw here is the expanding state sector under the incredibly limited supply of funds for investment and the important role of the FDI in supplementing the state investment and in sustaining the growth of the economy.

### (1) The Expansion of the State Sector

The assistance from the Soviet Union was terminated in 1989, and the bleeding reform that slashed significantly the number of state enterprises and cut the budget deficits very deeply was initiated in 1990. The two years, 1989 and 1990, witnessed the harsh belt-tightening adjustments. The economy started to rebound since then, and eight to nine percent real GDP growth rates has continued.

How has the state sector managed to survive during this reform period? Tables 1 and 2 show the GDP data of the state sector in comparison with the total and the non-state sector. The state sector's shares of GDP of various industries are depicted in Table 1. In total industries the state sector's share was about a third of the total in 1990 and 1991. But, along with the accelerated growth thereafter its share has increased to slightly more than forty percent. Vietnamese agriculture has been predominantly the non-state sector's activity, and the state's contribution has stayed at about three percent.

Probably, the most noteworthy development has occurred in the industry. The industry in the

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[3] To guide individuals and small owners, in their own interests and for the sake of production development, to step by step join in cooperatives voluntarily, or to work as satellites for State enterprises or cooperatives. (p. 54)

[4] The State budget finds itself in constant tension, laden with large deficits. The tax system is still complicated, with overlapping and irrationalities, which not only provides little incentives to production but also is fraught with loopholes. The decentralization of budget management is not yet rational, both scattered and over-centralized, and inconsistent, leaving room for rampant negative practices and constraining dynamism and creativeness. National asset, public finance and corporate finance of State enterprises remain poorly administered, resulting in considerable losses and waste. (pp. 124-25)

industry total (this should better be called manufacturing) has been the place for state enterprises in Viet Nam, and the sixty five percent of the industry's GDP was produced by state enterprises in 1990. This share has risen since then to reach more than seventy percent in 1994. Almost the same observation applies to the transportation and communications whose services have been predominantly supplied by the state sector.

These findings are confirmed in a more straightforward way when the industrial growth rates are compared between the state and the non-state sectors. Table 2 shows the results. The growth rates of the GDP of the state sector in total industries have consistently been twice as high as the non-state's. This difference between the two sectors is more striking in the industry in the industry total (i.e., manufacturing industry), and the two sectors' growth rate differentials seem to be significant in some of other industries.

The two tables, thus, point to the facts that the state sector has occupied sizable shares in certain industries like manufacturing, transportation and communications, and its shares have indeed been growing faster than those of the non-state sector. The Party's commitment to the state sector has really been materializing through its reform process.

**(2) Shortage of Capital for Investment**

The second characteristic of the economy of Viet Nam to which we pay our attention is the extremely severe shortage of capital. And this has resulted in very shallow investment of the state sector. Investment data of Viet Nam are very difficult to interpret; and it is even more difficult to sort the state investment out from the gross capital formation. Mere GDP statistics that has been reported by the World Bank and the IMF are hardly sufficient to do the job.

Table 3 shows the GDP data reported by the IMF with one modification; gross investment is divided into three categories. That is, the state investment, foreign direct investment and other investment now construct the total investment. Of the three types of investments the state investment has been taken from the Statistical Yearbook of Viet Nam, and the state investment in parenthesis in the table is the capital investment taken from the budget, which we understand finances the public investment.

Now, the numbers in 1995 read this way. The total GDP of the year amounting to 222,840 billion dong consists of domestic demand, 246,966 billion dong, and the trade balance, minus 24,126 billion dong. The domestic expenditure is further decomposed into gross capital formation and consumption, which are 60,488 and 186,478 billion dong respectively. While these numbers suggest very high propensity to consume and are important by themselves, the focus of our interest here lies in further breaking down the contents of gross capital formation.

The gross capital formation of 60,488 billion dong comes from the state investment, the FDI and the residuals, which respectively are 21,500, 19,646 and 19,342 billion dong. Since the capital investment of the government is 13,306 billion dong in this year, subtracting this from the state investment should give us the investment by the state enterprises, which turns out to be 8,194 billion dong.

If we can reach the gross investment of the state enterprises in this way, we can claim how small the investment of the state sector has been. In fact, the gross investment of the state sector in 1995 was much smaller than that of the FDI.

Table 4 shows GDP components in proportion to GDP. From this table we can find out that the gross capital investment of the state sector was only one to two percent of GDP during 1990 and 1992, and three to seven percent of GDP in the succeeding years. Note that these are the gross investment numbers, so in some years the net investment could have even be negative. And we can also find out that the gross investment of Vietnamese state sector has been more or less the same in magnitude with the FDI, showing the nation's very high dependence on the FDI for its capital formation. Thus, we can see clearly from Tables 3 and 4 that Viet Nam has been suffering from the shortage of investment funds; and moreover, this has not much been changed behind its high growth performance.

**(3) Rising imports and Trade Imbalances**

The other side of the coin of the excess of investment over savings is the trade imbalances. In fact, Table 5 shows this problem has been getting from bad to worse; the proportion of imports in 1990 was 28.5%, but it went up to a startling 46.8% in 1995. The resulting trade imbalance, too, are staggering; ten percent of the GDP was in short in Viet Nam to meet its rising imports in 1995. The bottom two rows of the table are the elasticities of exports and imports to GDP, and the numbers here indicate that Viet Nam's appetite for foreign goods are responding to its economic growth stronger than the demand for the Vietnamese goods.

## III. Development of Fiscal Management

### 1. Improved Budgetary Management

In a country like Viet Nam that has been suffering from severe shortage of capital, savings has to be supplemented by the government. Thus, it is understandable that tax reform was undertaken at the very early phase of the reform period. In 1990 various efforts were paid made to strengthen the government revenue. First, the legal framework of taxes was introduced: the turnover tax and the profit tax were defined as the laws, replacing revenue transfers from state enterprises; the taxes on tobacco, beer and spirits were transformed into the excise tax (the special consumption tax); and the law of export and import taxes was also introduced. Other legal framework like tax ordinances and decrees (including capital-user fees for state enterprises) was also actively employed to raise tax revenue.

The second institutional reform for increasing revenue was to set up the General Department of Taxation at the Ministry of Finance. Before the reform taxes were collected separately from the three organizations: Department of the State Sector, Department for Industrial and Commercial Sector and Department of Agricultural Sector. In other words, the transfers and turnover taxes by the state enterprises were managed by the first two departments, and the agricultural tax by the third. An important aspect of this reform is that the General Department of Taxation set up its local counterparts at provinces (fifty three altogether) and districts (a little less than six hundred over the country), and the administration costs as well as the wages at local offices were paid by the Ministry of Finance. While the personnel working at local tax departments did not change and only the source of their remuneration was changed from local governments to the central ministry, this organizational reform was an important step toward centralizing the tax administration.

Related to this, another administrative reform that helped strengthen the central government's tax collection was made; that is, certain taxes were earmarked for the revenue of the center. The export and import taxes have been reserved fully for the central government, though it is the custom offices of provinces and the cities that collect them. The special consumption tax has also been reserved fully for the center. These two taxes alone should have a big boost to the tax revenue of the central government. As for the profit tax, the proceeds from the centrally managed state enterprises like railways, postal offices and power companies are collected by the central government, and the rest shared between the center and the localities.

These efforts for raising tax revenue have turned out to be effective over the reform period. Table 6 shows the budget operation over the period the financial data are available. Of several interesting budgetary outcomes over the reform period we would like to stress the following two.

The first is the sharp decline of the budget deficits. The last row of the table gives the fiscal balance (in cash basis, i.e. the balance that remains after making necessary adjustments for interest payment and arrears) in proportion to GDP. As was alluded to at the outset of this section, the fiscal house of Viet Nam was deep in red before the serious reform took place. The year 1990 was the first year of such reform, and the years that follow have seen a drastic decline in fiscal deficits. The budget deficits of this order are really amazing, and the rate of inflation also has subsided significantly along this tight budget control, i.e., the rate of consumer price increase was above three hundred percent in 1989, whereas the corresponding number in 1995 about ten percent.

The second important fact of the budget management of Viet Nam is the sharp increase in revenue. The first row of Table 6 reports the proportion of the total revenue and grants to GDP. The major tax reform that took place in 1990 contributed to raising tax revenue very sizably; the government revenue in proportion to GDP has increased about ten percent from 1990 to 1995, and it has reached more than twenty percent along the process of reform. Probably no other transitional economies have ever achieved this high government revenue over less than a decade of reform.

## 2. Unstable Revenue Sources

Viet Nam's reform of budget management has, thus, been a success in mobilizing resources by the government. However, just as in the outcome of good macro-economic performance, noteworthy structural problems have been emerging; that is, behind the soaring revenue the government's dependence on a handful of taxes has been increasing significantly and the revenue sources of the country have become fragile.

Table 7 shows the structure of revenue where major taxes and other revenues are divided by the total revenue. The first row is the transfer from the SOE's (State Owned Enterprises). This was the tax in the socialist era in Viet Nam, but its share in revenue has consistently been declining over the period of reform. However, from practical point of view, it might be better to say that this tax still occupies about forty percent of the total revenue and by far the largest of the all revenue sources.

The second row of the table is the non-tax revenue, and it essentially comes from the exploitation of oil. Grants have two-to-three percentage share of the total revenue, but they are not a major revenue source. The fourth row is the taxes from imports and exports, and they are increasing very sharply; in proportion to the total revenue they have increased more than triple from 1986 to 1995, and they are as large as about seventy percent of the transfers from the state enterprises in 1995.

The last three rows of the table show the characteristics of revenue structure in Viet Nam. That is, the total of the taxes and other revenues in the table per se sum up to more than eighty percent of the total revenue. That this ratio was high before the reform period is nothing unusual. However, an interesting feature of the Vietnamese tax system is that the contributions from state enterprises have been replaced by the taxes on international trade. This fact reveals an important aspect of Viet Nam's tax structure: taxes on market activities by consumers, agricultural households and other non-state enterprises have not been developed, and the tax system of the country has essentially been unchanged over the reform period, carrying the archaic features of the socialist regime.

How narrow, then, is the tax base? One index that we can calculate from the limited fiscal data in Viet Nam would be the tax to GDP ratio of relevant economic sectors. The sectoral GDP may not be a proper tax base when considering income-base taxes, but this is as much we can do for presenting information about the tax base in Viet Nam, given especially the available data.

Table 8 shows our results. Their implication is very clear: In Viet Nam, taxes have been paid by the state sector. The sector has contributed about thirty percent of its value-added to the government, probably before and throughout the reform period. And the decline of their tax burden in 1995 was due to a reform that returned depreciation allowances to the state enterprises. This, however, should not be called a tax cut, for the deprecations are going back to where they should.

The tax to GDP ratios of non-state and agricultural sectors are very low. While there are many discussions and anecdotes that these sectors have been charged with various other non-tax and non-official contributions, the (official) tax they pay is exceedingly small. Making unofficial tax burden official and achieving better tax compliance is no doubt one of the top priority issues in taxation in Viet Nam, but widening the tax base for more stable revenue would be as much important agenda of reform for the country.

## IV. Intergovernmental Fiscal Relations

### 1. Strengthened Fiscal Centralization

Integrating a country and achieving the highest growth rate are sometime not a consistent policy goal, but two conflicting ones. This seems to apply to Viet Nam as equally as to any other country, for the country became one nation only in 1975 and has more than fifty (actually after recent separations, sixty one as of 1997) provinces. In fact, local problems are everywhere in Viet Nam, ranging from the nation's politics, where the General Secretary of the Party, the Prime Minister and the President are skillfully balanced in their affiliation to local places, to the allocation of budget, where incredibly many rounds of negotiations have been taking place every year between the center and provinces.

Probably no policy in Viet Nam has been prepared without due concern to provincial balances. And fiscal relations between the center and provinces are the core of regional problems. We will turn to this issue and claim that Viet Nam has been strengthening fiscal centralization over the reform period. This observation will be carried to the next section where we will overlook growth performance over regions and examine how state investment has been allocated to various provinces.

Table 9 summarizes the overall fiscal relations between the center and provinces. The numbers in 1989 were taken from the World Bank (1992) and the rest from Ministry of Finance of Viet Nam, and some of the critical numbers were not available in 1990. Therefore, the data are not complete in reading fiscal relations over the entire years from 1989 to 1995. The data are constructed as follows. The row (a) is the revenue collected locally, to which two adjustments are made: the transfer to the center, the row (b), and the receipt from the center, the row (c). The row (d) (=(a)−(b) + (c)) gives the net revenue of local governments, and this has been set equal to the local expenditure, for local governments have to balance their budget in Viet Nam.

Similar adjustments have been made to the budget of the central government. The transfer from the localities is now the receipt of the central government and is placed again at the row (h), and the transfer from the center to the localities is now shown at the row (i). The net revenue of the center is show at the row (j) (=(g) + (h)−(i)). The central government's expenditure is shown at the row (k) which, unlike the counterpart in the localities, has been more than the net revenue. The numbers here are all aggregates and compatible with the budget data.

Now, we have calculated three indexes. The first one is the local to central net revenue ratio, which is the ratio of (d) to (j) and is shown at the third row from the bottom. That this ratio was 1.06 in 1989 indicates that the localities received more revenue than the center after adjustments were made about the transfers between them. The numbers in the succeeding years of the reform period are very striking; that is, the localities have persistently been losing the capacities to raise revenue on their turf. Local governments collected as much revenue as the center at the time the economic reform started, but several years of reform enabled the central government to raise twice as much revenue as the local counterparts.

Although the direction of change has not been as straightforward as in the revenues side, the proportion of expenditure made available by the localities seems to have declined over the reform period. The index we have prepared is the ratio of the rows, (e) to (k), and is shown at the row (o). The qualification on the data of the year 1989 that we mentioned above applies here, and this year's numbers do not seem to fit well with those of the rest of years. However, over the succeeding years of reform, it seems that the expenditures of localities have been expanding less than the center.

Local governments have, thus, been giving way to the central government in both revenue and expenditure management. This has resulted in the decline of the proportion of revenue to expenditure in local governments. The last row of Table 9 gives the local revenue to expenditure ratio, and it has gone down very sharply. That is, the capacity of localities in mobilizing resources has become smaller over the reform period.

## 2. Distribution of GDP, Revenue and Expenditure Over Provinces

Having discovered that the fiscal pendulum has swung toward centralization in Viet Nam, we would like go on to see how GDP, revenue and expenditure have been distributed over provinces. For this we have done two sets of calculation: the Gini coefficients of respective variables at the provincial aggregate level; and those of the same variables at the per-capita level. Tables 10(a) and (b) report the results of the calculation.

Table 10(a) shows the degree of concentration of various variables at the provincial aggregate level. Three observations seem to be worth mentioning here. The first is that the provincial GDP has had a trend of further concentration. However, the second fact is that Gini coefficients of provincial revenue are much larger than those of GDP and have a clearer trend of increase. Since the revenue sources are so narrow in Viet Nam as we have seen at the preceding section, provincial revenue tends to concentrate more than their GDP.

The third fact we would like to pay our attention is that public expenditure has been distributed more equally than either GDP or the revenue. In fact, the Gini coefficients tell that the degree of distribution in expenditure has been very equal in Viet Nam.

Table 10(b) shows the Gini coefficients at the per-capital level. Since the economic and population sizes of provinces are so wide ranging, discussion at the per-capital level should be more relevant when we deal with the distributional aspect of fiscal policies. In fact, the Gini coefficients at per-capita level turn out to be much smaller than the aggregate level, though the three characteristics above apply equally here.

We can also confirm that the differences in the coefficient between revenue and expenditure at the per-capital level are as large as at the aggregate level. Additional discoveries at the per-capita level are that there are some differences in the coefficient within the expenditure. That is, the current expenditure has a smaller coefficient than the capital expenditure, and basic social expenditures like education and health have even smaller coefficients.

Thus, the picture of provincial distribution of revenue and expenditure that comes out from these observations is this: the provincial revenue that concentrates most has been split widely over provinces. And the way the public expenditure has been distributed in Viet Nam appeals to our common sense that social expenditure needs to be more equally distributed than other expenditures.

# V. Determination of Investment Over Provinces

## 1. Seven Regions in Viet Nam

Distributing social expenditure over provinces as equally as possible would be a sound policy from equity as well as growth perspectives, for the society will never be stable unless good social infrastructure is offered to the pubic. In a sense, a sound economy rests with sound social expenditure. However, distributing everything equally would discourage the incentives of the people, enterprises and local governments to work harder and to take better care of themselves.

Moreover, some of the public expenditures for provinces, most notably the capital expenditure, are crucial to their growth. Hence, putting too much emphasis on distribution and scattering capital expenditure about would not be a good policy, either. This should apply the better, the more capital deficient the economy is. Therefore, an important inquiry into the distribution of the public expenditure in Viet Nam is to show to what extent regional balances have mattered against growth.

We will deal with this question by classifying provinces into seven regions. This classification is nothing special and seems to represent the Vietnamese configuration of their country well. The seven regions are: North Central, Red River Delta, North Central, Central Coast, Central Highland, South East and Mekong River Delta.

Hanoi and Hai Phong belong to Red River Delta, and this region is the center of the north side of Viet Nam. Quang Nam-Da Nang (now separated into two) is at the Central Coast and this is a middle land of the country. Ho Chi Minh City (HCMC), Song Be (now separated into two), Dong Nai and Ba Ria-Vung Tau are located in the South East; needless to say, the center of the south side of Viet Nam. Mekong Delta, which consists of several provinces, is the food basket of Viet Nam and has contributed to rice export. The rest of the regions surround these four, and are economically more dependent on the center than those we gave a simple profile here.

Tables 11(a) and (b) show the GDP by region: regional shares of the GDP are shown in Table 11(a); and the GDP growth rates by region in Table 11(b). The tables give us an overview of the economic landscape of the country. Almost a half of the nation's gross output has been produced in the two regions in the south, and of the remaining half, about sixty percent has been coming from the two regions up north and the rest from the central part.

Table 11(b) shows that growth rates have been increasing over the years except for a noticeable decline in Mekong Delta. The reason for this is that agriculture has not grown as fast as other industries. The table also reports another evidence that the South East has been growing much faster than any other region; and this explains the increasing share of GDP of the region in Table 11(a).

Against this background we go to Table 12 which shows the expenditure to revenue ratios by region. We are interested in seeing here how the emphasis on equal distribution of the public expenditure has found its way into regional discrepancies in expenditure to revenue ratios. And the results are very much in line with our observation in the preceding section; those regions (relatively) rich and endowed with good revenue sources have been much taken away of what they have collected. The South East which is big and has been growing faster can now keep only less than twenty percent of their revenue for their own expenditure, be it for consumption or for capital investment.

## 2. Regional Allocation of Expenditure and Determination of Investment

Given this thorough distribution of expenditure over provinces, we would like to get into the determination of provincial allocation of investment. Basically, our idea is to identify heuristically the regional bias toward the investment and to explain it by simple regressions, using provincial investment data and regional dummy variables. Through this analysis we would like to show that the investment to GDP ratios of the provinces in southern part of Viet Nam, i.e., the South East and Mekong River Delta, have been set significantly lower than elsewhere. Thus, in Viet Nam, being able to grow faster does not necessarily imply having easier access to the state investment.

Tables 13(a) through (f) compare seven regions from several viewpoints. Total expenditure and revenue in proportion to GDP are shown by region, Tables (a) and (b). The capital expenditure by the local budget, and the state investment of both central and local provisions are also shown in proportion to regional GDP, Tables (c) and (d). The shares of expenditures in education and health to GDP are reported in Tables (e) and (f).

Tables 13(a) and (b) are somewhat repetitious of our preceding discussion, but the numbers in proportion to GDP give us more specific ideas about the extent of expenditure distribution and the differentials in tax burden over regions. Taxes tend to be the heavier, the more industrialized the region is, i.e., the more state enterprises the region accommodates. Comparison of Tables 13(a) with (e) and (f) reinforces one of our claims that social expenditures are distributed more uniformly than total expenditure, although the educational expenditure per GDP in the South East seems to be consistently below average.

Now, what about the regional differentials in investment? Do they point to the direction of more growth or more regional balances? Table 13(c) shows the local capital investment to GDP ratios. Overwhelmingly low levels of investment aside, the investment per GDP can be observed to be smaller in more prosperous regions than others. Though slightly higher than the regions in south, the local investment to GDP ratios in Red River Delta have also stayed smaller than its northern neighbor and central regions.

The last observation above, however, is corrected by Table 13(d), which shows the state investment to GDP ratios. Here, the state investment includes both center-to-local and local-self investment. Now, Red River Delta looks different from Southern regions, and it goes along better with northern and central regions. Thus, it looks as though local investment has been controlled by the two hands: the one from the center and the other from local governments.

Tables 13(c) and (d) facilitate our examination on the determination of provincial investment. We have a data set consisting of fifty-three provinces' GDP and the two types of investment, i.e., the local capital investment and the state investment. Using this, we have regressed the provincial investment to GDP ratios to the two dummy variables for each year: the first dummy variable, Region 2, which returns unity when the province belongs to Red River Delta, and zero otherwise; and the second dummy variable, Region 6&7, which is set unity when the province belongs either to the South East or Mekong River Delta, and zero otherwise. Regressions were run with the constant term, which should turn out to be the average investment to GDP ratio of the regions other than Red River Delta or the two southern regions.

The results of our regression are summarized in Table 14. Table 14(a) reports the case where the provincial capital expenditure is used as the local investment, and Table 14(b) the case where the state investment is taken. The results support our heuristic observations above. In Table 14(a), the estimated coefficient of the dummy variable Region 6&7 is significantly different from zero and negative over the regression period. The other dummy variable for Red River Delta has also been negative, but is not significant throughout the years of estimation.

Table 14(b) conveys more straightforward results. The variable Region 6&7 is negative and significant at the one percent level over the three years of our regression, whereas the other dummy variable, Region 2, is not significant (at the five percent level) in any year of our estimation. Thus, Tables 14(a) and (b) conform to our observation that the provinces in southern regions have been given less favorable allocation of capital than the rest of regions comprising the north and central parts of Viet Nam.

## VI. Conclusion

We have started this paper by participating in the Eighth National Congress in 1996. The message that we have received from this once-every-five-years gathering has been that the state sector will continue to assume a "leading role" in the path toward a market economy. The multi-sector economy so oft-repeated by the Party seems to be best conceived as a pyramid-shape one with the state sector at the top and the rest of sectors serving as "satellites" for state enterprises.

After a really painful time from 1989 to the beginning of the 1990s, the economy of Viet Nam seems to have been set on the track laid out by the Party and has been growing at unprecedented high rates. And behind this rapid growth the state sector has been expanding much faster than other branches of the economy, and the central government has been strengthening its capacity to manage fiscal affairs.

The tide seems to be on the side of the government. However, as we have seen at the outset of this paper, it is also the fact that the government has recognized serious problems have been coming up to the surface. As such it has referred to problems in the budget, tax policy, intergovernmental fiscal relations and the financial situation of state enterprises. And we agree that these problems are important enough to review the policies so far employed.

However, a more essential question would be whether the difficulties that the government have been concerned with are those that can be overcome through the process of growth advocated by the government, or the very outcome of the policies taken by the government. The government would quite naturally emphasize the transitory aspects of problems and seek to convince the public that state sector will take them out of the present difficult situation.

The paper has dealt with the same problem from a different angle, and has offered different perspectives about the future course of events. It would rather note that too much emphasis of the government on the state sector has made the tax base fragile, and too much concern with regional balances has distributed investment too thinly over the country. The outcome of these excessive commitments of the government at every corner of the economy would discourage the people, private enterprises and local governments to take their own risks to grow bigger. The paper, thus, envisages that the government of Viet Nam will have to face more squarely the outcome of their policy.

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Table 1 Shares of GDP by economic sector (%)

| Year | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|---|---|---|---|---|---|---|
| Total | | | | | | |
| State | 32.5 | 33.3 | 36.2 | 39.2 | 40.2 | 42.3 |
| Non-State | 67.5 | 66.7 | 63.8 | 60.8 | 59.8 | 57.7 |
| Agriculture | | | | | | |
| State | 2.9 | 2.9 | 2.7 | 2.8 | 2.9 | 2.8 |
| Non-State | 97.1 | 97.1 | 97.3 | 97.2 | 97.1 | 97.2 |
| Industry-Total | | | | | | |
| State | 62.8 | 63.5 | 64.7 | 65.7 | 65.2 | 66.1 |
| Non-State | 37.2 | 36.5 | 35.3 | 34.3 | 34.8 | 33.9 |
| -Industry | | | | | | |
| State | 65.3 | 67.2 | 69.8 | 71.4 | 71.9 | . |
| Non-State | 34.7 | 32.8 | 30.2 | 28.6 | 28.1 | . |
| -Construction | | | | | | |
| State | 51.0 | 45.3 | 45.0 | 49.4 | 45.9 | . |
| Non-State | 49.0 | 54.7 | 55.0 | 50.6 | 54.1 | . |
| Services-Total | | | | | | |
| State | 44.2 | 47.5 | 45.5 | 46.9 | 48.1 | 51.0 |
| Non-State | 55.8 | 52.5 | 54.5 | 53.1 | 51.9 | 49.0 |
| -Transport and communications | | | | | | |
| State | 60.0 | 60.5 | 68.4 | 68.3 | 68.3 | 72.0 |
| Non-State | 40.0 | 39.5 | 31.6 | 31.7 | 31.7 | 28.0 |
| -Trade | | | | | | |
| State | 33.0 | 28.0 | 26.0 | 23.2 | 25.6 | 26.2 |
| Non-State | 67.0 | 72.0 | 74.0 | 76.8 | 74.4 | 73.8 |

Source World Bank (1996), Table 2.1A.

Table 2 Industrial growth rates by economic sector (1989 constant price) (%)

| Year | 1990 | 1991 | 1992 | 1993 | 1994 |
|---|---|---|---|---|---|
| Total | 5.96 | 8.65 | 8.08 | 8.84 | 9.54 |
| State | 8.58 | 12.40 | 11.59 | 12.81 | 14.39 |
| Non-State | 4.71 | 6.79 | 6.24 | 6.66 | 6.73 |
| Agriculture | | | | | |
| Total | 2.17 | 7.08 | 3.82 | 3.92 | 4.74 |
| State | 2.27 | 2.22 | 7.14 | 6.96 | 20.05 |
| Non-State | 2.17 | 7.21 | 3.74 | 3.85 | 4.33 |
| Industry- Total | | | | | |
| Total | 9.04 | 14.03 | 13.13 | 14.02 | 13.95 |
| State | 10.38 | 18.60 | 14.70 | 14.54 | 16.03 |
| Non-State | 6.57 | 5.37 | 9.77 | 12.85 | 9.24 |
| - Industry | | | | | |
| Total | 9.85 | 14.61 | 12.14 | 12.94 | 13.74 |
| State | 11.76 | 19.10 | 14.71 | 13.77 | 16.92 |
| Non-State | 6.15 | 5.44 | 6.21 | 10.89 | 5.60 |
| -Construction | | | | | |
| Total | 5.05 | 11.05 | 18.30 | 19.38 | 14.95 |
| State | 2.74 | 15.58 | 14.63 | 19.37 | 10.79 |
| Non-State | 8.25 | 5.08 | 23.61 | 19.40 | 20.53 |
| Service- Total | | | | | |
| Total | 8.26 | 6.98 | 9.20 | 10.19 | 10.93 |
| State | 7.42 | 7.49 | 8.78 | 11.23 | 12.45 |
| Non-State | 8.97 | 6.56 | 9.55 | 9.33 | 9.66 |
| - Transport and communications | | | | | |
| Total | 6.45 | 6.31 | 6.53 | 7.02 | 11.04 |
| State | 8.05 | 7.66 | 8.27 | 7.46 | 12.07 |
| Non-State | 4.04 | 4.21 | 3.73 | 6.29 | 9.30 |
| -Trade | | | | | |
| Total | 4.82 | 6.10 | 5.98 | 8.98 | 11.23 |
| State | 4.66 | 5.91 | 4.53 | 5.11 | 11.93 |
| Non-State | 4.89 | 6.19 | 6.66 | 10.76 | 10.93 |

Source World Bank (1996), Table 2.2A.

Table 3 Gross domestic product by expenditure
Billions of Vietnamese dong (current prices)

| Year | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|---|---|---|---|---|---|---|
| GDP | 41,955 | 76,707 | 110,535 | 136,571 | 170,258 | 222,840 |
| Domestic demand | 41,857 | 75,643 | 107,725 | 141,561 | 183,114 | 246,966 |
| Gross capital Formation | 6,350 | 11,506 | 19,498 | 34,020 | 43,375 | 60,488 |
| State Investment | 2,703 | 4,503 | 7,566 | 16,751 | 21,141 | 21,500 |
| (from the budget) | 2,126 | 2,135 | 6,450 | 9,600 | 9,215 | 13,306 |
| Foreign Direct Investment | 629 | 2,023 | 2,907 | 8,852 | 11,505 | 19,646 |
| Other investment | 3,018 | 4,980 | 9,025 | 8,417 | 10,729 | 19,342 |
| Consumption | 35,507 | 64,137 | 88,227 | 107,541 | 139,739 | 186,478 |
| Government current Expenditure | 5,469 | 8,728 | 15,452 | 25,700 | 32,491 | 38,185 |
| Others | 30,038 | 55,409 | 72,775 | 81,841 | 107,248 | 148,293 |
| Trade balance | 98 | 1,064 | 2,810 | -4,900 | -12,856 | -24,126 |
| Exports | - | 22,915 | 35,767 | 39,974 | 58,590 | 80,262 |
| Imports | - | 21,851 | 32,957 | 44,965 | 71,445 | 104,388 |

Note State investment is from the *Statistical Yearbook, 1995,* and other investment is the residual in the gross capital formation. The rest of the data are from the IMF statistics.
Source IMF statistics and General Statistical Office (1996).

Table 4 Gross domestic product by expenditure: in proportion to GDP (%)

| Year | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|---|---|---|---|---|---|---|
| GDP | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Domestic demand | 99.8 | 98.6 | 97.5 | 103.7 | 107.6 | 110.8 |
| Gross capital Formation | 15.1 | 15.0 | 17.6 | 24.9 | 25.5 | 27.1 |
| State Investment | 6.4 | 5.9 | 6.8 | 12.3 | 12.4 | 9.6 |
| (from the budget) | 5.1 | 2.8 | 5.8 | 7.0 | 5.4 | 6.0 |
| Foreign Direct Investment | 1.5 | 2.6 | 2.6 | 6.5 | 6.8 | 8.8 |
| Other investment | 7.2 | 6.5 | 8.2 | 6.2 | 6.3 | 8.7 |
| Consumption | 84.6 | 83.6 | 79.8 | 78.7 | 82.1 | 83.7 |
| Government current Expenditure | 13.0 | 11.4 | 14.0 | 18.8 | 19.1 | 17.1 |
| Others | 71.6 | 72.2 | 65.8 | 59.9 | 63.0 | 66.5 |
| Trade balance | 0.2 | 1.4 | 2.5 | -3.6 | -7.6 | -10.8 |
| Exports | - | 29.9 | 32.4 | 29.3 | 34.4 | 36.0 |
| Imports | - | 28.5 | 29.8 | 32.9 | 42.0 | 46.8 |

Note State investment is from the *Statistical Yearbook, 1995,* and Other investment is the residual in the gross capital formation. The rest of the data are from the IMF statistics.
Source IMF statistics and General Statistical Office (1996).

Table 5 Export and import performances (billion dong)

| Year | 1991 | 1992 | 1993 | 1994 | 1995 |
|---|---|---|---|---|---|
| GDP | 76707 | 110535 | 136571 | 170258 | 222840 |
| Trade balance | 1064 | 2810 | -4991 | -12855 | -24126 |
| Exports | 22915 | 35767 | 39974 | 58590 | 80262 |
| Imports | 21851 | 32957 | 44965 | 71445 | 104388 |
| GDP ratios: percent | | | | | |
| Trade balance | 1.38 | 2.54 | -3.65 | -7.55 | -10.82 |
| Exports | 29.87 | 32.35 | 29.26 | 34.41 | 36.01 |
| Imports | 28.48 | 29.81 | 32.92 | 41.96 | 46.84 |
| Elasticities to GDP | | | | | |
| Exports | — | 1.27 | 0.49 | 1.88 | 1.19 |
| Imports | — | 1.15 | 1.54 | 2.38 | 1.49 |

Source The IMF statistics.

Table 6 Budget operations: in proportions to GDP (%)

| Year | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|---|---|---|---|---|---|---|---|---|---|---|
| Revenue and Grants | 13.9 | 13.2 | 11.3 | 13.9 | 14.7 | 13.5 | 19.0 | 22.5 | 24.3 | 23.9 |
| - Tax revenue | 3.0 | 2.4 | 2.9 | 3.9 | 4.0 | 3.7 | 5.0 | 8.3 | 9.0 | 11.2 |
| - Transfers from the SOE's | 10.0 | 9.9 | 7.2 | 8.0 | 8.6 | 8.1 | 10.8 | 11.2 | 12.3 | 9.9 |
| - Other Non-Tax revenue | 0.8 | 0.9 | 1.2 | 2.0 | 2.0 | 1.4 | 2.5 | 2.2 | 2.2 | 2.3 |
| - Grants | — | — | — | — | — | 0.4 | 0.8 | 0.7 | 0.8 | 0.6 |
| Expenditure-Total | 20.0 | 17.9 | 18.2 | 21.2 | 19.7 | 14.2 | 19.8 | 25.8 | 24.3 | 23.1 |
| - Current expenditure | 13.7 | 13.7 | 13.9 | 15.4 | 14.7 | 11.4 | 14.0 | 18.8 | 17.6 | 17.3 |
| - Capital expenditure | 6.3 | 4.2 | 4.4 | 5.8 | 5.1 | 2.8 | 5.8 | 7.0 | 6.6 | 5.7 |
| Budget balances | | | | | | | | | | |
| - Primary Balance | -6.2 | -4.6 | -7.0 | -7.4 | -5.1 | -0.7 | -0.8 | -3.3 | 0.1 | 0.8 |
| - Interest due | 0.2 | 0.1 | 0.2 | 2.9 | 3.0 | 3.0 | 2.9 | 2.7 | 2.6 | 1.9 |
| - Balance: Accrual basis | -6.3 | -4.7 | -7.1 | -10 | -8.0 | -3.7 | -3.7 | -6.0 | -2.5 | -1.1 |
| - Interest paid | -- | — | — | 0.2 | 0.7 | 0.8 | 0.9 | 1.3 | 1.7 | 1.3 |
| - Interest Arrears | 0.2 | 0.1 | 0.2 | 2.7 | 2.2 | 2.2 | 2.0 | 1.4 | 0.9 | 0.5 |
| - Balance: Cash basis | -6.2 | -4.6 | -7.0 | -7.5 | -5.8 | -1.5 | -1.7 | -4.6 | -1.6 | -0.5 |

Source World Bank (1995, 1996), Table 5.1.

Table 7 Structure of revenue: in proportions to total revenue (%)

| Year | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 |
|---|---|---|---|---|---|---|---|---|---|
| (a) Transfers from the SOE's | 71.4 | 75.2 | 63.8 | 57.6 | 58.8 | 59.8 | 56.7 | 49.9 | 41.3 |
| (b) Other Non-Tax revenue | 6.0 | 7.1 | 10.3 | 14.3 | 13.6 | 10.4 | 13.2 | 9.8 | 9.5 |
| (c) Grants | — | — | -- | — | — | 2.6 | 4.0 | 3.3 | 2.5 |
| (d) Import and Export tax | 7.1 | 4.5 | 7.5 | 9.3 | 11.9 | 10.6 | 10.4 | 20.8 | 27.7 |
| Aggregates | | | | | | | | | |
| (e) a+b | 77.4 | 82.3 | 74.1 | 71.8 | 72.4 | 70.2 | 69.9 | 59.8 | 50.7 |
| (f) a+b+c | 77.4 | 82.3 | 74.1 | 71.8 | 72.4 | 72.8 | 73.9 | 63.1 | 53.2 |
| (g) a+b+c+d | 84.5 | 86.8 | 81.6 | 81.1 | 84.3 | 83.4 | 84.4 | 83.9 | 80.9 |

Source World Bank (1995, 1996), Table 5.1 and Table 5.2A.

Table 8 Tax to GDP ratios (%)

| Year | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|---|---|---|---|---|---|---|
| State sector | 26.6 | 24.3 | 29.8 | 28.6 | 30.6 | 23.3 |
| Non-state Sector | 3.4 | 3.3 | 4.7 | 5.7 | 5.2 | 6.2 |
| Agriculture | 1.8 | 2.3 | 3.4 | 3.3 | 2.3 | 2.4 |

Note Tax paid by each of the above sector is divided by its respective value added.
Source World Bank (1996), Table 2.1A and Table 5.2A.

Table 9 Central and local fiscal relations (billion dong)

| | | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 (Plan) | 1995 |
|---|---|---|---|---|---|---|---|---|---|
| Localities | | | | | | | | | |
| Total revenue | (a) | 2836 | 4146 | 4116 | 7189 | 10169 | 13110 | 15934 | 13450 |
| Transfer to center | (b) | 1066 | - | 194 | 955 | 447 | 1390 | 729 | 0 |
| Receipt from center | (c) | 244 | - | 1023 | 2170 | 3619 | 2900 | 2500 | 4255 |
| Net revenue | (d) | 2014 | 3435 | 4945 | 8404 | 13341 | 14620 | 17705 | 17705 |
| Expenditure | (e) | 2014 | 3435 | 4945 | 8404 | 13341 | 14620 | 17705 | 17705 |
| Center | | | | | | | | | |
| Total revenue | (g) | 1063 | 2226 | 6237 | 13834 | 20331 | 29150 | 36836 | 39924 |
| Receipt from the localities | (h) | 1066 | - | 194 | 955 | 447 | 1390 | 729 | 0 |
| Transfer to the localities | (i) | 244 | - | 1023 | 2170 | 3619 | 2900 | 2500 | 4255 |
| Net Revenue | (j) | 1885 | - | 5408 | 12619 | 17159 | 27640 | 35065 | 35669 |
| Expenditure | (k) | 4091 | 5850 | 7136 | 15306 | 23669 | 30035 | 38265 | 38265 |
| Total (National budget) | | | | | | | | | |
| Revenue | (l) | 3899 | 6372 | 10353 | 21023 | 30500 | 42260 | 52770 | 53374 |
| Expenditure | (m) | 6105 | 9285 | 12081 | 23710 | 37010 | 44655 | 55970 | 55970 |
| Indexes | | | | | | | | | |
| Local to central Net revenue: (d)/(j) | (n) | 1.06 | - | 0.91 | 0.66 | 0.77 | 0.52 | 0.50 | 0.49 |
| Local to central Expenditure: (e)/(k) | (o) | 0.49 | 0.58 | 0.69 | 0.54 | 0.56 | 0.48 | 0.46 | 0.46 |
| Local revenue to Expenditure: (a)/(e) | (p) | 1.40 | 1.20 | 0.83 | 0.85 | 0.76 | 0.89 | 0.89 | 0.75 |

Note The rows (b) and (h), and (c) and (i) are same.
Source Calculated by the author, using the data provided by the World Bank (92) for 1989 and The Ministry of Finance, Viet Nam, for the rest of years.

Table 10 Gini coefficient over provinces:
(a) The aggregate level

| | GDP | Revenue Total | Expenditure Total | Current | Capital | Education | Health |
|---|---|---|---|---|---|---|---|
| 1990 | 0.442 | 0.657 | 0.324 | 0.344 | 0.301 | 0.320 | 0.405 |
| 1991 | 0.446 | 0.656 | 0.352 | 0.367 | 0.357 | 0.350 | 0.425 |
| 1992 | 0.454 | 0.701 | 0.347 | 0.359 | 0.384 | 0.320 | 0.409 |
| 1993 | 0.458 | 0.699 | 0.367 | 0.381 | 0.378 | 0.310 | 0.396 |
| 1994 | 0.470 | 0.720 | 0.336 | 0.356 | 0.330 | 0.325 | 0.403 |
| 1995 | . | 0.729 | 0.317 | 0.325 | 0.378 | 0.322 | 0.348 |
| 1996 | . | 0.726 | 0.310 | 0.313 | 0.384 | 0.321 | 0.359 |

(b) The per-capita level

| | GDP | Revenue Total | Expenditure Total | Current | Capital | Education | Health |
|---|---|---|---|---|---|---|---|
| 1990 | 0.267 | 0.488 | 0.277 | 0.280 | 0.311 | 0.236 | 0.297 |
| 1991 | 0.285 | 0.485 | 0.277 | 0.266 | 0.357 | 0.252 | 0.280 |
| 1992 | 0.307 | 0.538 | 0.250 | 0.238 | 0.346 | 0.204 | 0.255 |
| 1993 | 0.315 | 0.549 | 0.244 | 0.222 | 0.360 | 0.178 | 0.196 |
| 1994 | 0.324 | 0.565 | 0.218 | 0.200 | 0.327 | 0.146 | 0.185 |
| 1995 | . | 0.654 | 0.208 | 0.194 | 0.328 | 0.144 | 0.160 |
| 1996 | . | 0.638 | 0.224 | 0.198 | 0.366 | 0.163 | 0.188 |

Source Calculated by the author.

Table 11 (a) Shares of GDP by region (%)

| Region | 1990 | 1991 | 1992 | 1993 | 1994 |
|---|---|---|---|---|---|
| North Upland | 11.9 | 11.7 | 11.7 | 11.6 | 11.5 |
| Red River Delta | 19.1 | 18.6 | 18.9 | 19.3 | 19.0 |
| North Central | 9.2 | 8.8 | 8.5 | 8.6 | 8.5 |
| Central Coast | 8.4 | 8.4 | 8.1 | 7.9 | 7.8 |
| Central Highland | 3.2 | 3.3 | 3.1 | 3/0 | 3.0 |
| South East | 24.4 | 25.4 | 26.1 | 26.8 | 28.5 |
| Mekong River Delta | 23.8 | 23.9 | 23.6 | 22.8 | 21.8 |

(b) Growth rates of GDP by region (%)

| Region | 1991 | 1992 | 1993 | 1994 |
|---|---|---|---|---|
| North Upland | 4.3 | 8.5 | 6.8 | 7.8 |
| Red River Delta | 2.9 | 10.7 | 10.3 | 7.0 |
| North Central | 1.6 | 4.6 | 9.8 | 7.2 |
| Central Coast | 6.1 | 3.8 | 4.7 | 8.9 |
| Central Highland | 6.5 | 3.8 | 4.7 | 8.9 |
| South East | 10.3 | 11.8 | 11.0 | 15.5 |
| Mekong River Delta | 6.4 | 7.3 | 4.4 | 4.1 |

Table 12 Expenditure to revenue ratio by region (%)

| Regions | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|---|---|
| 1. North Upland | 190.2 | 162.8 | 129.4 | 126.9 | 110.9 | 115.3 | 100 |
| 2. Red River Delta | 58.3 | 50.3 | 34.1 | 38.1 | 32.7 | 38.1 | 37.1 |
| 3. North Central | 146.5 | 127.2 | 132.1 | 137.0 | 144.4 | 120.9 | 113.5 |
| 4. Central Coast | 127.7 | 99.1 | 83.7 | 68.6 | 76.2 | 69.9 | 67.5 |
| 5. Central Highlands | 136.7 | 140.9 | 158.2 | 153.7 | 147.6 | 126.2 | 105.3 |
| 6. South East | 31.7 | 32.8 | 31.5 | 35.1 | 25.1 | 15.6 | 14.1 |
| 7. Mekong River Delta | 74.1 | 81.8 | 87.7 | 80.5 | 79.2 | 79.9 | 82.4 |

Source Japan International Cooperation Agency (1997)

Table 13 GDP ratios of expenditures, revenue and investments by region

(a) Total expenditure (%)

| Regions | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|---|---|
| 1. North Upland | 11.3 | 10.4 | 11.7 | 13.5 | 13.5 | | |
| 2. Red River Delta | 7.8 | 7.2 | 7.8 | 10.0 | 9.2 | | |
| 3. North Central | 8.6 | 6.9 | 8.7 | 11.4 | 12.6 | | |
| 4. Central Coast | 13.6 | 10.6 | 11.1 | 12.7 | 13.0 | | |
| 5. Central Highlands | 10.6 | 9.6 | 10.4 | 13.0 | 15.5 | | |
| 6. South East | 5.5 | 5.1 | 6.7 | 8.8 | 7.4 | | |
| 7. Mekong River Delta | 7.1 | 5.9 | 6.1 | 7.2 | 7.4 | | |

(b) Total revenue (%)

| Regions | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|---|---|
| 1. North Upland | 6.2 | 6.7 | 9.6 | 11.2 | 12.7 | | |
| 2. Red River Delta | 13.4 | 14.4 | 22.9 | 26.2 | 28.2 | | |
| 3. North Central | 5.3 | 4.9 | 6.6 | 8.3 | 8.7 | | |
| 4. Central Coast | 10.6 | 10.7 | 13.3 | 18.5 | 17.0 | | |
| 5. Central Highlands | 7.8 | 6.8 | 6.6 | 8.4 | 10.5 | | |
| 6. South East | 17.4 | 15.4 | 21.2 | 25.0 | 29.5 | | |
| 7. Mekong River Delta | 9.5 | 7.3 | 6.9 | 8.9 | 9.4 | | |

(c) Capital expenditure (Provincial budget) (%)

| Regions | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|---|---|
| 1. North Upland | 2.7 | 2.7 | 2.6 | 2.8 | 2.7 | | |
| 2. Red River Delta | 1.9 | 1.4 | 1.5 | 1.9 | 1.5 | | |
| 3. North Central | 1.9 | 1.1 | 1.9 | 1.7 | 1.8 | | |
| 4. Central Coast | 2.8 | 2.4 | 2.1 | 2.4 | 2.7 | | |
| 5. Central Highlands | 2.7 | 2.1 | 1.9 | 2.6 | 2.7 | | |
| 6. South East | 1.0 | 1.0 | 1.3 | 1.8 | 1.3 | | |
| 7. Mekong River Delta | 1.6 | 1.2 | 1.3 | 1.5 | 1.4 | | |

(d) Total state investment: the aggregate of central and local investment (%)

| Regions | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|---|---|
| 1. North Upland | 4.8 | 5.5 | 6.3 | | | | |
| 2. Red River Delta | 5.4 | 5.0 | 4.1 | | | | |
| 3. North Central | 6.5 | 5.1 | 4.9 | | | | |
| 4. Central Coast | 5.3 | 4.4 | 4.1 | | | | |
| 5. Central Highlands | 4.7 | 4.9 | 5.7 | | | | |
| 6. South East | 2.0 | 2.1 | 2.4 | | | | |
| 7. Mekong River Delta | 2.5 | 2.2 | 2.3 | | | | |

(e) Expenditure in education (%)

| Regions | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|---|---|
| 1. North Upland | 2.0 | 1.8 | 2.2 | 3.0 | 3.3 | | |
| 2. Red River Delta | 1.3 | 1.2 | 1.3 | 1.7 | 2.0 | | |
| 3. North Central | 1.7 | 1.6 | 1.8 | 2.4 | 3.1 | | |
| 4. Central Coast | 2.5 | 1.8 | 2.0 | 2.5 | 2.6 | | |
| 5. Central Highlands | 2.1 | 1.9 | 2.0 | 2.4 | 3.2 | | |
| 6. South East | 0.9 | 0.7 | 0.8 | 1.0 | 1.2 | | |
| 7. Mekong River Delta | 1.4 | 1.1 | 1.1 | 1.5 | 1.8 | | |

(f) Expenditure in health (%)

| Regions | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|---|---|
| 1. North Upland | 0.8 | 0.6 | 0.8 | 0.9 | 0.9 | | |
| 2. Red River Delta | 0.5 | 0.5 | 0.5 | 0.7 | 0.7 | | |
| 3. North Central | 0.8 | 0.5 | 0.6 | 0.9 | 1.0 | | |
| 4. Central Coast | 1.1 | 0.8 | 1.1 | 1.0 | 1.1 | | |
| 5. Central Highlands | 0.9 | 0.9 | 0.7 | 0.9 | 0.8 | | |
| 6. South East | 0.7 | 0.6 | 0.7 | 0.7 | 0.7 | | |
| 7. Mekong River Delta | 0.6 | 0.5 | 0.5 | 0.6 | 0.6 | | |

Note The total state investment in (d) is available only up to the year 1992.
Sources General Statistical Office (1994, 1996), Japan International Cooperation Agency (1996).

Table 14 Regression results on provincial allocation of capital investment
(a) Dependent variable: Provincial capital expenditure to GDP

| | 1990 | 1991 | 1992 | 1993 | 1994 |
|---|---|---|---|---|---|
| Explanatory Variables | | | | | |
| Intercept | 0.034** | 0.028** | 0.031** | 0.035** | 0.038** |
| Region2 | -0.013* | -0.013* | -0.018* | -0.018 | -0.022 |
| Region6&7 | -0.018** | -0.016** | -0.017** | -0.016* | -0.020* |
| Adjusted R-Square | 0.218 | 0.197 | 0.185 | 0.074 | 0.093 |

(b) Dependent variable: Provincial total (central and local) state investment to GDP

| | 1990 | 1991 | 1992 |
|---|---|---|---|
| Explanatory variables | | | |
| Intercept | 0.063** | 0.059** | 0.069** |
| Region2 | -0.013 | -0.015 | -0.030 |
| Region6&7 | -0.031** | -0.032** | -0.035** |
| Adjusted R-Square | 0.108 | 0.183 | 0.115 |

Notes
1) The variables with ** and * are significant at 1% and 5 % respectively.
2) Region 2:The dummy variable for the region 2.
Region 6&7: The dummy variable for the regions 6 and 7.
3) Regressions have been run over provinces for each year, and the provincial total state investments are available up to 1992.

3

# Fiscal and Financial Sector Reform and Economic Development in Viet Nam

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## I. Introduction

Since the 1986 introduction of the so-called 'Doi Moi' reforms, whereby a transformation of the Vietnamese economy towards a market based system was undertaken in earnest, the Vietnamese economy has exhibited rapid and sustained growth. For example, while growth slowed somewhat in 1990 and 1991, from 1992 onwards the economic growth rate as measured by that of real GDP has exceeded 8 percent per annum in every year. Moreover, the rate of inflation as seen in the percentage change in the consumer price index dropped from three figures in the late 1980s to two figures at the beginning of the 1990s. By 1996 the rate of growth in this index had fallen to only 4 percent. Regarding the ratio of the government fiscal deficit to GDP, a steady decline in this measure too has been observed (see Table 1). In this way, it can now be said that the Vietnamese market economy reforms have been successful in achieving the first level of transition. In particular, the fiscal and monetary systems on which the centrally planned economy functioned have been used with a minimum of modifications to sustain development in this new era.

The next question is whether or not the Vietnamese economy will be able to maintain the sort of development that has been achieved to date. It is our opinion that the successful completion of the first stage of the transition will not necessarily translate into success in overcoming the difficulties faced in the second stage. Most likely success in this stage will involve a rather more comprehensive overhaul of the fiscal and monetary systems discussed above. In order to maintain growth of the Vietnamese economy the creation of a more technically advanced and larger scale production industry base will be of crucial importance. To this end, there will be a need for reform of the fiscal and monetary systems in order to encourage the efficient allocation of funds. Should the authorities fail to take appropriate steps to reform the fiscal and monetary systems, there is a danger that the stable economic growth that we have witnessed will come to a halt.

In Section II below we consider the performance of macroeconomic policy in Viet Nam in the first half of the 1990s. As has been pointed out by a great many specialists in this field, the Vietnamese economy has posted very impressive results over the last 10 years. This is a major achievement of the policies implemented by the Vietnamese economic planners. It is our opinion that the policy successes of the regime are closely tied to the pegging of the value of the local currency to the US dollar at a time when the Vietnamese economy was highly dollarized. The effect of the peg was to impose discipline on the policies of the Vietnamese government—making them disinflationary. However, it is necessary to bear in mind that the development process of Viet Nam in the coming years will be heavily influenced by its background as a dollarized economy. This will be one of the issues that we deal with in Section III.

More generally, in Section III we will be concerned with analyzing the difficulties and likelihood of success of the model of development expounded by the Vietnamese government in the current Five-year Plan (1996 to 2000). One aspect of the Five-year Plan is an ambitious scheme to increase the capital stock. However, a rather questionable assumption upon which the blueprint has been based is a massive projected inflow of foreign capital. In the highly dollarized economy which Viet Nam is today, reliance on such a large inflow of capital may prove to be a destabilizing influence upon the economy. In the short run the securing of a steady inflow of foreign investment will indeed be important, while in the middle to long term it will be necessary for policy makers to turn their attention to reduction of the trade account deficit and to boosting the amount of savings made available by domestic nationals. In particular, we wish to emphasize that in order for stable growth to be maintained, ensuring that a larger part of capital formation taking place is funded by domestic savings will be of great importance, and, in this connection, reform of the current fiscal and monetary policy apparatus is vital.

In Section IV our attention will be on clarifying pertinent aspects of the current financial system and making apparent the lack of sufficient conditions for mobilization of domestic savings. Necessary policy measures for rectifying this situation will be discussed with particular reference to plans for systemic reform. Within this area, focus will be concentrated on the banking sector and its ability (or lack thereof) to mobilize savings and to supply funds to firms. As is well known, the financial intermediary mechanism that characterizes the banking sector can come to be a form of hidden fiscal deficit by allowing for soft budgeting. This is especially the case when banks lack sufficient credit appraisal abilities, allowing soft budgeting on the part of the borrower. On the other hand, for the mobilization of domestic savings there is often little alternative but to rely on the functions provided by the banking system. Indeed, it may be fair to say that the success or failure of the drive for development in Viet Nam will depend on the creation of a more efficient financial intermediary mechanism and reform of the supporting institutional arrangements.

Section V will proceed with a detailed discussion of the steps required for reform of the financial system on the basis of the analysis undertaken in the previous chapter. Many proposals have already been made as to the need for, and appropriate direction of, reform in the financial sector. However, it is not necessarily the case that reform should be undertaken on all fronts in a parallel manner. On the contrary, a more rational approach is to consider the optimal sequence of reform based upon recognition of the various different components of the financial system and their interrelationships. Section V contains our own proposals for the steps to reform of the financial system and consideration of the optimal sequence in order that this reform proceed smoothly.

Table 1 Major Macroeconomic Indices

| Year | Growth Rate, Real GDP | Growth Rate, CPI | Fiscal Deficit to GDP | Trade Balance to GDP | Financial Deepening M2/GDP | Growth Rate, M2 |
|---|---|---|---|---|---|---|
| 1986 | | 774.7 | 6.81 | | 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, Viet Nam: 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.

However, it is not realistic to expect the construction of an efficient financial system built around the banking sector over the short-term. On the contrary, this aim is one that should be pursued with a time frame of around one decade. In the interim, there is no choice for the Vietnamese authorities but to implement development strategies within the context of an incomplete financial system. In Section 5 we take this into consideration by offering proposals not only for the long term but also, to some extent, for more immediate areas of concern.

## II. Management of Monetary Policy in Viet Nam

From the perspective of macroeconomic management, the monetary policies implemented by the Vietnamese authorities have been extremely successful. By means of reform of the fiscal system whereby government assistance to state-owned enterprises (SOEs) has been replaced by funding from banks (loans from state-owned commercial banks (SOCBs) in particular), it has been possible both to decrease the fiscal deficit and, through the imposition of direct upper limits on borrowing, to drastically reduce the rate of price inflation.

### 1. Monetary Policy in Viet Nam's Dollarized Economy

From a macroeconomic perspective, the monetary policy conducted by the Vietnamese authorities in the first half of the 1990s has earned high marks. It is our opinion that the policy of dollarization pursued by the government facing a situation of high currency substitutability has been, in effect, a source of strong discipline for domestic monetary policy. Provided that the strategy has credibility, pegging the local currency to a relatively stable foreign currency is an effective method of achieving disinflation. The reason is that domestic inflationary policies do not permit for a rigid stabilization ratio of units of the local currency to units of the currency of some more powerful economy. By pegging the dong to the US dollar, the Vietnamese monetary authorities have been able to 'import' relative price stability from America.

The dollar has long played an important role in monetary affairs in Viet Nam. During the time when triple digit rates of inflation prevailed, it was the natural reaction of money holders to lose faith in the dong in its function as a store of value and to switch their monetary assets into such substitutes as dollars or, alternatively, dollar denominated bank deposits. Furthermore, the Vietnamese government itself has over time allowed the dollar to play an important role in the domestic system of payments, the so-called policy of dollarization. While the first half of the 1990s—with its attendant fall in the rate of inflation—has seen a general rise in the level of confidence in the dong, it remains the case that the dollar plays an extremely powerful role in the Vietnamese economy. As seen in Table 2, the share of foreign denominated bank deposits in total deposits of the banking sector (with the majority of such foreign deposits thought to be in US dollars) was over 50% at the start of the 1990s but fell in the following years and by 1996 was just over 30%. On the other hand, the share of foreign denominated loans in total loans supplied by the banking sector has in fact been rising through the 1990s. While in 1991 the share of foreign in total loans was only 18%, it subsequently rose to around the 40% level in 1996 (see Table 2). The reason that the dong to foreign currency ratio is growing on the assets side of the balance sheet and falling on the liabilities side for the banking sector is the relative price stability that has been achieved, leading to a rise in the real interest rate of dong denominated monetary assets compared to those denominated in the alternative currencies and hence to banks adopting a short position on the holding of dollar assets.

Table 2 Foreign Currency Denominated Deposits and Loans in Viet Nam

(trillions of dong, %)

| Year | Total Deposits | (Share of Foreign Denominated Deposits) | Total Loans | (Share of Foreign Denominated 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) |

Source State Bank of Viet Nam

It is also necessary to be aware of the fact that within Viet Nam the supply of dollar denominated deposits is entirely without restriction. In such an environment a shift from dong denominated assets to those denominated in dollars (or vice versa) is not difficult to accomplish. Should holders of the local currency come to expect a fall in its value vis-à-vis the dollar as a result of a weakening of the trade or current account position, for example, the result will be a portfolio shift towards the dollar, causing difficulties for the authorities responsible for management of a stable rate of exchange.

In Figure 1 the official dong to dollar exchange rate (the offer rate for dollars on the part of the Vietcombank) is given alongside the market rate for comparison. The figure shows that the rate (VND/dollar) has stabilized around the 11,000 mark in the years following 1993, and, moreover, that the difference between the official and market rates has also subsided. The situation has come about as a direct result of the peg to the dollar that the Vietnamese monetary authorities have adopted (see Dodsworth et al., 1996). While on one hand this peg has restricted the freedom of these authorities to carry out discretionary policy, the other side of this situation is that the disinflationary policies of the government have been lent credibility precisely because domestic monetary policy is forcibly subordinated to the demands of external conditions. This credibility, and hence the peg which sustained it are thus directly responsible for successful disinflation. Although the peg has reduced the freedom to adjust monetary policy in accordance with domestic conditions, from the perspective of the Vietnamese economy at its present stage of development, the peg is indeed the optimal policy choice.

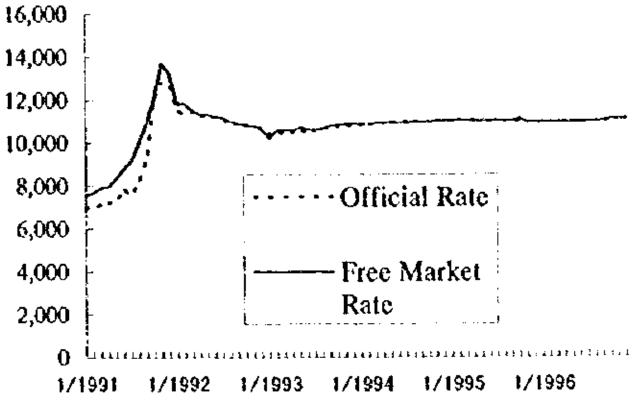


Figure 1 The VND/Dollar Exchange Rate for Jan. 1991 to Dec. 1996

The pegging of the domestic currency to the dollar has been supported by a strong inflow of foreign capital and hence dollars. The Vietnamese central bank (the State Bank of Viet Nam, or SBV) has increased its reserves of foreign currency in dramatic fashion from only 27 million dollars in 1991 to 875 million dollars at the end of 1994 and 1.8 billion dollars at the end of 1996. The economy is now at a critical stage where a change in the value of the local currency has the potential to cause serious dislocation in Vietnamese financial markets and weaken confidence (especially that of foreign asset holders) in the hitherto successful disinflationary policies of the Vietnamese government. For example, a fall in the value of the dong will not only cause domestic prices to rise but may well also lead to expectations of further weakening in the rate and hence a shift of asset portfolios away from dong and into dollars. A portfolio shift puts downward pressure on the exchange rate and the expectations become self-fulfilling, setting in motion a downward spiral in the value of the local currency. Given this situation and the successful disinflation that has been brought about by effectively fixing the VND/dollar exchange rate through policies pursued by the monetary authorities, it is safe to say that the cost of sudden devaluation in terms of the amount of financial dislocation that would result would potentially be large.

**Box 1**
**Is an Exchange Rate Peg Effective in Providing Discipline for Monetary Policy?**

The monetary authorities of many different countries have had success in restoring discipline to the monetary affairs of a previously troubled economy by pegging the local currency to a hard foreign currency such as the dollar.

For example, over the 1950s and 1960s the Japanese monetary authorities maintained a fixed exchange rate of 360 yen to the dollar. As a result, the excessive rate of domestic economic expansion fueled a build up in the trade account deficit, forcing abrupt and severe tightening of monetary policy. While some commentators have referred to the limiting of rapid economic expansion under fixed exchange rates by increasing disequilibrium in the foreign accounts as the "foreign accounts ceiling," it is also apparent that the existence of this ceiling prevented the prolonged use of inflationary policies in that country.

In Europe, the European Monetary System, established on the firm foundation of the German mark, was implemented in 1979. Initial participants in the EMS were France, Germany, Italy, Belgium, Denmark, Luxembourg, Holland and Ireland, and membership gradually expanded over time. The system was essentially a fixed exchange rate market for the currencies of the participating countries, but the essential benefit for those countries was that the value of their own currency was tied to that of the extremely stable German mark, leaving the monetary authorities of the country in question little room to pursue anything other than anti-inflationary policies. In fact it was the case that, from the end of the 1970s until the beginning of the 1990s, the inflation rates of the EMS countries converged on the low rate achieved by Germany.

Attention has widely been paid to currency boards which guarantee complete convertibility of a local currency at a fixed exchange rate and completely back the supply of currency by foreign reserves. This system was once adopted by British colonies and has been introduced recently in such countries and economies as Hong Kong in 1983, Argentina in 1991and Estonia in 1992. Although under this system monetary policies and foreign exchange policies have to be abandoned, it provides separation of the central bank from the fiscal sector, stabilization of macroeconomy due to the recovery of confidence in currency, and an auto-recovery mechanism for the balance of payments. It played an important role in stabilizing the Argentine economy. It is regarded as an effective measure when the demand for currency is unstable and other policies become dysfunctional due to high inflation. Bulgaria is the latest country to adopt this system.

For further reference, see Paul R. Krugman and Maurice Obstfeld, International Economics: Theory and Policy, 3rd Edition, Harper Collins, pp. 603~11, and John Williamson, What Role for Currency Boards?, Institute for International Economics, 1996.

## 2. Tools for Monetary Management

The lending restrictions implemented in the years following 1994 (which are similar to the restrictions imposed through the administrative guidance measures carried out by the Bank of Japan) have been criticized even by domestic commentators (see, for example, Hung, 1996). However, given the almost nonexistent state of the money market in Viet Nam, there is little alternative to pursuing such means of governance. In the present situation of strict control of financial matters by the central bank, to abandon such restrictions is not a realistic policy strategy. On the other hand, it must also be said that as the lending restrictions were not implemented in earnest until 1995, by which time the rate of inflation had already subsided, it is clearly not the case that these restrictions made any contribution to the disinflation of the early 1990s.

It is often pointed out that by use of the lever provided by reserve requirements it should be possible to control the supply of high powered money and hence the monetary environment. However, in order that such an indirect means of exercising control be effective it is necessary that the reserve holding behavior of commercial banks with respect to deposit liabilities be sufficiently stable. In reality, as will be shown in Table 7, the reserve holding behavior of Vietnamese commercial banks is subject to large fluctuations and a high degree of uncertainty. As such it is difficult to believe that adjustment of reserve requirements is likely to serve as a powerful tool of monetary policy in the Vietnamese context.

However, while continuation of the lending restrictions system is to be recommended, the same cannot be said for the system whereby the central bank makes specific lending instructions concerning individual borrowers, for to do so is to prevent a strengthening of the financial intermediary role of the banking sector. Indeed there is little hope for an improvement in the ability of banks to play this intermediary role while the conditions for banks to make lending decisions in an autonomous manner are not met. The lending restrictions should be concerned only with limiting the total lending of institutions or the rate of growth thereof.

While domestic inter-bank markets in the local and foreign currencies were established in 1992 and 1993 respectively, it remains the case that the functionality of these markets is completely insufficient. For the time being it is inadvisable to design monetary policy under the assumption that the economy possesses a flexible inter-bank market. On the other hand, all efforts should be made to establish an inter-bank money market as soon as possible. The short-term interest rate that regulates such a money market when it is operating in a flexible manner plays a vital role in signaling the relative strengths of fund supply and fund demand. As a result of the lack of an adequate inter-bank money market, the Vietnamese economy is missing an important indicator for comprehending the situation in the entire financial sector.

As has been pointed out by Professor Vu Van Hoa (1997), in developing an inter-bank money market it would be useful to create a market in commercial bills. Funding carried out by commercial banks through the discounting of commercial bills is one means of providing a relatively stable flow of short-term funds in an economy where the screening ability of banks is yet to become well developed. The creation of an inter-bank rediscounting market for commercial bills is perhaps not such a difficult task. In addition, by introducing a means of rediscounting of sound commercial bills at a given requirement, the central bank sets in motion a new tool of monetary policy in the rediscount rate. The rediscount rate (the official discount rate) determined by the central bank should come to serve as the basis for the interest rate that holds in the inter-bank money market.

## 3. Macroeconomic Performance: Causes for Concern

As has been discussed above, the performance of the Vietnamese economy in the first half of the 1990s has been extremely encouraging. However, it is necessary at this point to note a number of causes for concern in view of the desire for sustained development of that economy.

### (1) Stagnant Savings

The first point is that the domestic savings rate has failed to rise despite the relatively favorable macroeconomic environment that has been created. According to IMF statistics, the rate of domestic savings (i.e. the ratio to GDP) fell from over 20% in 1992~93 to 17.9% and then 16.3% in 1994 and 1995 respectively. It goes without saying, of course, that the rate of savings is a critical limiting factor in domestic capital formation. That the economic development plan leading up to the year 2000 relies on a huge inflow of foreign capital is also a result of the low domestic savings rate.

However, it is necessary to note at this point that the figures for the rate of savings are ambiguous in a number of respects. The statistics on the rate of domestic savings given by the Vietnamese General Statistics Office (GSO) are not consistent with those provided by the IMF, indicating that the ratio to GDP has grown steadily through the first half of the 1990s to reach a level of around 20% in 1996. If the GSO statistics are taken to be correct then a rather more optimistic picture of economic development in Viet Nam over the next few years than the one painted below would be appropriate.

For example, the current position under the Five-year Plan to the year 2000 is that one half of the 30% of GDP to be invested annually, that is 15% of GDP, will have to be financed from foreign sources. However, if domestic savings were to hold at around 20% of GDP only 10% would have to be raised through overseas credit.

### (2) Rapid Expansion in the Trade Account Deficit

The second cause for concern that will be mentioned here is, in fact, the other side of the coin from the first, namely the rapid expansion in the trade account deficit. As can readily be observed from inspection of Table 1, since 1993 the size of the Vietnamese current account deficit (as a ratio to GDP) has increased rapidly. This situation is a reflection of the fact that investment is running far ahead of domestic savings in that country. Of course it is not unnatural for a developing country to be exhibiting a deficit in this account, but it is also true that there is a limit beyond which this situation cannot be sustained. Faced with a large deficit the Vietnamese government is placed under pressure to ensure a steady flow of foreign investment to finance the deficit, or, alternatively, to devalue the local currency with a view to reducing the size of the deficit. The latter means a shift from the dollar peg policy which imposed discipline on the policies of the Vietnamese government—making them disinflationary policies. These concerns will be central to the success or failure of current development plans over the coming years.

### (3) Inefficiencies in the Banking Sector

A third concern that should be mentioned is that the banking sector does not appear to have improved its ability to carry out its various functions sufficiently. It is useful at this point to turn again to Table 1 which gives the ratio of broadly defined money (i.e., M2) to GDP, an index which is referred to as the degree of financial deepening. We can view this index as measuring the relative importance of the role played by the banking sector in the economy. It is seen that the index has almost not risen at all in the 1990s. In contrast it is an almost universal case in developing countries that financial deepening proceeds in step with economic growth, with differences a matter of degree rather than absence or presence. The implication is that the intermediary role of banks is crucial to the economic development process, and hence that the future development of the Vietnamese economy will be heavily influenced by the relative improvement in or development of this intermediary role played by the banking sector. In order to boost domestic savings over the long-term establishment of a financial system built around the foundation of an efficient banking sector will be necessary.

In the third section our purpose will be to evaluate the financial aspects of the economic development plan leading up to the year 2000 and its feasibility in particular. Central to this discussion will be the three concerns that we have raised above.

**Box 2**
**The Relationship Between Financial Deepening and Economic Development**

At this stage it should be mentioned that there is room for debate as to whether or not financial deepening as measured by the ratio of M2 to GDP is actually a good indicator of the degree of maturity of the banking sector. Of course it is not the case that this variable alone is sufficient to assess the workings of the banking and financial systems. However, the index is driven by the aggregate money demand function for the economy as a whole as well as the demand function for bank deposits, and as such can be thought of as a good indicator of the efficiency of the banking system.

The demand for bank deposits on the part of economic agents increases with their evaluation of the relative merit of those deposits as a store of value and as a means of settlement for transactions. If we assume that the central bank carefully regulates the total nominal value of bank deposits (M), then regardless of how much the demand for such deposits increases it is not possible (by assumption) for their holdings to exceed the total supply, (M). However, it is possible for the total holdings of bank deposits to change in real terms. This is because the reverse side of accumulation of bank deposits is a reduction in outlays on goods and services. The implication is that a high level of demand for bank deposits results in a decline in the price level (P) of goods and services, and hence a rise in the real value of deposit holdings (M/P). In addition, if we assume that real GDP (Y) is not directly affected by the money demand-related behavior of agents, then it is clear that the ratio of real deposit holdings (or real money balances) to real GDP (M/PY) will also rise. But this is essentially the same as the ratio of nominal money to nominal GDP (the latter being approximately equal to the product of P and Y). Therefore it is the case that, all other things being equal, in economies where the bank system delivers a well functioning deposit service the ratio of M2 to GDP will be higher.

On the other hand, it is of interest to ask whether the central bank is able to increase the ratio of nominal money balances (M2) to GDP by loosening monetary policy and increasing the rate of growth of M2. The answer is in fact negative. The reason is that, over the long term, growth in M2 due to a relaxed monetary policy stance will lead to a rise in the price level (or a rise in the rate of inflation) and hence expectation of further price rises (expectation of further inflation), increasing the opportunity cost of holding cash and bank deposits. In particular, the equilibrium nominal interest rate in financial markets will have risen to accommodate inflationary expectations.

Holders of deposits at banks must bear in mind that they will face a depreciation in the real value of these assets when the price level rises. As a result, a rapid increase in the money supply and hence in the price level will have the effect of shifting down economic agents' demand for monetary balances, resulting in a movement of demand away from bank deposits and towards real goods and services. The shift adds to inflationary pressure. The overall result is that the ratio of nominal money balances (M2) to nominal GDP will decline despite the rapid increase in M2 itself.

## III. Regarding the Feasibility of the Five-year Plan

According to the current Five-year Plan that ends in the year 2000, the Vietnamese authorities are forecasting a rise in the domestic capital stock in the order of 41~2 billion dollars over the years 1996 to 2000. This sum implies an annual rate of investment equal to a not inconsiderable 30% of GDP over those years, and when one considers that the comparable figure for the first half of the 1990s was 19.1% (see Table 3), the plan appears to be all the more ambitious.

Table 3 Investment and Fundraising under the Vietnamese Five-year Plan for Economic Development

| | 1991~1995 (Realized) | 1996~2000 (Planned) |
|---|---|---|
| State | 7.7 | 15.6 |
| Direct Investment | 4.9 | 14 |
| Private Corporation | 5.4 | 12.4 |
| ODA | 2.0* | 8 |
| Direct Investment | 4.5 | 14 |
| Domestic Savings | 11.5* | 21 |
| Investment/GDP (%) | 19.1** | 30 |

* Realized ** Calculated using 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.

Under the 42 billion dollar capital formation assumption of the government's Five-year Plan, over 22 billion or over 50% (15% of GDP on an annual basis) of the funding will come from foreign sources. It is perhaps possible to argue that such a policy of capital inflow dependence is the obvious course of action when faced with a savings rate that is proving to be unresponsive to high growth rates (in this case the rate is in fact weakening despite high growth). However, we are forced to consider, then, whether a plan based on such large capital inflow forecasts is in fact realistic. Let us now carry out an item-by-item feasibility study of the plan.

We consider the feasibility of the development plan from the following two perspectives.

(1) Whether or not foreign capital inflow is likely to be sufficient to cover the anticipated gap between domestic capital formation and domestic savings.

(2) Whether or not the current account deficit (or trade deficit, of which it is primarily comprised) implied by the anticipated savings/investment gap—in fact equal to the savings/investment gap—is realistic.

It goes without saying that these two lines of inquiry are prompted by simple identities based on the accounting relationships that underpin all of macroeconomic analysis.

**Box 3**
**The Relationship between (i) the Savings/Investment Gap and (ii) Capital Inflow and the Trade Account Deficit**

In the following let $K$ denote domestic capital formation, $S$ denote domestic savings, $C$ denote domestic consumption, $F$ denote net capital inflow, $M$ denote imports, $X$ denote exports and $TD$ denote the trade account deficit. Clearly it must be the case that domestic capital formation is equal to the sum of domestic savings and the net inflow of foreign capital. That is,

$$(1) \qquad K - S = F$$

On the other hand, it is also the case that domestic capital formation plus domestic consumption (absorption) must be equal to the sum of gross domestic product and imports minus exports (actually we are simplifying the analysis somewhat by ignoring payments to and from foreigners other than those accruing from the purchase or sale of goods and services). Hence we have,

$$K + C = GDP + M - X$$

Using the fact that domestic savings is equal to GDP minus domestic consumption we arrive at

$$K - S = -(X - M)$$

$$(2) \qquad = TD$$

Table 3 indicates by which form of foreign investment the Vietnamese authorities anticipate covering the difference between domestic capital formation and domestic savings. This is the relationship given in Equation 1. However, as is demonstrated by Equation 2, at the same time it will also be necessary to consider whether or not the projected shortfall of domestic savings over domestic capital formation fits with the projected trade account deficit.

## 1. Funds from ODA

As can be seen from Table 3, under the Five-year Plan a net capital inflow from ODA in the region of $8 billion is projected. When repayment of interest and principal due is taken into consideration it is seen that the projection requires an inflow of ODA amounting to $11 billion over the five years of the plan, implying a $2.2 billion dollar annual inflow. We now consider whether or not this target is likely to be achieved or not. At present Japan and most of the other developed nations are beginning the process of reviewing their ODA programs, and as such there is little room for optimism as to the size of future outlays. Nevertheless we are not of the opinion that the ODA target will be impossible to reach.

In the period from 1993 to 1995 the Vietnamese government received pledges in the region of $6.2 billion in ODA from donor nations. At the end of 1995 some $1.7 billion (i.e., 27.4%) had actually been delivered. In addition, another $2.4 billion in aid was pledged as a result of the international conference of donor nations held in December of 1996. As a consequence, even in the case where no other aid were to be forthcoming, the Vietnamese authorities would still be in the position of having pledges worth some $6.9 billion (= 6.2 − 1.7 + 2.4 billion) in aid, which we can safely assume will be disbursed by the year 2000.

As can be deduced from the preceding discussion, an ODA inflow of $4.1 billion (the difference between $11 billion and $6.9 billion) in the period 1997 to 2000 would be sufficient to meet the ODA projection contained in the Five-year Plan. Suppose for a minute that the Vietnamese government receives in each of these years pledges equal to the $2.4 billion sum for 1996. The total for the four years would be $9.6 billion. With a realization rate of a little over 40% the remaining $4.1 billion in ODA inflow would be achieved by the year 2000. However, if the ratio fails to climb above the recent level of around 30% then funds raised by ODA under this scenario will be only in the region of $2.8 billion. Thus one important point over the coming years is the necessity of boosting the ratio of actual receipts (disbursement) to pledges.

## 2. Fund Raising through Direct Investment

Under the Five-year Plan an inflow of some $13 to $15 billion in direct investment on the part of foreigners (foreign direct investment, or FDI) is predicted, implying an annual inflow of $2.6 to $3 billion over the five years from 1996 to 2000 inclusive. In fact the Vietnamese authorities project an inflow of $2.8 billion in 1996, $3 billion in 1997 and $3.5 billion in 1998, so that in order to achieve the highest inflow of $15 billion it would be necessary to realize a combined inflow of $5.7 billion for 1999 and 2000--an average of $2.85 billion in each year. We now consider whether this projection for FDI inflow is realistic or otherwise.

Let us approach this problem by means of a simple simulation based on a number of assumptions which we shall now make explicit. In reality, the figures for FDI given by calculation of government authorized projects includes both investment contributed by Vietnamese partners and planned investment that is not actually carried out. In the light of these discrepancies we will assume that one half of direct investment as measured in these figures is actually realized as capital inflow in the foreign accounts, and that the investment is disbursed over a period of 5 years. (Although we can claim no firm justification for making these two assumptions, they are in fact the assumptions used by the Indonesian Central Bank when calculating the contribution of FDI to net foreign currency inflow. It is instructive to calculate past net direct investment inflows using these assumptions and compare the results to the actual figures for those years and we do so in Table 4. The actual and estimated figures prove to be quite close, suggesting that the method of calculation adopted is not excessively flawed.)

Table 4 Actual and Estimated Net Inflow of Direct Investment

($ million)

| | 1993 | 1994 | 1995 |
|---|---|---|---|
| Actual Net Inflow | 830 | 1,050 | 1,780 |
| Inflow as Estimated by Above Method | 660 | 990 | 1,590 |

Regarding the prospects for FDI as seen in the authorized investment statistics for the years following 1997, there are arguments to support the taking of either an optimistic or a pessimistic stance. FDI for 1996 as measured by authorized projects up until December of that year was $5.0 billion, a figure which falls far below actual direct investment in 1995. Thus pessimists are able to claim that the environment for direct investment in Viet Nam may not in fact be particularly favorable, and, moreover, that those foreign firms interested in investing in Viet Nam have already done so by now. Therefore, they argue, direct investment may continue to stagnate, as was indicated by the investment figures up until December of 1996. Optimists, on the other hand, point out that the weakness in these particular figures are simply a result of slow processing of applications over that year as a result of government preoccupation with the holding of the Communist Party National Congress—an event held once every five years—and the concurrent opening of the National Assembly. The underlying rate of FDI is said to be as yet positive.

As matter of fact, the Vietnamese authorities rushed through the approval of two large direct investment projects worth a total of $3.1 billion on the 31st of December, 1996. As a result of this action the sum of FDI in that year as measured by government authorization was actually higher than similar figures for the previous year. Realistically speaking, it is not yet possible to decide between the two views presented above. Therefore our approach in making an estimation is to use the pessimistic forecast as a lower bound and the optimistic forecast as an upper bound.

The lower bound: The estimate we give for this case is $5.3 billion per year in direct investment over the years 1997 to 2000 as measured by government authorized projects. This is simply an extrapolation from the $5.3 billion achieved in the period from the 1st of January 1996 to the 30th of December of that same year, with the two projects valued at $3.1 billion approved on the last day of 1996 treated as exceptional.

The upper bound: The 1996 total of $8.4 billion will be repeated in each year of the 1997 to 2000 period.

Making use of the above two calculations, and assuming that there are no major changes to the present macroeconomic environment and the economic policies pursued by the Vietnamese authorities, we estimate that total net inflow of FDI over the 1996 to 2000 period will come to between $13.9 billion and $17.0 billion.

## 3. Feasibility of the Capital Inflow Projections: A Summary

As we have already seen, by means of conservative estimation it is found to be possible to expect an ODA capital inflow of $9.7 billion (= $6.9 + $2.8 billion) over the period up until the year 2000. In addition, net inflow of capital to Viet Nam by means of direct investment is estimated to be between $13.9 billion and $17.0 billion. The sum of these two suggests a capital inflow somewhat larger than the projection of $22 billion made in the Five-year Plan. In this sense the capital inflow projection used in the plan is found to be feasible.

Nevertheless, in order to ensure that capital inflow, and that from direct investment in particular, continues smoothly it will be necessary to make changes to the conditions that investors face in Viet Nam. Here the points raised by Kinoshita (1996) regarding the need for change in some of the conditions facing investors are of considerable importance. We now list the most pertinent of these.

(1) The licensing procedure for foreign investors should be made faster and more transparent.

(2) Regarding the price of land and rights of land usage it is necessary to make adjustments to the legal system concerning the right to rent land and to use it as collateral in a way that is beneficial to potential direct investors.

(3) Progress will have to be made on infrastructure improvements such as those concerning ports, roads, electricity generation and transmission and industrial-use land.

(4) It is crucial that Vietnamese banks raising funds in international fund markets follow the relevant behavioral norms and procedures. The Vietnamese government and central bank will have to recognize that inappropriate behavior will, in this context, lead to a weakening of international confidence in Viet Nam's entire banking system, in other words that such behavior involves a negative external economy.

## 4. Predictions Regarding the Trade Account

In the preceding discussion it was found that the Five-year Plan funding requirements for domestic capital formation as described in Table 3, and particularly those from overseas, are not without foundation in reality. However, this is not sufficient cause to become overly optimistic as to the likely success of the development plan. The reason is that there are serious problems concerning the projected trade balance, and more specifically projected imports, under the Five-year Plan.

As was shown in Table 3, under the Five-year Plan for the period up until the year 2000 a rate of domestic capital formation reaching 30% of GDP will be 50% financed by capital import. The implication is that for the length of this period the Vietnamese economy will run a trade deficit amounting to some 15% of GDP. As observation of the trends in exports and imports over the first half of the 1990s will suggest, there is some room for doubt as to the feasibility of such a program.

In Table 5 a simple simulation is carried out with the aim of analyzing whether or not the assumptions regarding the trade account used by the development plan are realistic. For the purposes of the estimation it will be convenient to make the following assumptions regarding the Vietnamese economy over the years 1996 to 2000.

1) Nominal GDP will grow at an annual rate of 15%. (The Five-year Plan estimates that real GDP will grow at 9~10% per annum. If we assume that the GDP deflator will grow at the rather modest rate of 5~6% per annum during this period then the nominal rate will be as given above.)

2) The real exchange rate will remain unchanged and exports will grow at an annual rate of 28%. In the five years from 1991 to 1994, the rate of export growth was on average 24.8%, and in this light the projection appears to be rather 'optimistic.' However, it is pertinent that the preliminary growth rate for exports was 36.6% in 1996.

Table 5 Trade and the Five-year Plan

($ million)

| | Nominal GDP | | Exports | | Imports | | 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 in each year up until (and including) 1996 is converted into dollars using the average exchange rate for that year. From 1997 onwards the calculation is done at a rate of 11,000 dong to the dollar. The figures in parentheses give the rate of change on the previous year.

Source GSO

3) The trade account deficit will be 15% of GDP through the 1997~2000 period. Here we are just following the assumption in the plan of financing 50% of capital formation equal to 30% of GDP through the import of foreign capital.

At this stage it is necessary to mention the fact that we have as yet paid no attention to other items in the foreign accounts apart from trade of goods and services. Profits on investments and other asset services certainly do play an important role in the Vietnamese economy. In particular, Viet Nam receives large private transfers from abroad to the extent that the otherwise strict external disequilibrium constraint has been mitigated. Therefore it can be argued that a consideration of these non-trade items leads to a rather less pessimistic picture than the one that we have painted.

Nevertheless, the case for greater optimism disintegrates when we take into account the fact that the current Five-year Plan for economic development is dependent on further large inflows of foreign capital. The reason is that an ongoing and sizable inflow of capital will eventually lead to an increase in the amount of interest and dividends that must be paid out to foreign investors. The conclusion, then, is that even if we do include the non-trade aspects of the foreign accounts, there will in fact be little change to the underlying message regarding the feasibility of the current development plan.

On the basis of the above simulation we conclude that the projections for the trade account under the Five-year Plan are supported by overly optimistic assumptions. If the ratio of the trade deficit to GDP does not in fact exceed the 15% estimate, then, as we have seen, it is not unrealistic to expect sufficient capital inflow to finance this shortfall. However, this scenario requires that either the rate of growth in imports slows dramatically relative to the last few years or that the rate of export growth continues to accelerate rapidly. In summary, in order for the current Five-year Plan to be feasible it will be necessary to achieve outstanding success either with export promotion policies or with import substitution policies (or a combination of the two). Without the success of such measures the plan will be marked by expanding trade account deficits that may eventually exceed the limits of foreign funding.

In fact, we have already pointed out that the rapid economic growth of the first half of the 1990s was accompanied by a surge in the size of the trade deficit (see either Table 1 or Table 5). It is desirable to achieve a policy framework whereby economic growth does not translate directly in an expansion of the deficit position. Given such a situation the Vietnamese authorities essentially have two policy alternatives: (1) they can effect a real devaluation of the local currency, or (2) they can avoid pushing the trade deficit out by reducing the target for domestic capital formation. The latter option relates directly to the question of how to raise domestic savings and as such will be discussed in the next section. In the remainder of this section our concern will be with the former, that is, with the relationship between the feasibility of the Five-year Plan and adjustment of the foreign exchange rate.

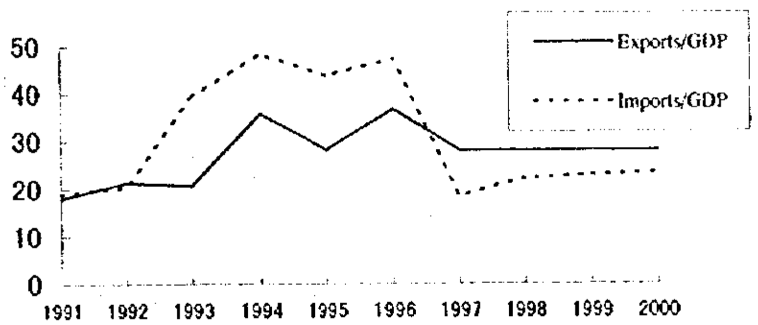


Figure 2 Growth Rate of Imports and Exports (realized and forecast values)

Figure 2 is a graph of the values given by the simulation conducted in this chapter. In addition to the realized values for import and export growth up until 1996, the graph also gives the projected values found by the simulation for the years 1997~2000. As is made clear from the graph, in order to bring the trade account deficit under control along the lines of the plan a very sharp drop in the rate of import growth is necessary.

## 5. Economic Development and Exchange Rate Management

Barring exceptionally favorable foreign investment flows, difficulties can be anticipated when attempting to stabilize the exchange rate of an economy which exhibits a long-term increase in current account (or trade account) deficit. In fact it may be argued that some delicate problems with exchange rate management have already become visible in Viet Nam over the 1996~7 period. As we have already seen, Viet Nam's trade deficit has ballooned over the last few years. This increase in relative disequilibrium is exerting strong downward pressure on the value of the local currency. In fact the Vietnamese central bank (the SBV) has increased the size of the band in which the inter-bank foreign exchange transaction rate is allowed to fluctuate around the reference rate: from 0.5% to 1% in April of 1996, and to 5% in February of 1997. Thus it appears that the SBV is effectively responding to the expanded trade deficit by permitting a controlled decline in the value of the dong.

In fact the rate of exchange in terms of VND per US dollar depreciated, albeit gradually, from 11,155 in December of 1996 to 11,650 in March of the following year. This is evidence that the Vietnamese authorities have indeed reacted to the expansion in the size of the trade account deficit by permitting a controlled dong depreciation. In addition, the government has launched a campaign aimed at repressing imports, with the main thrust being a direct ban on the import of consumption goods. Also, in order to cut back the increase in imports stemming from letters of credit, as of June 1996, the central bank has required that for each issue on the part of commercial banks the company in question must have deposits equivalent in value to 80% of the letter of credit. These direct import controls have had some success in reducing imports, with the trade deficit in the first five months of 1997 coming to $11 billion as compared to the $40 billion trade deficit registered in 1996 (Vu Van Hoa).

However, it is important to note that these import controls amount to a policy of fostering the growth of import-substituting industries. By directly restricting consumer access to imports the net effect will be to distort the allocation of scarce resources and encourage a shift from export-oriented industries to import-substituting industries. Protecting import-substituting industries allows them to enjoy monopolies in domestic markets, thereby weakening management discipline in domestic industrial sectors. On the other hand, export-oriented industries must compete with foreign firms in foreign markets and this competition is instrumental in disciplining management of individual firms. This disciplinary effect accounts for why those countries which have promoted export-oriented industries rather than import-substituting ones have achieved relatively good performance in terms of economic development. Thus, in the long term a policy measure of directly restricting imports is bound to affect negatively the international competitiveness of the Vietnamese economy.

In order to treat the rapid expansion of the trade account deficit, the more desirable approach would be to allow the value of the dong to depreciate in a controlled manner. The reason is that such a devaluation would reduce the relative size of the nontradables sector by boosting activity in tradables, particularly exports. Thus it may be argued that for the Vietnamese authorities to expand the band of permissible fluctuation and in this way gradually allow the exchange rate to fall is a realistic response to the increase in the trade account deficit. However, it is advisable for the monetary authorities to ensure that a sudden drop in the value of the dong is avoided, and as a basic policy stance to permit the nominal rate to change only to the extent that the real rate remains unaltered. Certainly a policy of attempting to treat the external disequilibrium by means of major devaluation is unlikely to be beneficial for the Vietnamese economy. The Vietnamese economy is thought to still be facing the problem of currency substitution. See John R. Dodsworth et al, "Viet Nam: Transition to a Market Economy," IMF Occasional Paper 135, March 1996.

In summary, the Five-year Plan leading up to the year 2000 is based on rather optimistic assumptions regarding the trade account projection, and should the forecasts prove to be unrealistic the domestic currency will then fall under the influence of downward pressures. However, given that the Vietnamese economy currently exhibits a high degree of currency substitutability, it is likely that any devaluation would lead to nontrivial dislocation in local financial markets. In this light we are forced to conclude that the current Five-year Plan in fact rests on highly unstable foundations.

Even if it is thought that the essence of the current Five-year Plan should remain unaltered, there is a need for immediate review of the plan with a view to adjusting policies that have bearing on the real rate of growth, on the real exchange rate and on imports and exports (long-term trade account deficit reduction policies) in a mutually complementary manner. In addition it is hoped that Vietnamese banks will conform to the international norms of behavior when engaging in transactions concerning foreign loans. According to recent reports (see the Asian Wall Street Journal, 8th of May, 1997) some Vietnamese banks have been less than diligent in repayment of borrowings from foreign banks. These kind of actions, which fail to meet the accepted standards of conduct in international dealings, entail a real danger of damaging international confidence in the entire Vietnamese banking system. In order to avoid such negative externalities it is necessary that the Vietnamese monetary authorities intervene actively in such matters.

**Box 4**
**The Baht Crisis in 1997**

The Thai baht was depreciated about 20% against the U.S. dollar on July 2, 1997 when the Thai authorities chose a policy of managed float based on currency basket. This move was a consequence of the speculative attack against the baht which started around the beginning of this year. The Thai authorities had intensively intervened in the foreign exchange market to keep the de facto peg to the U.S. dollar, but had not succeed in fending off the speculative attack, and they had exhausted a substantial amount of foreign exchange reserves. As will be shown below, Thailand's macroeconomic fundamentals are rather weak. Thus, although the IMF has already approved stand-by credit and some Asian countries including Japan have agreed to pledge at least a US$16 billion in financial package to Thailand, there remains serious concern about the financial stability of the Thai economy. The Thai authorities have reportedly tried to counterattack the speculative moves by applying direct control over foreign exchange transactions. However, direct control in the foreign exchange market will exacerbate investors' distrust of efficiency in Thai financial markets and will both hinder capital inflows from abroad and motivate capital flight from Thailand in the future. Thus, from the long-term perspective, it is doubtful whether these measures are constructive for economic development in Thailand.

The direct cause for the speculative attack against the baht was reportedly the deterioration in the Thai trade deficit produced by the dollar appreciation. Since the baht was rather closely pegged to the U.S. dollar, the appreciation of the dollar automatically appreciated the baht, deteriorating the trade balance deficit.

However, we should note that structural problems related to the Thai financial system have something to do with the baht crisis. Just like Viet Nam, Thailand has depended heavily on capital import in its development process. According to IMF statistics, the current account deficit was on average 7% of GDP during the seven years from 1990 to 1996. Of course, this statistic implies a huge amount of capital import. It is noteworthy that foreign direct investment has not been as large as bank loans. Actually, the amount of direct investment from abroad has been slightly decreasing since 1990 (see the attached table). In contrast, the relative importance of foreign lending through Bangkok International Banking Facility (BIBF) has grown since 1993. Thus, the major components of imported capital have taken the form of liquid investment and lending. This feature makes the Thai financial system vulnerable to speculative attack in the foreign exchange market.

In contrast to the case of Thailand, the foreign direct investment into Viet Nam has taken a relatively higher share of the total capital inflows. In this sense, the Vietnamese financial system seems less vulnerable to foreign exchange speculation.

The fragility of the banking system is making the Thai situation worse. In our understanding, a substantial amount of imported capital has been poured into property development through banks and finance companies. Due to a surge in bank loans in this sector, Bangkok housing was reportedly 200% over capacity in 1996 (TIME,