F. Alternative Reform Scenarios of the Financial System

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Evaluation of Viet Nam's Financial System

Nguyen Van Tan
State Bank of Viet Nam

1. Evaluation on reforming steps of various sectors of Viet Nam's financial system (including the State Bank, state-owned commercial banks, state-owned enterprises, private enterprises, stock market, foreign exchange market) which impacts on and comes under influence of other sectors renovation progress in the period of 1995 - 2000:

The relationship among different sectors of financial system is dialectic, dependent and indispensable. Therefore each activity of one sector impacts on and comes under influence of other sectors. The relationship in the reforming period of various sectors of financial system will be notably analyzed in the following writing.

(1) State Bank's reform and its impacts on other sectors

Since the State Bank's system operated under two-tier banking system model, operating function of the State Bank has been clearly separated as " working out policies, conducting state's management over monetary , credit and banking activities while commercial banks shall conduct monetary operation and banking services functions". Up to present, many steps of reforming were conducted in order to renovate the economy.

1) Reform on the State Bank's activities: The target of reforming the State Bank's system is to upgrade capacity of management and control over monetary and credit activities in order to stabilize national monetary system – the decisive factor for the macro-stabilization and steady development of the economy. After the establishment of the state bank under the Ordinance on the State Bank issued in May 1990, many steps of reforming several activities such as organization status, inspetoring and monitoring activities, operation of monetary policies... In this writing, only reforming steps that have exercised strong influence on activities of other sectors are stated as following:

(a) Reform on managing monetary policies : the orientation of reform on managing monetary policies is to shift from direct monetary instruments to indirect ones. The process of renovating monetary instruments notably impacted on operation of commercial banks, activities of enterprises, stock market and foreign exchange market.

- The gradual renovation on interest rate managing mechanism toward interest rate liberalization has significally influenced on the progress of reforming commercial banks and operation of enterprises because the interest rate is the price of capital and if the price is appropriate the distribution of capital will be suitable, effective and undistorted . Therefore, it became a motive that helped to encourage the intermediary role of commercial banks, to distribute capital over effective places, to stimulate the domestic production.

During the shift from the negative interest rate mechanism to the real positive one, the impact was clearly seen as the operating outcomes of commercial banks became profitable instead of many losses. It created initial fundament for the effective reforms of commercial banks.

For the enterprises, the shift from the negative interest rate mechanism to the real positive one woke them up to consider the effectiveness of lending capital in order to be able to pay principals and interests for commercial banks.

The next step of renovating the real positive interest rate mechanism was to liberate deposit rates and to regulate the ceilings of lending rates. It helped commercial banks to operate actively and deposit rates were freely decided basing on the ceiling of lending rates regulated by the Governor of the State Bank. Although this mechanism did not well originated the equilibrium prices in comfomity with the market demand and supply and distorted the allocation of capital, it created more flexible room for the commercial banks to distribute their capital.

The latest step of renovating the real positive interest rate mechanism was to conduct the base interest rate mechanism applied for VND deposit rates and SIBOR plus fees applied for foreign exchange lending rates. It can be seen as the most important step in the process of liberating interest rate. The calculation of base interest rate basing on the best lending rates of commercial banks plus specific margins proved that under this mechanism interest rates are more actively decided by market factors in comparison with the previous lending rate ceiling mechanism. Therefore, the prices of capital have been tightly linked to the demand of and supply for capital in the market, to the risk levels of the each lending activity. This encouraged the appropriate movement of capital, created the fundamental base for pricing other assets in the market, especially for pricing security, and stimulated the development of secondary market, stock market.

In short, renovation on interest rate managing mechanism not only created favorable conditions under which the State Bank controlled monetary policies by indirect instruments, but also significally impacted on reform of commercial banks, enterprises and the development of foreign exchange and stock market.

- Reform on exchange rate managing mechanism : The final target of reform on exchange rate managing mechanism is to float exchange rate. The State Bank only intervenes in market to stabilize exchange rate and then foreign exchange market , monetary market.

Firstly, the reform on exchange rate managing mechanism directly impacts on the development of the market, on the development of exporting enterprises. On the other hand, the suitable exchange rate managing mechanism helps to restrain imports and to encourage domestic production. It may not be necessary to recall steps on reforming exchange rate managing mechanism from fixed exchange rate to current one (because it has been stated in special paper No 2-1-7). However, the State Bank was cautious in reforming exchange rate managing mechanism. The cautiousness played an important role in stabilizing monetary market, boosting exports, limiting negative impacts caused by the regional financial monetary crisis, taking part in the establishment and development of the exchange market in general and interbank market in particular.

However, there were definite constrains in the current exchange rate managing mechanism such as the limitation of interbank operation, irregular buying and selling activities, limited number of participants. Foreign exchange hoarding phenomenon is still popular in the interbank market...etc. And exchange rate is an important reason among those causing these phenomenons.

- There is a closed sensitive relationship between interest rate and exchange rate—the two monetary instruments of the State Bank. Therefore, the more synchronously these instruments cooperate the better their effectiveness is created. In fact, in the combination of reforming these 2 instruments there is a limitation caused by the financial monetary crisis and the productivity of enterprises. The weakness in production of enterprises during the crisis, especially 1999, caused a difficulty in harmonious combination between exchange rate and interest rate management, created the flow of capital from domestic currency to foreign currencies, increased the ratio of dollarization in the economy (the ratio of foreign exchange in total liquidity of the economy was up from 19 % in 1995 to roughly 29% in 2000), limited capacity of controlling monetary policy of the State bank and usage of capital resources of commercial banks.

- Reform on other instruments for implementing the monetary policies such as required reserve, refinancing , the establishment of open market operations impacted on the operation cost of commercial banks. The shift from regulating the ratio of required reserve for everyday within a month to regulating the average ratio of required reserve for a period of holding required reserve helped commercial banks to be more flexible in managing their usable capital, created opportunities of effective investment. Otherwise, the decrease of the required reserve ratio from 10 % to 5 % helped to cut down the operation cost of commercial banks.

Relating to the impact on activities of commercial banks, the open market operations created high liquidity of capital for them, then allowed them to utilize their mobilized capital resources. If the liquidity is not high, commercial banks must keep the ratio of reserve at a higher level in order to guarantee their liquidity. Although the open market operations is one of state bank's monetary policy instruments, it is not only dependent on the State bank but also influenced by other factors such as the development of market instruments, level of liberalizing interest rate, the development of payment system. Besides, the capital management ability of commercial banks, their evaluation on the important role of managing capital are very important for speeding up the development of the market.

(b) Reform of inspecting, monitoring activities: the reform of inspecting, monitoring activities has its significant impact on reform of other sectors in financial system.

In broad meaning,inspecting, monitoring activities are not only on- site inspecting, off-site monitoring and upgrading officer's ability, but also regulating criteria of security for commercial banks operation. Since 1996 a great reform on this field has been conducted, many monitoring regulations have been issued:

- Perfection of these regulation following Decision No 296, 297 in 1999 created the movement of commercial banks operation toward effective and secure orientation. The regulation on issuing security ratios for operation of credit institutions : minimum security ratio is 8% of own capital in total assets including off-balance sheet, forced commercial banks to have plans to increase their own capital, to decrease debts. That guaranteed the popular security ratio from 5 –6 % up to 8 %.
- Regulation on credit allows lenders to have a broader access to capital in conformity with Article 94 of the Civil Code in order to encourage economic sectors to lend for developing production. Under this regulation, forms of lending insurance are not only clear but also tight for enterprises, enterprises which are lost in production will be difficult in accessing to bank's capital. It helps to create legal environment for the effective investment of credit institutions.
- Regulation on off-site monitoring was issued to upgrade off-site monitoring activities, to prevent unsecured exposure and to have time for adjustment in order to avoid negative impacts on security of the system. However, this regulation also helps credit institutions to be more confident in lending to customers.

In short, reform on inspecting and monitoring commercial banks activities significally impacted on the security of the system, on the credit relationship between commercial banks and enterprises. Regulated security ratios will speed up the development of money market, then create high liquid instrument in the market, and encourage other sectors to develop.

(c) Reform on policies relating to the operation of commercial banks: The State Bank issued several new policies such as : credit mechanism, interest rate, lending insurance, settlement, contingency plans, foreign exchange operation... in order to perfect legal framework for operations of commercial banks. For example, the Decision No 324/QD –NH1 that was issued on 30/9/1998 regulated the lending objectives applicable to legal entities in accordance with the Civil Code helped credit institutions to be active in widening lending objectives. On 25/8/2000, the State Bank issued Regulation No 284/ QD-NHHN1 on lending activity instead of Regulation 324 that limited lending for foreign debt payment before maturity.

2) *Sector of commercial bank system*: The target of reforming commercial bank system is to consolidate banking system as a steady base for economic development. Therefore, the reform orients to strengthen capital mobilization and lending, to conduct security mechanism in operation, to consolidate off-site monitoring and inspecting activities, to renovate banking management toward more simple procedure in order to support customers, to widen lending objectives, to perfect and upgrade banking technology for international integration, to apply new services in conformity with domestic economy. Reforming activities are clearly seen in the following aspects:

* For the organization and charter of operations, the State Bank issued Charter on organization and operation of commercial banks to consolidate system and operation of urban and rural stock commercial banks as well as to add some requirements applicable to foreign banks branches which operate in Viet Nam in order to create an equal competitive environment. Up to present, banking system composed of 04 state-owned commercial banks, a Cuulong river delta commercial bank, a commercial bank for the poor, 23 foreign banks branches, 4 joint venture banks, 51 stock commercial banks, 01 Central credit Fund, 21 regional credit funds, 960 local credit funds with over 60,000 cadres working for commercial bank system. There are branches of state owned commercial banks in provinces, cities, districts, and towns. In particular, the agriculture and rural development bank has its inter-villages branches, " on- road" bank, which creates favorable conditions for customers. The widening of credit institutions network supports their ability in mobilizing and lending capital, in allocating capital on time for enterprises, takes part in implementing Goverment's strategy on developing industrialization in rural areas.

  Banking activities were widened, consolidated toward international integration and development of advanced commercial banks in the region and all over the world. The Project of settlement modernization granted by the World Bank (total amount is 48 millions USD) was implemented in order to upgrade the effectiveness of capital movement. Up to present, the State Bank established the Project's management Board and guided 6 state-owned commercial banks, 2 stock commercial banks to establish sub-projects in order to receive and conduct banking settlement modernization following the reform plan on that in 2001 the modern settlement system will be in effect. Initially, mostly companies, modern corporations in the world, conducted the bidding on the sub-projects of commercial banks.

* For consolidating banking activities : The State Bank is setting up project on consolidate the state-owned commercial banks which have a leading role in commercial banks system in Viet Nam economy for submitting to the Government.

No	List	Ratio of mobilized capital in total capital	Ratio of lending from the state bank in total capital	Ratio of lending from credit institutions in total capital
1	Industrial and commercial bank	82%	6.6%	1%
2	Vietcombank	86%	4.3%	0.8%
3	Agricultural bank	78%	7.5%	7%
4	Investment bank	80%	17%	6.5%

Data of 31/12/1999

Commercial banks system from headquarters to branched in provinces, cities perfected and consolidated operation system, especially taking care of Chairman of the Board of Management and General Managing Director positions, reinforcing off site monitoring, inspecting all activities of credit institutions. Credit mechanism was established, interest rate created legal environment for commercial banks operations, many types of possession of commercial banks were built up, and inspecting and monitoring activities were considered. In this period, commercial banks system grew up quickly, the annual average growth of credit was roughly 25 %, total capital was up 35 % which helped macroeconomic stabilization, encouraged the annual average growth rate of GDP at 8.5 %. Parallelly, activities of Peope's credit funds system were experimented in order to support demand for capital in rural areas; this system is being consolidated and developed. Capital supplementing in addition to the charter capital of the state owned commercial banks was conducted to increase their charter capital from 1100 billion VND to 2,200 billion VND; and 70 billion VND for the urban stock commercial banks; 15 billion VND for rural stock commercial banks ; 20 millions USD for joint venture and foreign banks.

* For restructuring bad debts : Currently commercial banks system is facing many difficulties, so in the reforming period the State Bank guided credit institutions to concentrate on decreasing overdue debts under 5 % of total credit oustandings. In fact , the overdue debts were 12.5 % of total credit outstanding, 7.25 % of total assets, especially some stock commercial banks had overdue debts up to 40 % of total credit outstanding. The State Bank is guiding the reform on ineffective stock commercial banks by options of withdrawing licenses, setting up requirements of operation, conditions for merging, buyback in order to reinforce stock commercial banks system.

Since May 1998,the Government started solving problems caused by stock commercial banks and in June 1999 setting up strategy on developing state-owned commercial banks to improve stabilization of operating environment. Stock commercial banks, which had difficulties, 18 in 51 commercial banks were in insolvency and great losses, are put in special monitoring mode by the State Bank in order to solve problems. Up to present, 2 stock commercial banks were already closed. In 1999, the State Bank planned to restructure all 51 stock banks by reforming activities, solving bad debts, supplementing charter capital including the increase in the capital possession ratio of foreigners to 50 % of banks total own capital . The State Bank is in the process of establishing

Liabilities Management Company to support debt-restructuring activities . Capital of the company was granted by the Government. The company will sell and buy lending guaranteed by collateral assets which commercial banks could not liquidate.

* For auditing, evaluating international credibility standards: The state owned commercial banks were internationally audited in 1999, the Government is guiding relating Ministries to submit projects on solving the frozen debts, charter capital of the state owned commercial banks was supplemented in October 1998, the evaluation the state-owned commercial banks at the beginning of 1999 showed a low ratio of profits , lending activity was not strong, system of on site monitoring and inspecting was weak. Basing on that evaluation, the State Bank built a general plan on reinforcing the competitiveness and transparency of the state-owned commercial banks, enhancing internal management, international integration. This strategy consisted of restructuring, solving and managing debts, reforming management methods such as:
  - To self control in operation and distribution
  - To re-organize managing system and board of management
  - To establish internal controlling board and independent monitoring board
  - To decrease costs
  - To improve the standardized accounting and information system
  - To improve managers and to train staffs
* Establishment of a policy bank: The Government guided to separate policy making function from operation of commercial banks, then to establish a policy bank whose capital is granted by state's budget and sphere of action is clearly set up by the Government. In the next period, Government may establish a bank for exports and a bank for encouraging exports and investment in order to stimulate exports, investment. Trading activities will be reinforced during the process of restructuring the state-owned commercial banks.

Process of reforming commercial bank system impacted on the reform on enterprises sector as followings:

a) State and private enterprises are confident of reforming commercial banks system on operation network, regulations and policies, advantages and services of commercial banks, access to bank's capital for developing production. Banking services in this time are better than those in the period of 1990-1995, settlement services well match with customer's demand for transaction in trading relation of both banking and enterprise sectors.

b) Issued regulations were regularly oriented to the market economy, so that state and private enterprises are well encouraged to effectively operate, to access to bank's capital in order to increase production such as the regulation on lending guarantee under Decree No 178ND-CP which set up conditions for good enterprises having fair credit relationship and profit in the 2 latest years to borrow without guarantee.

c) Various types of commercial banks in term of possession, capital resources, banking technology helped the competitiveness in the market to be greater, stronger, made the credit market, interest rate, exchange rate... closed to the equilibrium levels, helped customers to utilize capital for effective production.

d) Some regulations did not encourage state and private enterprises to operate effectively or irregularly, to face difficulties in accessing to bank's capital for widening investment. Some private enterprises were not credible for borrowing from commercial banks – it is a restrain in the process of reforming the economy in general and the private sector in particular.

(2) Enterprise sector

1) Reform on state-owned enterprises: Continuing comprehensive reform on the economy toward the market-oriented economy under the state's management with the above target which required by the economy; setting up targets, guidelines for stabilizing several socio-economical fields; continuing establishing necessary premise for industrialization and modernization, allocating suitable economic structure, investment, construction, consolidating socialist productive relation with social stabilization.

(a) Reform on General corporations : under the reforming strategy of the Party and Government, from 1995 Government issued policies on developing and reinforcing state-owned enterprises such as Decision No 90/TTg, Decision No 91/TTg signed by the Prime Minister which specified the restructuring and establishing state enterprise system, disintegrating group of factories, general corporations which played an administrative intimidation role and established general corporations within suitable scale for enhancing internal and external competitiveness. Regime of directly managed ministries was abolished, state's management and operating management was separated in order to let the production of general corporations to be more self controlled. The restructuring activities were the first step in improving accumulative capacity of general corporations in the period of industrialization and modernization.

In the reform, 70 general corporations were established and these corporations played the leading role in the economy : power generation was 94 %, coal : 97 %, tobacco: 63 %, cement : 59 %, paper: 50 % in comparison with the economy. Credit relation of the general corporation model was initially advantageous, commercial banks concentrated capital resources for lending to production in new period. However, under this model, there were some limitations such as lending capital to a borrower was capped within 15 % of the own capital of credit institution. This limitation impacted on lending activity of credit institutions. This problem must be solved in conformity with security criteria on operations of credit institutions and demand for capital of General Corporation under Decision 90,91.

Output weights of general corporations in total output of the economy:

No.	List	1997 (%)	1999 (%)
1	Electricity	90 %	94 %
2	Coal	95 %	97 %
3	Tobacco	59 %	63 %
4	Cement	55%	59 %
5	Paper	40 %	50 %

Data source : Enterprise renovation committee

In period of 1998 up to present, on 21/4/1998 Government issued instruction No 20/TTg on restructuring and reforming state-owned enterprises basing on classification of enterprises and on 26/ 5/1999 issued instruction No 15/TTg on perfecting organization structure of general corporations, re-organizing corporations, experimenting with establishment of economic group, privatization of state-owned enterprises, selling and hiring state-owned enterprises.

As the results, 50 % of enterprises was terminated, self-controlling activities, full responsibility and flexibility of enterprises were upgraded, productivity and competitiveness was enhanced and capacity of international integration was consolidated.

Results of restructuring enterprises

No	List	1995	1999
1	State-owned enterprises, of which	12,000	6000
2	- merging		3100
3	- dissolution		3350

Data source : Enterprise renovation committee

Reform on policies created synchronous legal framework toward self controlling of state-owned enterprises in operation, wages distribution , remains of profits, accounting in conformity with demand and supply forces of the market, state management organizations while administrative organization do not deeply intervene in state-owned enterprises operation.

Results in reforming period showed that the number of enterprises which possess capital below 1 billion VND decreased (1994 : 50 %; 1998 : 26 % in total number of enterprises) while the number of those having capital above 10 billion VND increased (1994 : 15 %; 1998 : 20 %), the average capital of enterprises was up from 3.3 billion in 1994 to 18 billion in 1998, profit ratio was 14 %. Those advantaged can be seen from such results:

- State-owned enterprises play a leading role in the economy
- State-owned enterprises is an effective tool to manage the market economy toward socialist guidelines

- State-owned enterprises play a definite role in social policies
- State-owned enterprises account for a great proportion in imports and exports revenues
- State-owned enterprises play an important role in budget revenues

However, there are following troubles :

Productivity was still not high, profits of some enterprises decreased, some enterprises exposed to bankruptcy. In 1995, one dong of state's capital bore 3.46 dong in turnover and 0.19 dong in profit, but in 1998 it created only 2.9 dong and 0.14 dong.

Estimated number of enterprises having profit was 50 %, getting losses was 20 % and other were irregular profitable, sometimes lost

Outstanding debts of enterprises accounted for 124 % of total assets granted by the State

Collecting debts of enterprises accounted for 80 % of total assets granted by the State

Working capital of state owned enterprises accounted for 15 % in total demand for capital of enterprises, the other 85 % was borrowed from banks. Therefore, many enterprises lacked capital for developing, renovating and reconstructing production, waited for capital granted by budget (in fact capital granted by budget was small, since 1990 it was only 200 billion dong, in 1998 it was 3000 billion dong). Besides, bond issuance conducted by enterprises was not well implemented, some enterprises faced difficulties in borrowing capital or consuming products. These factors required the priority of taxation, interest rate from the State. Now the number of state owned enterprises is 5248 with the average capital of 18 billion dong, the numbers of enterprises having capital below 5 billion dong accounts for 62.5 % and above 10 billion dong: 20 %. Technological and technical level of enterprises is backward, capacity of international integration is weak, production line is 10 – 20 years backward in comparison with international standard, invisible attrition accounts for 30 – 50 %, in which 52% comes through reparations, products are higher than ones imported by 5 to10 %.

(b) Privatization of state owned enterprises: Government issued Decree No 28/CP dated May 07,1997 on transforming some state-owned enterprises to stock enterprises in order to mobilize and utilize capital resources to invest and renovate technology, to develop enterprises, to consolidate self-controlling roles and motivate effective production. This Decree allowed small-scale enterprises having capital below 10 billion and effective production plan to be privatized by issuing shares, to be given tax priority, to give employees the priority for buying deferred payment shares within 5 years, to be able to borrow bank's capital. And then Government issued Decree No 25/CP amending some points in Decree 28/CP in which decided that enterprises having over 20 billion dong capital will be submitted to Government, enterprises having around 10 – 20 billion are submitted to Ministries, Provincial people Committees and reported to relating Ministries, the others are submitted to Ministries, Provincial People Committees.

Based on Goverment's policies, Ministries, local authorities conducted privatization. Since 1995, 370 enterprises were privatized and after privatization results are good such as: average annual turnover increased by 25 % (some increased by 50 %), job creation was up by 10 % , income of employees increased 20 %, annual profit was up by 26 % and payment for Budget's collection was up by 30 %.

(c) Contracting out, hiring state owned enterprises : Government issued Decree No 103/1999/ND-CP dated September 10,1999 on transferring, selling, contracting out production, hiring state owned enterprises to facilitate state owned enterprises restructuring activities, to upgrade effectiveness, competitiveness and job creation of state's sector, to change management method of enterprises in order to consolidate owner rights of employees, to utilize invested capital and mobilize potential resources from all economic sectors; to decrease costs and state's responsibility of management. This Decree is applicable to enterprises having below 1 billion dong capital, except for state-running farms, enterprises operating in consulting, designing and inspecting. Government will decide the enterprise having capital around 1 – 5 billion. Up to now Government is taking care of the implementation of this Decree.

Process of reforming state-owned enterprises affects to the reform on banking sector

a) Firstly, the restructure of state-owned enterprises enhanced competition and domestic production, then created a safe effective credit environment for commercial banks to be more confident in investment. Up to now, total credit outstanding of state owned enterprises accounted for 24.5 % of GDP.

b) State-owned enterprise privatization supplemented financial instruments for the capital market – it was one of important factors that effected to the establishment and development of security market.

c) Government issued some policies on supporting enterprises in the period of 1995-1999 such as allowing lost enterprises to borrow capital, to lend without collated assets, to have priority in lending interest rate... that influenced and caused in exposure to commercial banks.

d) Reform on state-owned enterprise did not stop written off, rescheduling and blocking debts, giving priority in investment, exempting taxation and price subsidiary. Some state-owned General Corporations such as Postal and Telecommunications, Aviation, Maritime, Cement supplemented their own capital themselves by 1.5 –2.2 times in comparison with the initial charter capital. It made credit relationship with commercial banks more advantageous. Besides, many other enterprises have very low charter capitals, their demand for borrowing bank's capital accounts for 85 %, especially 95 %, so that it will be very difficult for banks to avoid risks.

e) Reform on state-owned enterprises left the burden of bad debts on commercial banks. The current bad debt is roughly 4,650 billion dong while in Viet Nam credit market there are potential risks in changes of interest rate, exchange rate policies.

f) Organization Schema of state-owned enterprises was not suitably renovated in order to mobilize collective forces and motivate the development of enterprises. Especially, distribution activities could not encourage employees to work causing the tardy growth of production.

2) *Private enterprise sector*: Government issued the Law on Private Company, the Law on Stock Company and other regulations in order to create operation environment, to secure legal rights of operation. Tax policies, financial management policies were established in initial step. Credit and state's management policies were gradually guided to help this sector to operate legally and effectively and to increase annual budget's collection. It is an important reform on private enterprises in the period of 1995-1999. However, up to present, legal regulations, circulars for guiding the implementation of these 2 Laws are not synchronous, many enterprises operate ineffectively, some are in fraud or losses.

In order to continue reforming this sector, Government is reinforcing and perfecting legal framework. And in January 1, 2000 Law on Enterprise was issued to replace the above mentioned 2 Laws. It helped services operation of private sector to be safer and more effective in conformity with the market economy trends and laws under the state's management.

The private enterprise reforming process may exert some impacts on the reforms of other sectors as follows:

(a) Despite of the huge number of private enterprises (about 16,677 limited companies, 7,500 private companies so far, and 8,000 companies being established from the 1st January 2000 to September 2000 under the effective of the Law on Enterprises), the fact of inadequate or without working capital has driven these enterprises into losses or bankruptcy, even banks' loan fraud resulting in banks' loan burdens. This is an important point in the private sector reforming process in last period.

(b) With regards to the restructured effective private enterprises, the application of capital safety standards and annual recapitalization have facilitated the security and effectiveness of the credit markets. It's easier to access the wide range of banking services. Commercial banks gain their own confidence in investing to renovate this sector's business activities. Total credit outstanding of this sector in commercial banks have accounted for 20.6 percent of GDP.

(c) Policies set up and applied by the banking system without differentiating private economic sector from public sector have facilitated the private sector in getting banks' credits in compliance with market economy.

(d) Unfinished or unable to recover the bank loans during the private sector reforms made investors reluctant if not to say not to invest to this sector. This has been a real trouble in the credit markets recently. In additions, most of the low capital private enterprises which found difficult in accessing bank credits tried to illegally use other enterprises' capital or to defraud in order to have capital, causing the instability in the general economic relations.

(e) In this period, the burdens of unrecovered nonperforming loans by the private sector on state-own commercial banks are rather significant. The most updated data have shown the total of 4,650 billion of dong of these bad loans which were mostly caused by some large illegal uses of banks' capital (Minh Phung, Epco, Tameco, Ngoc Thao...). Furthermore, credit markets in Viet Nam still face a lot of potential risks such as risks on interest rates, foreign exchange rates, and policy instability causing many difficulties for the banking system.

(f) The private sector is still in modest scale, with low competitiveness and inappropriate reforms. The low motivations for the development of the private economic sector together with the problems in distribution mechanism have discouraged employees.

(3) **Reforms on the stock market**: concerning the establishment of the stock market of Viet Nam, the Government had promulgated the Decree No. 48/1998/ND-CP on the organization and operations of the stock market in Viet Nam, regulating the conditions to establish and develop stock trading companies, brokerage companies, stock custody companies and Stock Trading Centers in Hochiminh City and Hanoi. Although the Stock Trading Center has been operating since the August 2000, the conditions for proper operations of this Center are still not synchronous, total trading volumes are very small with an average of 10 billion per session. On the other hand, the number of primary stocks issued by companies is quite modest, and they have not been listed in the Stock Trading Center yet. The companies' stocks and bonds have not yet gained the full credibility of the private investors so that total trading volumes in the Center are limited.

In short, in order to have an efficient stock market in the future, it is essential to reform the financial system towards the market orientations to mobilize capitals for long term investment in the economy, to enhance the state management and conduct on the operations of stock market, as well as to speed up the state-owned enterprise privatization process.

(4) **Foreign exchange markets**: the foreign exchange markets have been gradually improved and developed. The legal frameworks have been established since the promulgation of the government's decree on foreign exchange management and operations applied to banks, institutions and individuals in the economy, ensuring the principle that all the lending, payments, and other transactions in the economy must be executed in Viet Nam dong.

The Government Decree No. 63/1998/ND-CP dated 17 August 1998 on foreign exchange management and the Circular No. 01/1999/TT-NHNN7 providing the guidance for the Decree No. 63 provided regulations on foreign exchange transactions of residents and non-residents in order to encourage institutions, individuals to bring foreign currencies to the economy. However, after a period of application, there arose some problems such as: lending on foreign currencies for loan payment before due maturity, surrender regulations, domestic lending on foreign currencies... Referring to these problems, the State Bank has drafted the official letter to the Government for the approval of amending some articles in the Decree No.63; the services supplied to foreign partners would be allowed to be executed in foreign currencies, institutions and individuals having foreign currencies inflows would be permitted to sell to commercial banks at the foreign exchange rates quoted in the market.

The State Bank allowed commercial banks to enter the foreign exchange transactions including spots, forwards, and swaps. In additions, commercial banks as well as State Bank actively sold and bought foreign currencies in the interbank market, provided regulations on time deposits and carried out their investment in some international financial institutions. On the other hand, the State Bank promulgated regulations on foreign currency positions applied to the permitted credit institutions for the foreign exchange trading, managing the foreign borrowings and repayments of the credit institutions and enterprises including managing short and long term borrowings, granting guarantees for deferred payments... so as to control the foreign currencies inflows and outflows the economy, significantly contributing to the Viet Nam balance of payments improvement. Up to 1999, the Viet Nam current account balance is getting surplus, annual export turnovers increase by 15 to 20 percent in the period of 1995-2000, total export turnover is 11.5 billion USD in 1999, and estimated to be 12.5 billion USD in 2000, remarkably contributing to the monetary stability and exchange rate management in the economy.

The regulations that the exchange rate management should be closed to the interest rate and credit mechanism have influenced on the capital movements, and thus exerted impacts on exchange rate fluctuations. In fact, the State Bank had taken into account the exchange rate movements when decided to adjust the ceiling interest rates, especially the effect of interest rate changes on the shifts from domestic currency capital inflows to foreign currency ones.

The process of foreign exchange management reform may result in some of the following influences on the reforms of other sectors:

1) The renovation of foreign exchange management to improve the ability of State Bank in controlling the capital flows thereby facilitating the conduct of monetary policies encouraged enterprises to get foreign currency inflows, met the demand on foreign currency to import materials and goods of exporting companies, strictly controlled the foreign exchange trading in private enterprises, lessened the strain of foreign currency supply and demand.
2) Foreign exchange management mechanism applied to exporting enterprises such as surrendering 80%, and then 50% of their current foreign currencies inflows contributed the rest to satisfying foreign currencies for import demand, raising foreign exchange reserves. To some extent, however, this surrender requirement affected the self-control rights in doing business of exporting enterprises, causing certain adverse movements towards exporting companies, especially in case of exchange rate depreciation expectation.
3) Owing to the psychological factors as well as the limited foreign currency supply in commercial banks, it is still difficult for individuals and private sector to access the foreign exchange market of commercial banks. Upon the regulations, exporting enterprises are responsible for selling their current

foreign currency inflows to banking system, and then commercial banks will sell foreign currency to enterprises to meet their demand of importing materials and goods. In fact, however, it's quite different thus affecting the development of this market.

4) The foreign exchange inspection in non-bank institutions has not been seriously implemented so far, resulting in the disregard of law and regulations, somewhat affecting other sectors.

2. Descriptions of financial and enterprise sector reforms in the period of 2000-2005 in Viet Nam

(1) Financial system reforms: Financial system reforms are aiming at exploiting internal as well as external resources in order to implement the objectives of socio-economic development in the new period of the 5-year plan from 2001 to 2005. It is important to improve the market oriented financial system under the state management, especially to establish and develop financial intermediations so as to effectively mobilize capital for the development of productions and businesses in the economy, thereby improving the national fiscal policies. Here are some of the main ideas of financial system reforms:

1) Enhancing the legal framework on the issuance of companies' stocks and bonds to pave the way for the development of Viet Nam financial market and to mobilize long-term capital for investment in the economy. At the same time, it is important to launch other long-term capital mobilizing instruments to balance the capital sources such as government bonds, project bonds, ... Viet Nam stock markets, i.e. Hochiminh City and Hanoi Stock Trading Centers, are going to be upgraded by the end of the year 2000. In the initial period of operations, however, the markets are still in primary scale, low trading volumes. In additions, primary securities issued by companies are very modest and underdeveloped; people have not yet totally believed in the stocks and bonds issued by these companies; there are only several companies planning to issue these kinds of instruments.

2) Continuing to develop financial intermediation system such as insurance companies, leasing companies, commercial bank system, and financial companies, thus giving the markets competitiveness and effectiveness in exploiting resources for the socio-economic development, and facilitating the objectives of macro-economic stability, economic growth, and industrialization and modernization in the economy.

3) Strengthening the state management in financial mechanism towards every forms and sectors in the economy, especially creating comprehensive and equally competitive legal environment for financial management in state-owned enterprises, general corporations, and private sectors in compliance with their operational characters.

(2) Banking system reforms:

+ *Reforms on the State Bank system*: the State Bank system will continue to carry out their functions of a central bank such as setting up management mechanism and policies, managing, inspecting and supervising the business activities of commercial banks. Bellows are the stages to be taken:

- Going on promulgating the guidance document for the implementation of the 2 laws (Law on State Bank, and Law on Credit Institutions); setting up monetary- credit- interest rate policies; improving the effectiveness of monetary policy by developing monetary policy instruments in order to gain the monetary stability, inflation constrain, and to build up a legal environment for mobilizing and lending activities in the economy of the commercial banks; summing up the operations of banking system, establishing other forms of commercial banks in conformity with the Law on Credit Institutions to effectively use the capital resources for lending purposes.
- Renovating and enhancing the roles of monetary policy instruments such as required reserves, re-discount, exchange rate, interest rate policies, especially the open market operations. In the coming time, the open market operations will be a very important channel to realize 50 to 70% money supply into the economy.
- Consolidating and completing the organization and operations of commercial banks, supplementing credit and interest rate mechanism, creating a comprehensive legal environment for commercial banks' operations; concentrating on the inspection and supervision activities because in this period, commercial bank system are growing up rapidly, with estimated annual average credit growth of 18%, capital resources increase 25%, contributing to the economic stability (estimated GDP at 7.5 per year).
- Consolidating the commercial bank system, people credit fund system, and setting up regulations on paid-in capital as follows:

State-owned commercial banks	: 2000bil - 3000bil dong
Urban joint-stock commercial banks	: 100bil - 200bil dong
Rural joint-stock banks:	: 15-50 billion dong
Joint-venture banks, foreign banks' branches	: 20-30 million USD
Local people credit funds	: 300 million dong

- Broadening the banking operations in accordance with the integration and development tendency of regional and international developed commercial banks.
- Modernizing and widening the payment system to ensure a rapid and efficient capital movements; extending the sphere of banking operations to outlying and remote areas as well as to regional and international markets.

+ *Reforms on state-owned commercial bank system*: State-owned commercial bank system will continue to be enhanced under the project approved by the Government. The reforming process will be taken in the following basic stages:

- Establishing resources to cover the overdue debts and to ensure the solvency of state-owned commercial banks; extending credit to effective projects, especially rural agricultural credits; enhancing the capital mobilization and lending in the economy.

- Restructuring state-owned commercial banks; focusing on recovering bad debts, liquidating collateral properties through the Property Disposal Company; emphasizing the internal inspection throughout the state-owned commercial banks' operations; raising capital, contributing to economic investment and development.
- Differentiating the policy-loans and commercial loans by setting up policy banks with main functions of: granting preferential credit to the poor, extending credit to students and other state sponsored projects to support mountainous and islandish areas, Khome and to overcome consequences of serious natural storms, floods....
- Widening banking operations, strengthening the trend of development and integration into modern regional and international banking system; promoting the development of payment system to ensure of efficient and rapid capital circulation, making banking services accessible in remote and outlying areas in the country as well as modern regional and international markets.

+ *Reforms on joint-stock commercial bank system*: Keeping on consolidating the operations of joint-stock commercial banks in order to ensure the safety in banking operations. Paid-in capital should be accumulated in a larger scale, credit quality should be improved to obtain reputation and make use of new technology to be capable of fair competition to meet the requirements of economic development in the coming years.

- Consolidating, reorganizing and restructuring joint-stock commercial banks; improving operational quality;
- Preventing potential collapse of weak banks, avoiding turmoil, reducing the number of inefficient banks with bad financial situation as stipulated in relevant legal document.
- Strengthening inspection and off-site supervision towards every operations of banks, especially paying attention to stock possession, capital security in joint-stock commercial banks.

(3) **Reforms on foreign exchange market**: Foreign exchange markets have been step by step improved and developed. Legal framework is initiated by the Government Decree on foreign exchange control towards banks, institutions and individuals in the economy, ensuring the principles of using only VND in every transactions as lending, payment, and other transactions in the territory; services supplied to foreign partners are allowed to be executed in foreign currencies; foreign currency inflows of individuals and institutions may be sold to banks at exchange rates of the markets. In additions, commercial banks as well as State Bank actively sold and bought foreign currencies in the interbank market, carried out SWAP, time deposit transactions and other investment in some international financial institutions.

The reform process will be taken as follows:

- Emphasizing economic solutions in dealing with foreign exchange controls, minimizing inefficient administrative solutions.

- Trying to make VND convertible, restricting foreign currency circulation in the territory, and finally giving up the use of foreign currency in the territory.
- Completing and developing the regular operations of foreign exchange interbank market in terms of trading volumes, scale, and number of participants,...
- Formulating and conducting exchange rate policies in a more flexible manner, giving close reflection of supply-and-demand relations; determining official exchange rates based on the combinations of currency basket, supply-and-demand in the foreign exchange markets, and foreign exchange fluctuations in the international markets.

(4) **Reforms on state-owned enterprises (SOE)**: the objectives of the reforms: Keeping on the reorganization, renovation and development of SOE in the period of 2000-2005 to raise the socio-economic efficiency and competitiveness of SOEs so as to prove the their leading economic roles in the economy; contributing to macro-economic stabilization, ensuring main balances of the economy, playing a core role in speeding up the economic growth and developing the material producing industry, high-technology industry to carry out the modernization and industrialization cause in the economy; giving strength to SOEs, and in co-ordination with other factors of state economic sector, to show their key roles in the socialism oriented multi-sectors economy; continuing the possessive structure renovations to motivate the management and capital mobilization in the society, reasonably adjusting SOEs' structure; step by step developing fair competition environment between economic sectors and defining the state possession representatives in SOEs based on differentiation between the rights of possessors and these of institutions, individuals using state properties to do their business; eliminating administrative intervention in SOEs in the fields of doing business; accelerating the SOEs privatization process to reach the projected target of only 2000 SOEs available in the year of 2005, while implementing the program of enterprise hire..... on the basis of

1) Scale and schedule of SOE reforms in 2000-2002 period:

Implementing solutions focusing on organization and financial problems, formulating appropriate policies to facilitate the reorganization of SOE and provide them with latitude in doing business. Based on the restructure of inefficient SOEs and principles, requirements for establishment of new SOEs, this reform stage is scheduled to restructure about 2000 existing SOEs. This reform is tended to raise average paid in capital level from 18 bil to 30 bil VND in a SOE. In the period of 2003-2005, the government shall promulgate legal regulations on the master plan for SOE restructure which results in efficient SOE system capable of facing competition in domestic, regional and international markets. Large and medium corporations shall be reorganized to be capable of competing domestically and internationally, facilitating capital centralization and accumulation of these corporations in the modernization and industrialization period, aiming at:

- ensuring the key role of SOE in the national economy;
- making SOE system to be effective tool for the government to regulate the economy along with socialism orientation;
- ensuring the real power of SOE system in social policy and the political and social stability;
- building up a great portion of SOEs' contribution to the external economic activities (import-export);
- developing SOEs' key role in contributing to the Government revenues.

Schedule of SOEs reforms:

No.	Items	year 2000	year 2003
1.	SOEs reform schedule	5,280	3,000
2.	Number of reorganized SOE		2,280
	o/w: - equitized, sold, hired, contracted out	1,498	
	- merged		380
	- dissolved		368
	- shifted to administrative enterprises		43
3.	Number of employees working in reorganized enterprises		429,095
4.	Total outstanding loans of SOEs to be reorganized	21,165 bil dong	
5.	Projected enterprise scale	18 bil dong	27 bil dong

Sources: SOE Renovation Committee

2) Employees of the SOE are entitled to take 50% of the value of assets and profits derived from the total assets of these enterprises that have already paid up all the banks' loans.

3) State general corporations are entitled to decide investment for B-group projects, monopolistic enterprises have a right to decide investment for C-group projects and also take full responsibility for the projects' efficiency.

4) SOEs are allowed to recruit, dismiss and pay wages to employees; SOEs that have suffered from losses for 2 years due to their subjective reasons must face the reshuffle in their board of management; their financial situation must be annually audited.

The above-mentioned reforms are very important during the process of SOE reforms. It's also an essential factor and can help SOEs meet necessary requirements of running the business activities in competitive markets, bring the existing strength of SOEs into full effect and provide requisites for reforms implemented in other sectors.

(5) **Reforms on private enterprise sector**: The government has a policy to encourage all economic sectors to invest in production and trading to promote socio-economic development and job creation in the following forms:

1) Establishing legal framework to regulate operations of private enterprises such as Law on Enterprises promulgated in 1999 or other legal document in order to create comprehensive business environment for this economic sector, protecting their legitimate interests in doing business;
2) Properly conducting and thoroughly materializing tax policies, corporate finance management policies, credit policies, and state management to encourage and to help this economic sector to do their business legally and efficiently, significantly contributing to annual budget revenues.

However, there still remains some problems such as issuance of legal document providing guidance for law implementation is often behind schedule, and not synchronous; many enterprises are in inefficiency, even losses or fraud.

These problems have gradually been solved by the government issuance of Law on Enterprises replacing the former out-of-dated laws, as details:

- building up favorable legal environment, especially private enterprise financial management mechanism, to encourage the self-control of enterprises, to develop internal capability, and to exploit resources for production and business.
- adjusting this economic sector's business operations in compliance with laws and state's policies on finance, credit, taxes that are equally applied to other economic sectors.

3. Assessment on risks related to projects of reforming financial sector and enterprise sector in the 2000-2005 period

(1) Small banks may find difficulties in investment, capital balances, risk elimination as well as capital demand fulfillment during dong their business due to severe competition in the markets, especially when they integrate into regional and international markets. It's suggested that small commercial banks should merge in so as to increase their scale by accumulating paid-in capital, thus strengthening their competitiveness to firmly and stably exist in the markets. However, recent forecast has shown that a number of joint-stock commercial banks are likely to face difficulties in implementing this strategy because it is really tough for most of the joint-stock commercial banks whose paid-in capital are smaller than 200 bil dong or even below 5bil dong (in some rural joint-stock commercial banks) to increase their paid-in capital. On the other hand, having suffered from overdue debts at above 10% of the total credit outstanding, rural joint-stock commercial banks may find difficulties in financial balancing and even fall in bankruptcy.

To deal with these problems, State Bank of Viet Nam plan to keep on restructuring joint-stock commercial banks by merging, taking over in order to ensure the safety of businesses and competition in the markets, regulating the increases in paid-in capital of joint-stock commercial banks.

(2) Risks in investment activities: along with the financial and banking system reforms as well as monetary market renovation, it's impossible for foreign exchange markets and enterprise reforms to avoid risks such as: facing fierce competition or being unable to compete in the markets, losses. Besides, international integration tendency also results in competitive disadvantages. Losses due to incomplete markets and inefficient business in the economy may heavily affect financial institutions as well as enterprises in the national economy and international markets.

(3) Abundance of labor force in the enterprise restructure process: the fact has proven that SOEs restructure process has brought unemployment to a portion of employees (number of people working in SOEs accounted for 5% of the total national labor force as the most updated data). A survey conducted by the Ministry of Labor, Invalid and Social Affairs showed that there may be some 450 thousand of employees being out-of-work, details as follows:

- About 100 thousand people de jure registered in the employee list of SOEs but de facto out-of-work have to find jobs outside their enterprises.
- 75 thousand employees of 357 SOEs planned to be dissolved in the 2000-2002 period will be out-of-work.
- About 200 thousand employees of the total 2000 full State's capital enterprises may be remained after restructuring. However, they are still facing the potential of being cut off with a view to facilitating efficiency and high productivity in these enterprises, especially in the case of applying new technology to improve their competitiveness in the markets.
- To solve this problem, Government have the guidance to the Ministry of Labor, Invalid and Social Affairs of the following solutions:
- Training under-40-year-old people with appropriate careers to provide them with job finding chances.
- Allocating a proper portion of budget, which estimated to be 5000 bil dong, to subsidize for sack employees, pensions...
- Encouraging investing to labor intensive projects by tax reduction and exemption, preferred interest rates, post-investment subsidy...

(4) It is important to take into consideration potentially bankrupt enterprises during the process of banking and financial sector reforms because these enterprises with their huge unpaid debts and low paid-in capital may cause great burden on banking system and the economy.

(5) Financial market may face losses and turmoil if the government and related competent authorities do not

regularly and strictly manage and supervise the market. In additions, the feasibility and implementation of state policies are likely to be spoilt by sophisticated corruption resulting in unstable general socio-economic reforms in the national economy.

To deal with these problems, the government decides to enhance the management mechanism by promulgating legal document on fines imposed upon administrative violations in the fields of accounting and statistics, banking operations, supervisions, taxation, customs...

(6) Risks in credit activities and inadequate mechanism on allocating and using risk provision funds amplify the credit outstanding of enterprises as well as burden of bad debts on commercial banks. Data show that SOE reforming process will have to deal with 21000 bil dong credit outstanding of 2280 SOEs of which banking credit outstanding is about 7300 bil dong, accounting for 34 percent.

Coordination of the Reforms of the Financial System and the Business Sector

(In Particular, State-Owned Enterprises)

Le Quoc Ly

Ministry of Planning and Investment

1. Evaluation of how the reform steps in different sectors of the financial system (including State Bank of Viet Nam, state commercial banks, joint-stock commercial banks, state-owned enterprises, private enterprises, securities market, foreign exchange market), influence (and are influenced by) the progress of reforms of other sectors.

1.1 It is extremely difficult to analyse and evaluate reform steps on the basis of providing persuading procures on reciprocal effects between different reforms of the financial system and the business sector (including: state banks, state commercial banks, joint-stock commercial banks, state-owned enterprises, private enterprises, securities market, foreign exchange market) influence (and are influenced by) the progrss of reforms of other sectors. Thus, the report will highlight general information on the fundamental renovations and mutual influences between the reforms.

In the years 90s, the economy of Viet nam has faced fierce difficulties and big challenges which seemed to be unable to overcome. Therefore, many business entities have took their efforts and have played an active role in finding out solutions; the Party and the State have undertaken all measures in renovating policy-related decision-making process and management mechanism in order to get out of this crisis. Many initiatives arised from the grass-root level, for instance, the product-based contract mechanism of agricultural production in rural northern areas were accepted and institutionalised into concrete policies and they were pioneer in local renovation steps. It was the kick-off for further reforms in the fields of finances, banking, enterprises and social polices.

1.2 In September 1985, the second stage of the innovation program was approved in the sixth plenary of the Central Committee of the Communist Party (Session 5), and was further developed in the sixth Congress in 1986. The main strategy is aimed to escape from the constraints of the central planning system. During this period, the renovation focused on new policies of "Price - Salary - Monetary". The Government has tried to erase the subsidized system by applying "salary adjustment policies which based on price was subsidized in salary" which was aimed to avoid a significant reduction of the real income. The price reform, which aimed to erase the dual price system, was undertaken. Along with price - salary reforms, measures, which aimed to innovate monetary policy, were launched. In addition, some solutions, which streamlined to reduce the direct intervention of the State towards in the economic activities and to minimise the power of central planning and of subsidized system, had been taken initial steps. With the reforms, the initial steps of self-accounting and self-financing mechanism of enterprises have been applyed together with removement of the system of "quota-ticket for commodities". Furthermore, through out replacing the centrally planed mechanism by the oriented plans, the State has kicked off the development of economic components, by which, the economy had been raising.

1.3 Measures of reforms for the period 1985 - 1987 included policies and mechanism for erasing the "budget-subsidy system" by "compensation for price in salary" (**"salary adjustment based on price index in salary"**); Wiping out the "dual-price system"; monetary reform; circulation of new paper money... money exchange was conducted on the principle of "10 units for a new one" in conformity with a limitation, and that, the excess money kept in the State Bank for a long time. A part of the monetary reform was aimed at separating commercial banking from the State Bank and empowering the State Bank to function as a Central Bank. Accordingly, monetary and credit activities had been initially changed, and the two tier - banking system were established to separate the business function of commercial banks from the state management of State Bank. Those initial innovations had changed the way in definition of the developed orientation for the economy, and had been the foundation for taking shape of monetary market and capital market. If there was not changed from the one-tier banking system toward the two - tier banking system, the interbank monetary market (foreign exchange market and domestic monetary market) and joint-stock commercial banks, joint-venture banks, foreign banks could not be set up. Through activities, the State Bank of Viet Nam has summed up a lot of experiences in circulation of currency, readjustment of interest rates determined in the market, foreign exchange controls, establishment of a legal foreign exchange market, building up liquidation instruments satisfying the demands of state governed-market economy. In monetary businessis function, Commercial banks have been greatly progressed. For over 10 years of renovation, 6 state commercial banks, 60 joint-stock commercial banks, 5 financial companies, 19 representative offices of foreign banks, hundred of rural credit funds and co-operatives, ... have been established in Viet Nam. The the banks and credit organisations, which were established, have satisfied capital demand of different economic sectors for investment of development not only in cities and towns, but also in rural areas. And, the establishment of the two-tier banking system and the capital market has created essential conditions for reforming enterprises, especially, state-owned enterprises.

1.4 Thanks to development of the banking system, which has pushed up the opening of monetary markets (interbank foreign exchange market and domestic monetary market), and constructed a new environment and an important channel for mobilising capital for economic development. On the basis of strong development of the banking system and the monetary market, all liquidation instruments, which satisfying international standards, have made considerated contributions in building up the stock market. In July 2000, a centre for stock exchange was opened in Ho Chi Minh City. This was the beginning of a new channel for mobilising capital, and was the initial for financial liberalisation and integration into the world economy. Establishment of the stock market was considered as one of factors to speed up the process of equitization of state-owned enterprises, and also defined new demands required to the banking system which have to continuously reform in order to supply financial services better. On the contrary, because of the enterprise renovation, especially the equitization of state-owned enterprises, preconditions and securities for establishment and operation of stock market have been taken shape. Flowingly, for selling dividends in public to raise capital for development of production, whic was necessary to require the enterprises to reform themselves and to enhance efficiency of their business continuously.

1.5 Accompanying with the reform of the financial system, there was the innovation of enterprises. Policies for development of a multi-sectoral economy have brought forward to establishment of private enterprises, enterprises with foreign owned capital, limited liabilities companies, State owned enterprises,... and speeded up the institution of joint-stock commercial banks, foreign banks, joint-venture banks, and financial companies. Those organisations have been operated in accordance with not only laws on credit organisations, but also the Law on Enterprises. Though out reorganisation of enterprises following the Decision 315/ HDBT, the Decree 388/HDBT, and the Order 500/TTg, approximate 3000 enterprises ... and other enterprises in sectors of technology and market had been merged; And 3500 other enterprises had been dissoluted. Thus, there have been only 5800 State owned enterprises since June 1998.

1.6 In the process of reforming state-owned enterprises, it have been facing with a lot of serious difficulties such as lacks of capital, and backward technology. In 5800 state-owned enterprises above mentioned, there are 3997 enterprises under locality authorities. Most of them are small-sized enterprises with weak financial ability, of which the borrowed capital amounted to 85% - 90%. In many enterprises, the borrowed capitals are usually fourfold or tenfold compared with their owned capital, and, efficiency and benefit rate are low. About 30% of enterprises are suffered losses in capital. Due to the renovation of the banking system, many enterprises have just raised necessary capital for development of the business. For state-owned enterprises, which had total debts borrowing from banks (including guaranteed debt) and from other investors and exceeded the amount of capital granted by the State, the density of borrowed capitals in total debts to the banking system was about 53%. The total capitals of state-owned enterprises up to 31 December 1997 were 103,000 billions Dong, and up to 1998 were 108,000 billions Dong. And, the capitals were mainly concentrated in National business corporations (about 70%), of which approximate 80% of the capital were in fix properties, but most of them were worn and backward, thus, the efficiency of capital were very low. About 50% of the fix capital were frozen because of losses, non-performing loans and missing property. Total mature debts and loans of State owned enterprises were too high. Up to 31 December 1997, total overdue debts of state-owned enterprises amounted to 128% of total owned capital, of which the short-term debts occupied 64%, the medium and long term debts occupied 29%; foreign debts occupied 12% (short-term debts: 1.3%). Total mature loans were about 50% of total owned capital, in which the non-performing loan was 2.5% of total mature loans.

1.7 Together with reform and development of the economy, the capital resourses, which were not longer concentrated in state-owned enterprises, were released. The amount of capital investment have been raised. As a natural result, a requirement for exchange of capital resourses in the market economy was appeared. And, together with the banking system' prompt-integration into the market economy, the financial - monetary market have been also taken shape. The financial - monetary market has been improving and developing with reform of the banking system. For recent years, the reform has been conducted in conformity with integration into the international financial market, and with ensuring a stable development of monetary system in order to mobilise maximum of available capital investment with a view of economic growth, and macro-economic stability. Conducting the reform of economic polices, Viet Nam has mobilised different capital resources for building national material and technical, social and economic infrastructure of the country. Capital resources have been gradually diversified, from which, the capital raised from banks occupied about 29 - 30% of total capital investment in the whole country.

1.8 The Reforms in the different sectors also had reciprocal impacts and the reform of one sector has been the foundation for others, and so on. Since removing the budget-subsidies system, and building up the multi-sectoral market economy with a system of autonomy in "cost-accounting", "self-financing", and "self-responsible" in business, as a result, the banking system had been also reformed, and which was came a precondition for establishment of commercial banks, credit organisations, financial companies, and monetary market. The financial liberalisation and liquidation of state-owned enterprises have built up a basement of establisment of stock market. In addition, the banking system reform, financial liberalisation and stock market establishment would have pushed the innovation of enterprises, especially state-owned enterprises.

1.9 Reform stages of different components of the financial system (including: state banks, state commercial banks, joint-stock commercial banks, state-owned enterprises, private enterprises, stock market, foreign exchange market) not only contributed substantially to the process of economic renovation, but also played a key role in speeding up the reform in social policies, also awareness and living standards peoples. It was obvious that, social-thriving and civilisation have been gradually built up. And, the continuously social-economic reform and development have been given a push to the financial system and enterprises. Although the banking system reform has strongly impacted to the development of State owned enterprises, but those effects to non-state enterprises reform were only a little and not shaped. Including only 6000 state-owned enterprises in total of over 55000 enterprises (about 11%) and 1.6 millions household businesses, but the percentage of loans borrowed from the banking system amounted to 53% of total debts. The rate of bad loan shows that amount of capitals, which were borrowed by non-state enterprises from banks are not too high. Otherwise, many state and non-state enterprises which had not been able for paying their debts, has negatively affected to the banking system. Overdue debts have been blocking upon banking activities, coursing rotation to capital resources, and obstructing an objective to enlarge credit activities of commercial banks and the credit target of the State Bank of Viet Nam. Event, in 1990, due to extreme amount of overdue debts, the system of joint-stock commercial banks and credit co-operatives had been in crisis and macroeconomy was in unstability and which made unbelieving environment of people to the banking system for the decade 90. In the last half of the Decade of 90, thanhks to applying several necessary solutions, there were not any bad debts, which could been able to bring about a banking-crisis, and a macroeconomic unstability as happened in 1990. The bad debts above discribed, especially the "frozen-debts" of state-owned enterprises have reduced the success of the banking system reform. After the debt Crisis in 1990, the proportion of bad debts borrowed from the banking system has been continuously growing up in the process of renovation (1991 and 1992: 19.7% and 13.7%). The ratio of total credit debts only touched the minimum in 1994, but it was back increased in 1995. Especially, the percentage of bad debts of state-owned enterprises were always higher than the private sector' one. This proved that, the business and financial states of state-owned enterprises were strongly serious. For settlement of non-performing debts, the Government of Viet Nam had undertaken solutions such as "frozen-debts", "erazed debt". In the second step of debt settlement, total overdue debts of enterprises before 1995, which borrowed from state-owned banks, accepted as frozen-debts by the Government, were 2233.2 billions Dong, including 1606 billions belonging to foreign banks, 472 billions belonging to industrial-trade banks, 117 billions belonging to investment and development banks, and 38.2 billions belonging to agriculture and rural development banks. During the step, the State Bank estimated the debts for elimination amounted to 1116.7 billions Dong, occupied half of total bad debts above mentioned.

Many joint-stock commercial banks and non-state-owned enterprises conducting business inefficiently, and being in loses, in crisis or bankruptcy, had been damaging a lot of their capital and property, losing people' hearts, and negatively affected to economic reform process and banking system renovation in particular. Those consequences had negatively acted upon the economic reform steps. In joint-stock commercial banks, the rate of overdue debts in total credit debts were extremely at a high level. Especially, it amounted to 98.21% in several banks. A number of enterprises, which conducting business on the way of snatching opportunities, breaking laws, for example, companies such as Tamexco, Epco, Minhphung, who damaged thousands of billions Dong of State.

2. Description of alternative scenarios of reforming the financial sector and business sector

2.1 Up to January 1st 2000, about 5.500 state-owned enterprises were reorganised, including 732 public state-owned enterprises, from which 1,802 enterprises established by Central authorities, and 3698 enterprises under local authorities (provinces and cities). Thus, a number of state-owned enterprises was 50% less than before. Accompanying the reorganisation of state-owned enterprises were the equitation of them, up to now, the number of state-owned enterprises for equitization, sale, contracting out, and leasing have been 450 enterprises (2/3 of the total are local enterprises; 1/3 of them are central enterprises), including 47 transportation enterprises, 176 trade and tourist enterprises, 209 construction - industrial enterprises, and 23 agriculture - forestry - fishery produced enterprises. This was an important achievement of the renovation, through which, many enterprises have grown up and substantially contributed to development of the Economy. However, it is necessary to put up the reform toward fewer of number of enterprises, but which have an ability to play a leading role in all economic fields such as financial potential, efficiency, production-scale, commodities... In general, the reorganisation of state-owned enterprises was not only focused on administrative formalities, but also fully concentrated in efficiency and abitlity of integration into the world economy. The professional schemes of enterprises have not yet reached to the their aiming; also, the structure of branches was irrational; in addition, with numerous state-owned enterprises, but they have been in distributed and overlapped situations in many branches and localities. There have been more than 25% of enterprises having the capital less than 1 billion Dong, and 60% of them having their capital valued less than 5 billions Dong. Some indicators on enhancing the efficiency, labour productivity.... have not been satisfied the requirements. Therefore, most of enterprises, including National business corporations established following the Decisions 90/TTg and 91/TTg, have a weakly competitive ability, which only conduct business internally, and have not yet had necessary financial potential and managed capability for external businesses. In fact, the organisations of "National Business Corporation" according to the Decision No 90 /TTg and No 91 /TTg were only a result of movement of "administrative management board" from ministries to corporations, they were not reflected the natural capital concentration. The present organisation of "National Business Corporation" should be renovated following the tendency of establishment of "National Business Corporation" on "volunteer". In addition, there are many remains neccessary for removement during enterprise's equitization, for example, in equitization of a part of an enterprise, the state capital was handed over to individuals, it inflicts damages of state property, but not raising the economic efficiency.

The sale, contracting out, and leasing of state-owned enterprises have been reflected a sound tendency. Among 450 enterprises being equitized, sold, contracted out, and leased since 1992, there have been 250 enterprises being done for 1999.

2.2 By way of dissolution, merger and re-registrar applying to state-owned enterprises (following the Decree No 388/HDBT on establishment, re-registrar, and dissolution of state-owned enterprises; The Order No 500/TTg of the Pri minister on continuing the reorganisation of state-owned enterprises; The Decree No 28/CP on transformation of state-owned enterprises into a joint-stock company; The Decree No 44/1998/ ND-CP on equitization), up to now, the number of state-owned enterprises has been reduced by more than 50%, from 12000 enterprises to 5000 enterprises, and there have been about 700 thousands redundancies to get settled through paying approximate 300 billions Dong, included 55% of the total sponsored by state budget and the remains (45%) from enterprise' capital accounted for their business cost. The two categories of "National Business Corporation" of 90 and 91 had been established on the basis of reorganisation of 250 state-owned enterprises (companies, manufactures, connected enterprises), including 17 "National Business Corporation" of 90, and 74 "National Business Corporation" of 91; Furthermore, issuing the Law on Enterprises has initially defined the relations between state bodies and non-state enterprises. However, it is continuously needed to remove entanglements of present administrative formalities, first and foremost are entanglements on the factors of land, credit, and tax to create convenient environmental for more development of non-state enterprises. In fact, many legal documents, which is overlapped, or negative to each other, have coursed difficulties to non-state enterprises in businesses. However, by establishment of about 500 thousands non-state enterprises, and reducing a lot of state-owned enterprises, it has marked a great achievement in the economic reform and enterprise renovation in particular.

2.3 It costed the State over 100 billions Dong for equitization and reorganisation of 450 state-owned enterprises. And the total expenditure for equitization and diversification in the process of renovation has amounted to 500-600 billions Dong, not including capital for redundancy-payment for the period 1992-1995. The State has decided to conduct the reorganisation, equitization, assigning, sale, contracting out and leasing of more than 2600 state-owned enterprises for the stage of 2001-2005, of that, 1300 enterprises for equitization, 300 enterprises for sale, 200 enterprises for contracting out, merger, and leasing, 500 enterprises for consolidation, and 300 enterprises for dissolution, bankruptcy or transformation into other categories. Thus, it will cost 3000 to 4000 billions Dong, excluding 1200-1500 billions Dong for creating new jobs for redundancies from state-owned enterprise, which are not reorganised in the period of 2001-2005. Those are great expenses that require to cut down other expenditures for attain the target above mentioned.

2.4 Accompanying with the renovation of state-owned enterprises, there is a financial system reform and timely establishment of commercial banks, financial companies and credit organisations. Up to now, through out the financial system reform, the banking system has been improved in all sectors. In which, state banks and commercial banks (including 6 state commercial banks, 60 joint-stock commercial banks, 5 financial companies, hundreds of rural credit co-operatives and funds, 19 foreign banks, 4 foreign joint venture banks, and 40 representative offices of foreign banks...) have better satisfied the capital requirements for all economic sectors. In addition, many branches of commercial banks have been rapidly developed. At present, there are 4 state commercial banks (Foreign-Commercial Bank of Viet Nam, Industrial-Commercial Bank of Viet Nam, Investment and Development Bank of Viet Nam, Agriculture and Rural Development Bank of Viet Nam), and 236 representative offices and branches of them in provinces and cities (not including hundred of bodies under the branches). With only 4 state commercial banks, more than 40000 labourers and hundred of thousands of billions Dong were mobilised. The state commercial banks have played a decisive role in monetary sector, of which, the capital being mobilised for loaning amounted as to more than 80% of the total capital undertaken through the banking system. From business on skilled sector, the banks have diversified their business on credit and monetary sectors.

2.5 In addition to the rapid establishment and development of the commercial banks after 1990, many weak points have been remained, and they alarmed a bankruptcy danger of joint stock banks. In this situation, to the demands of the market economy, it is needed to renovate the banking system, including joint venture banks. This functions have decided in the Government'action programs, and has been carrying out by the Governor of State Bank of Viet Nam. First of all are restrictions of licensing new joint-stock banks, and issuing legal regulations to create legal framework for operation and self-renovation of credit organisations. In 1998, escorted the Governmental project (approved by the standing committee of the Politburo) of reorganisation of joint-stock banks in Ho Chi Minh city was issuing the Decree No 22/1998/ND-CP dated on October 3, 1998 regulated the legal capitals of credit organisations. The State Bank of Viet Nam has ordered commercial banks to increase their chartered capital because they were so low that the banks would not be able to enlarge their business in other professional sectors and other localities. Furthermore, the settlement of overdue debts through economic and administrative solutions, even criminal sanctions have been applied to avoid damages to the banks. The State has required that joint-stock commercial banks, which have to establish a fund of "preventive measures for risk", have to maintain a percentage at a safe level and to conduct services of ensuring bank deposites according to regulations of State Bank of Viet Nam (the banking system's fund of preventive measures for risk valued 600 billions Dong)

3. Evaluation of the risks associated with alternative scenarios of reforms

3.1 In fact, the commercial banks, including joint-stock commercial banks, have the same characteristics such as: owned capital is small; competitive ability is weak, which is not satisfied severely natural law of the market economy; A large part of the capital is not for banking business. (Usually, the capitals are mobilised from other professional sectors or temporarily borrowed from shareholders); Estimated benefits of banks are not stability and which have not contained economic growth and development; High risky position would have led to danger of bankruptcy; Total debts are not in conformity with the law in force; Doing businesses on the way of snatching opportunities based on falling off ethics, included cheating in capital mobilisation and in guarantee for debts; The liquidation power is too low, many banks have only occupied real estates (most of them are land) immovable into money. Thus, the former establishments of joint-stock commercial banks have coursed danger of doing business inefficiently and bankruptcy of the banks.

3.2 The innovation of enterprises has brought a lot of significant results, and built up an enterprise's system which is gradually satisfied with requirement of market mechanism, and made noticeable contribution to the economy. However, in the renovation process, many enterprises have loosen of their capital, and bearing high value of debts, especially, the debts to banking system. Also, for the non-state enterprise sector, there were many enterprises such as Epco, Minh Phung, Tamexco... conducting business on the way of snatching opportunities, Thus, they had brought about serious consequences. For recent years, a rate of bad debts in total capital of state-owned enterprises is increasing at a high level. At the end of 1997, the rate of bad debts in total credit debt amounted to 12.3%, and to 13.1% in the end of 1998, and to 13.7% at the end of 1999. Because of the bad financial situation of enterprises, a proportion of the bad debts was at a greatly high level, and directly impacted to the financial position of the banking system.

3.3 In fact, if it could collect 50% of total bad debts, a missing property of commercial banks would still be at a high level. In the mean time, financial situation of state banks were more serious. In 1997, a proportion of bad debts occupied to 12.3% (13.3% according to the State Bank' report) of total debts and 128.5% of total capital. If 50% of bad debts could be collected, so about 65% of total capital of the banking system would be losen. For the whole Decade 90, total bad debt was always higher than total capital in state-owned enterprises. It was such an anxiety financial position, which was because of non-performing debts of enterprises, especially of the economic crisis which is so hard for recovering. In private sector, a proportion of debts in capitals was lower, but this rate of debts in total credits allowed for borrowing was above alarm level (13.5% in 1997). Debt-structure is toward worse, because a proportion of short-term debts and foreign-currency debts growed up. In 1997, in the overdue debts, the short-term debts occupied to 51.8%, foreign-currency debts occupied to 40.7%, meanwhile, only 6.5% were the long-term debts.

3.4 According to formal reports, the financial state of the banking system in June 1999 was at a relative low level compared with estimations of economic specialists. Especially, several international auditing companies had confirmed that total loans at an interest rate of 0% would was higher than the value published by the State. Up to June 30, 1998, a proportion of overdue debts in total credit debts of state banks was only at 9.4%, meanwhile, the propotion in joint- stock commercial banks reached up to 16.6%. Bad-debt situations of joint-stock banks and joint-venture banks have caused the most considerable nail-biting. In contrary, the loan safety in branches of foreign banks proved that the branches had been automatically operated following market mechanism, which are not impacted from economic, political, and social organisations, and only foreign companies and joint- venture enterprises have the right to borrow their capital for the reason of safety.

3.5 To considerate the rate of bad debts in total overdue debts, we founded out a bad situation above mentioned: about 58% of total overdue debts of the banking system had been considered as bad debts, even as non-performing debts, which amouted to 5620 billions Dong. Especially, this density in state-owned banks was worse than it happen in join-venture banks. Although, an amount of credit loans was low in joint-venture banks, but there had been 93% of overdue debts being non-performing. For other considerable point, a proportion of overdue, and non-performing debts in the banks which were supplying services in agriculture and rural areas were much lower than other banks providing services in foreign economic relations (foreign commercial bank), or services for industrial services enterprises (industrial commercial bank). Therefore, the presentation above discribed indirectly show that the financial state in agriculture and rural areas were better than urban areas. The ability of the banking system Viet Nam have been in bad position, and easy to be shaken in difficulties. Capitals mobilised through the 4 state-commercial banks amounted to 80% of total capital mobilised through the banking system, but, in the beginning of 1998, the density of capital in their property and in credit debts were 5.3% and 8.9%.

3.6 During the establishment and renovation of public credit funds, several weak points arised as similar as they happened in the joint-stock commercial bank reform. The safety for credit activities continued to cause anxiety, althought, in different periods, it was not in the same serious situation. In the beginning of 1990, there were 470 public credit funds, who had been mobilising total capitals equal to 21.7 amounts of their owned capital, of which, 90% were short-term capital with the high benefit rate, and 93.8% of total capitals for borrowing, thus, 73% of the loans were not collected in time. Consequently, since the middle of 1990 to the end, 100% capital for borrowing had become overdue loans. As a natural result, most of the public credit funds had been in bankruptcy, and this was such reason, from which, many joint-stock banks were followingly in bankruptcy.

3.7 In the decade of 90, the reorganisation process of public credit funds had been cautiously carrying out together with issuing laws and regulations for their operation and state management. Up to February 1999, there were 975 credit funds operating in 53/61 provinces and cities of the country. Although, the danger of crisis was low, but for the period 1996 - 2000, many negative facts have appeared and harmed to the financial state. Up to February 1999, in public credit funds, the overdue debts had occupied 4.2% of total debts. Gap between income and expenditure was higher, about 30% of the credit funds had their income less than their expenditure. Operation of central and regional credit funds were better, but in many areas, the overdue debt had reached at a high level.

3.8 For the period 1999 - 2000, the State Bank of Viet Nam had applied solutions for reorganisation of public credit funds in accordance with the Law on Credit Organisations, and strengthening their supersition, direction and dealing with in order to minimize frozen-debts and avoid new crisis. Up to March of 2000, the rate of overdue debts in the total credit debts of the credit funds had been 2.1% in the northern mountain and midland areas, 4.2% in the Red River detail, 1.5% in the former area No 4, 2.8% in the North Central coast area, 3.0% in western highland, 2.0% in Southeast area, and 5.7% in Cuulong Delta area. The density of overdue debts in total debts had been reduced to 3.88%

3.9 During the enterprise and financial organisation renovation, many risks arised that was because of the overdue debts were at a highest level in the end of 1999. The Banking system' financial state were slowly improven in 2000, in the main, it was based on the economic rehabilitation and new initiatives of the Government. The economy has been rehabilitated since 2000, due to foreign demands has been increasing, also, the state budget revenues were increased by growing up of the price of oil in 2000; and due to the Government'policy on "stimulating the demands of investment and comsumtion", and the increasing of citizen' income, thus led to increasing domestic demands. Because of increase of the demands, sale runs very smoothly, thus enterprises could accumulate capital for not only reproduction, but also payment for their debts. For settlement debts, particularly frozen debts, the Government have undertaken initiatives such as wiping off a debt, and transformation of debts in to dividends. So that, rate of those debts in total debts has been continuously reduced for the last two years. By applying solutions, up to the end of 2000, Viet Nam has nearly remove two weak points of the banking system, the first of one was a characteristic of easy being affected by domestic and foreign crisis, and the other was the fragile ability in mobilising savings for investment in efficient projects.

In summary, the financial system and enterprise reforms have brought a lot of achievements that have been a pace of development and foundation for other reforms. In which, they had reciprocal affects and made each other developed. Enterprise's reform could not be succesfully without renovation of the banking system. Incontrary, without innovation of enterprises, it is difficult to get succesful in the banking system reform. Otherwise, without renovation of enterprises and the banking system, there is not establishment of the stock market. Incontrary, without establishment of the stock market, it is difficult for enterprises to mobilise capitals and to be achived in their equitization. However, during the reform, several risks and failures have also arisen, but, in the main, achievement has been attained. So that, the renovation of the banking system, financial organisations, and enterprises should have been continuously undertaking.

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Benchmarking the Stage of Economic Development of Viet Nam

Shinichi Watanabe
International University of Japan

This paper examines the characteristics of the economic development of Viet Nam during 1990s, in comparison with those of average low-income countries, China, transition economies in East and Central Europe and average middle-income countries. By finding economies that can serve as benchmarks for the economic development of Viet Nam, we can identify the characteristics of Vietnamese economy more accurately and discover better policies that match the stage of economic development of Viet Nam.

1. Relationships among macroeconomic flow variables

Table 1 shows the changes in the composition of GDP in final demand in Viet Nam from 1990 to 1998. Data in Tables 2 to 4 are for comparing the basic macroeconomic structure of Viet Nam with those of three groups of countries: low-income countries (excluding China and India), China and transition economies in Central and Eastern Europe.

1.1 Consumption, domestic saving and investment

A large change took place in the relationships between private consumption (PC), domestic saving (S) and domestic investment (I) in Viet Nam during 1990s. From 1990 to 1998, the PC/GDP ratio declined from 89.6% to 71.1% by 18.5% and the S/GDP ratio increased from 5.2% to 21.4% by 16.2%. As a consequence the values of PC/GDP and S/GDP ratios of Viet Nam in 1998 became almost the same as the average ratios (70% and 20% respectively) of the low-income countries (excluding China and India) in 1998.

Table 1 Composition of GDP in final demand (%): Viet Nam					
	1990	1992	1994	1996	1998
PC/GDP	89.6	79.3	74.7	74.4	71.1
GC/GDP	7.5	6.9	8.3	8.4	7.5
Investment/GDP	14.4	17.6	25.5	28.1	28.7
Net Exports/GDP	-9.2	-4.1	-9.4	-11.0	-7.3
Exports/GDP	26.4	34.7	34.0	40.9	42.0
Imports/GDP	35.7	38.8	43.5	51.8	49.3
Statistical errors	-2.2	0.2	1.1	0.1	0.0
S/GDP	5.2	13.5	16.1	17.1	21.4
Source: IMF(July 1999), Vietnam: Statistical Appendix, p.3.					
PC: private consumption, GC: government consumption, S: domestic saving (= I + Net exports).					

Table 2 Composition of GDP in final demand (%): Average low-income countries (excluding China and India) and China				
	Average low-income countries		China	
	1980	1998	1980	1998
PC/GDP	65	70	51	44
GC/GDP	11	9	15	13
I/GDP	22	24	35	39
Net Exports/GDP	2	-3	0	5
Exports/GDP	25	27	6	22
Imports/GDP	23	30	6	17
S/GDP	24	20	35	43
Source: WB (1999), Entering the 21st Century, World Development Report 1999/2000, pp.254-255				

Starting from the economic crisis characterized by the extremely high PC/GDP ratio of 89.6% and low S/GDP ratio of 5.2% in 1990, Viet Nam rapidly overcame the economic crisis and restored the average consumption-saving relationship of low-income countries by the end of 1990s, allocating more economic resources to capital accumulation rather than consumption.

Table 3 shows the (average) growth rates of real GDP of Viet Nam, the low-income economies (excluding China and India) and China. Judging from the domestic saving, however, it is somewhat puzzling to observe the growth rate 8.6% of Viet Nam during 1990s that was much higher than 3.6% of the average growth rate of low-income countries.

Table 3 Growth rate of real GDP		
	1980-90	1990-98
Viet Nam	4.6	8.6
Average low-income countries (excluding China and India)	4.1	3.6
China	10.2	11.1
Source: WB (1999), Entering the 21st Century, World Development Report 1999/2000, pp. 250-251		

One reason for the 5% difference in the growth rates is in the contrasting behavior of the domestic saving ratios between Viet Nam and the low-income countries. The S/GDP ratio of Viet Nam increased continuously during 1990s, but the S/GDP ratio of average low-income countries in 1998 declined from the level observed in 1980. The continuous increase in the saving rate in Viet Nam increased the steady state capital per labor continuously, which increased the growth rate of the economy. But the steady state capital per labor declined in the low-income countries.

Another reason is the difference in I/GDP ratios. The I/GDP ratio of Viet Nam increased from 14.4% in 1990 to 28.7% in 1998. The value of Viet Nam exceeds the average I/GDP ratio (24%) of low-income countries in 1998 by about 5%. The reason for the higher I/GDP ratio will be discussed in Section 1.3.

The increasing saving rate and the high I/GDP ratio, however, do not seem to be sufficient to explain the large difference in the growth rates between Viet Nam and the average low-income economies. We will take up this issue again in Section 3 where we discuss the imbalance between human capital and physical capital.

Note that Tables 2 and 4 show also that the structure of final demand of Viet Nam is quite different from that of China or transition economies in Central and Eastern Europe.

The PC/GDP, S/GDP and I/GDP ratios of China in 1998 were 44%, 43% and 39% respectively, while those of Viet Nam were 71.1%, 21.4% and 28.7% in the same year. The domestic saving rate of China was twice as much as that of Viet Nam.

The behavior of the PC/GDP ratios of most transition economies in Central and Eastern Europe was in sharp contrast with that of Viet Nam or China: they increased and their I/GDP ratios declined from 1980 to 1998.

Such observations indicate that the design of the growth policy of Viet Nam should be very different from those of China or transition economies.

Table 4 The PC/GDP and I/GDP ratios of transition economies (%)

	1980		1998	
	PC/GDP	I/GDP	PC/GDP	I/GDP
Albania	56	35	103	12
Bulgaria	55	34	70	12
Hungary	61	31	63	27
Mongolia	44	63	60	23
Poland	67	26	65	24
Rumania	60	40	77	20

Source: WB (1999), Entering the 21st Century, World Development Report 1999/2000, pp.254-255

1.2 Integration with the world economy through trade

Table 1 shows that the Vietnamese economy has been more closely integrated with the world economy during 1990s. There were sizable increases in both Exports/GDP and Imports/GDP ratios, the former increasing from 26.4% to 42.0% by 15.6% and the latter from 35.7% to 49.3% by 13.6% respectively between 1990 and 1998.

In comparison with the changes in the ratios of the average low-income countries observed over two decades from 1980 to 1998 (Exports/GDP from 25% to 27% and Imports/GDP from 23% to 30%), the speed of the integration of Vietnamese economy with the world economy was significantly faster. The degree of its integration was also much deeper in 1998 than the average low-income economies, although the Exports/GDP ratio of Viet Nam in 1990 was about the same as the average Exports/GDP ratio of the low-income countries in 1980.

The external economic relation of China is again very different from that of Viet Nam. Both its Exports/GDP and Imports/GDP ratios were only 6% in 1980. In spite of the significant increase during the two decades, its Exports/GDP and Imports/GDP ratios were still 22% and 17% respectively in 1998, much lower than the values of Viet Nam.

1.3 Integration with the world economy through capital flows

One important aspect of the integration with the world economy in capital flows can be measured by Net Exports/GDP ratio. The negative value of net exports is equal to net capital inflows (including the change in official reserves), which is called foreign saving in contrast to domestic saving. Table 2 shows that Foreign Saving/GDP ratio of Viet Nam in 1998 was higher than the ratio of the average low-income countries by 4.3%. Since the S/GDP ratios were roughly the same between them, the difference in the I/GDP ratios between Viet Nam and the average low-income countries was attributable to the difference in the Foreign Saving/GDP ratios. The higher investment ratio of Viet Nam as compared with that of the average low-income economies was supported by the higher than average net capital inflows from abroad.[1]

1.4 Summary

The structure of final demand of Viet Nam at the end of 1990s can be summarized as follows:

(1) The relationships between consumption and domestic saving of Viet Nam at the end of 1990s is very close to that of average low-income economies, but significantly different from that of China.

(2) The investment rate of Viet Nam is higher than the average low-income economies by the amount of foreign saving, but it is much lower than China.

(3) In terms of exports and imports, the Vietnamese economy is much more highly integrated than the

[1] The value of net private capital inflows to Viet Nam in 1997 was USD2.0 billion, out of which FDI was USD1.8 billion. China received FDI of USD44.2 billion, exceptionally high among all the low-income countries. India was the distant second, accepting USD3.4 billion as FDI. Viet Nam was the third among the low-income countries. Nigeria received USD1.5 billion. No other low-income countries received FDI of more than USD1 billion. As for major ASEAN nations, Indonesia received USD4.7 billion, Malaysia USD5.1 billion, Thailand USD3.7, Philippines USD1.2 billion and Singapore USD8.6 billion.

average low-income economies that are more highly integrated than China.

(4) The Vietnamese economy is also more highly integrated with the world economy than the average low-income economies in net capital inflows (foreign saving). Furthermore, foreign direct investment into Viet Nam is very large among the low-income economies (except for China and India), but it is much smaller compared to the middle-income ASEAN nations.

These observations suggest that a large part of the difference in the growth rates between Viet Nam and average low-income economies is attributable to the effects of international trade and foreign direct investment. They have enhanced the technological progress of Viet Nam by improving the efficiency of resource allocation and by transferring foreign technology. While the positive effect on economic growth of the increase in the domestic saving rate may be temporary, the technological progress may have more long lasting effects on economic growth, especially when it is embodied in human capital.

2. Industrialization

This section describes the industrialization of Vietnamese economy and compares its structure of output with that of average low-income countries and China.

Table 5 shows the change in the output share of the production sectors (agriculture, industry and services) of Viet Nam, average low-income economies and China. Output share of each sector is measured by the ratio of its value added to GDP.

The change observed in Viet Nam during 1990s was quite sizable, larger than those observed in the average low-income economies and China over two decades. From 1990 to 1998 in Viet Nam, the share of the agriculture sector declined from 40.8% to 26.0%, and the shares of the industry[2] and services increased from 22.8% to 32.7% and from 36.4% to 41.3% respectively. The structure of output of Viet Nam in 1998 was almost the same as the average low-income economies, in which the shares of the agriculture, industry and services were 25%, 33% and 42% respectively. The statistic shows again that Viet Nam started 1990s with the level of industrialization much lower than the average low-income economies and reached the level of industrialization of average low-income economies in 1998.

As was the case of the demand structure, the production structure of Viet Nam is quite different from that of China which had a much larger sector of industry already in 1980.

[2] Industry consists of mining, manufacturing, construction, and electricity, gas and water supply.

Table 5 The share of value added of the three broad sectors (%)						
	Viet Nam		Average low-income economies		China	
	1990	1998	1980	1998	1980	1998
Agriculture/GDP	40.8	26.0	29	25	30	18
Industry/GDP	22.8	32.7	32	33	49	49
Services/GDP	36.4	41.3	39	42	21	33
Source: IMF(July 1999), Vietnam: Statistical Appendix, p.4.; WB (1999), Entering the 21st Century, World Development Report 1999/2000, p.252.						

3. Characteristics of capital stocks of Viet Nam

Sections 1 and 2 find that Viet Nam shares almost the same economic structure with average low-income countries both in final demand and output. Its economic structure, however, is found to be very different from that of China which is at a more advanced stage of industrialization.

This section compares the state of capital stocks including both human capital and physical capital with that of low-income countries and China.

3.1 Human capital

In contrast to macroeconomic flow variables, Table 6 shows that the level of human capital of Viet Nam was significantly higher than the average level of the low-income economies in all the measures of human capital compiled in the World Development Indicators of the WB (1999).

The adult illiteracy rate of Viet Nam was 5% for male and 11% for female in 1997, which were much lower than the average values of low-income economies, 30% for male and 47% for female. In fact, the illiteracy rate of Viet Nam was even lower than that of China or average middle-income countries.

The life expectancy at birth of Viet Nam was 66 for male and 71 for female in 1997. Again they were much better than the average low-income economies, 55 for male and 58 for female, and at par with China and the average middle-income countries.

While the data is somewhat old, the school enrollment rates of Viet Nam both in primary and secondary education were much higher than the average ratios of low-income economies in 1980. For secondary education the enrollment rate of Viet Nam was 44% for male and 40% for female, which were much higher than the average rate of the low-income economies, 25% for male and 14% for female. However, the rates were somewhat lower than those of China, 54% for male and 37% for female, and those of the middle-income economies, 53% for male and 48% for female.

The data of the fraction of children aged 10-14 in the labor force is available for 1980 and 1998. The lower rate is likely to be associated with a higher school enrollment rate. The ratio of children in labor force decreased from 22% in 1980 to 8% in 1998 in Viet Nam. The average ratio of children in labor force of the low-income economies was 24% in 1998. The value of Viet Nam in 1998 was between China (10%)

and the middle-income economies (6%).

In all, the level of human capital of Viet Nam is much higher than the average level of the low-income economies, and is comparable to that of China or the middle-income economies. This indicates that it is not unrealistic for Viet Nam to catch up with the middle-income economies in terms of per capita income in the long run over 10 or 20 years period.[3] In other words, the policy agenda for development for Viet Nam should be different from the one for the average low-income economies with much lower level of human capital.

Table 6 Human capital

	Viet Nam		Average low-income econ.		China		Average middle-income econ.	
	Male	Female	Male	Female	Male	Female	Male	Female
Life expectancy (1997)	66	71	55	58	68	71	66	72
Adult illiteracy rate (1997)	5	11	30	47	9	25	10	16
Primary school enroll.(1980)	111	106	85	64	121	104	106	99
Secondary sch. enroll.(1980)	44	40	25	14	54	37	53	48
	1980	1997	1980	1997	1980	1997	1980	1997
Under-5 mortality per 1000	105	40	151	97	65	39	NA	42
	1980	1998	1980	1998	1980	1998	1980	1998
Children (age 10-14) in labor force	22	8	29	24	30	10	10	6
Urban population %	19	20	21	31	20	33	55	66

Source: WB (1999, p.232), WB (1997, p.226).

4. Institutional changes toward a market economy

This section reviews the progress of the institutional changes from a centrally planned economy to a market economy.

4.1 Changes in the importance of the state sector in production

Table 7 shows the share of value added produced by the state sector (excluding general government) as against the non-state sector. The share of the state sector increased from 22.7% in 1990 to 36.9% in 1998.

[3] It has been found in many theoretical and empirical works that the imbalance between the low per capita income and the high human capital causes an economy grows faster in the long run. See Barro and Sala-i-Martin (1995).

Table 7 The share of value added of SOEs (%)		
	1990	1998
GDP	22.7	36.9
Agriculture/GDP	1.6	1.2
Industry/GDP	10.3	15.6
Services/GDP	10.7	20.1
Source: IMF(July 1999), Vietnam: Statistical Appendix, p.4.		

This is in sharp contrast to the experience observed in Central and Eastern Europe, in which the share of the state sector fell precipitously in 1990s. According to the chart in WB (1996, p.15), among about 30 transition economies Viet Nam was the only country in which the state sector increased its share of GDP from 1990 to 1995.

However, the share of the non-state sector of Viet Nam in 1990 was already as high as 70.7% which was far higher than those of transition economies in 1990 and even in 1995 after the implementation of various privatization programs. The shares of the non-state sectors of most transition economies did not exceed 10%. Only Poland and Georgia had more than 20% and China more than 40% as of 1990.

The large share of the non-state sector in Viet Nam in 1990 reflected the fact that Viet Nam was still at an early stage of industrialization and the non-state agriculture sector had a dominant share of output, 39.1% of GDP.[4]

These observations combined with those examined earlier indicate that it is not proper to understand the transformation process of Viet Nam within the same context of transition in East and Central European economies that are at much higher levels of industrialization. Judging from the statistics observed above, the essential change in progress in Viet Nam is not from a centrally planned economy to a market economy. The central characteristics of the transformation process of Viet Nam during 1990s was that an agrarian economy at an early stage of industrialization rapidly overcame its economic crisis and restored its macroeconomic relations and output structure comparable to those of average low-income economies by the end of 1990.

If that is the case, it is not surprising to find that state enterprises expanded its role as agents of industrialization during 1990s. Even if millions of small household enterprises existed, it is rather obvious that it would have been impossible for them to play the central role of industrialization that exploits the benefits of scale economies.[5]

[4] The share of the state agriculture sector was only 1.6% of GDP. The agriculture sector as a whole was 40.8% of GDP in 1990 as was shown in Table 5.

[5] From the mid-1990s Viet Nam accepted FDI larger than any other low-income economies except for China and India. Many FDI established joint venture firms with SOEs. The joint venture firms thus formed are classified as a part of the state sector. Thus the increase in the share of value added of the state sector might be a "statistical fact" which reflected the contribution of the joint ventures. Therefore, the increase in the share of the state sector should not be interpreted as the lack of progress toward a market economy.

4.2 Financial deepening

Table 8 evaluates the progress of financial deepening in terms of the ratio of domestic credits provided by the banking sector to GDP. Although the level of the financial depth of Viet Nam increased from 15.9% in 1990 to 22.6% in 1998, it was much lower than the average value of the low-income economies, 38.1% in 1990 and 37.4% in 1998. This indicates that the financial system in Viet Nam is not well developed even in comparison with the average low-income economies and that it may not be able to support the growth potential observed in Section 3.

[This section is very much incomplete.]

Table 8 Domestic credit provided by the banking sector, % of GDP

Viet Nam		Average low-income economies		China		Average middle-income economies	
1990	1998	1990	1998	1990	1998	1990	1998
15.9	22.6	38.1	37.4	90.0	120.0	57.9	52.9

Source: WB (1999, p.260),

5. Implications of the findings for development policies of Viet Nam

In terms of the balance between consumption and domestic saving, Viet Nam is about the same as the average low-income economies whose GDP growth rate was 3.6%. Structure of output of Viet Nam is also very similar to the average composition of production sectors of the low-income economies. However, Viet Nam has the growth potential in excess of the average low-income economies if the Government chooses right policies:

(1) The growth of Viet Nam much faster than the average low-income economies during 1990s was partly attributable to a rapid integration of the economy of Viet Nam with the world economy. Both international trade and FDI enhanced technology transfer from abroad and productivity growth in Viet Nam. Policies that enhance the integration of Vietnamese economy with the world economy are essential for a higher growth.

(2) The level of human capital of Viet Nam is much higher than the average low-income economies and is comparable to China and the middle-income economies, implying that the potential growth rate of Viet Nam is much higher than the average low-income economies and that Viet Nam may be able to catch up with the middle-income economies in the long run. But in order to realize the growth potential of the economy, it is essential to implement the policies that enhance high employment and help firms and individuals combine the high human capital with market opportunities.

(3) Financial system of Viet Nam is very much underdeveloped even in comparison with the average low-

income economies. Unless policy measures are taken to strengthen the financial system, it may not be able to support the flow of funds necessary to realize the growth potential of the economy.

6. Concluding remarks

Growth process of an economy is a complex process that consists of many interactive component processes each of which is characterized by its own initial condition and its own law of transition. As a consequence some component processes are more advanced than others. This non-uniformity of the progress seems to offer both challenges and opportunities for finding and designing better growth policies for the government.

F − 4

The Analysis of the Effects of Long-Term Reform Policies and the Ad Hoc Measures

Shinichi Watanabe

International University of Japan

1. Problem

In order to alleviate the financial difficulties of state enterprises caused by the Asian crisis, a series of ad hoc measures have been implemented. Watanabe and Ly (1999) has found, however, that the economy of Viet Nam may be trapped in an inefficient growth path by the combined effects of long-run reform policies and ad hoc measures.

The purpose of this paper is to examine the existence of such a risk by reformulating the problem in a theoretical framework developed by Krugman (1991), Matsuyama (1991) and Ray (1998) to study the logic of cumulative processes in which expectations play a crucial role. We use a simplified KMR model to capture the effects of ad hoc measures and long-term reform policies on the development process of Viet Nam.

2. An analysis

Institutions and ownership of firms

Let C denote the set of complementary institutions inherited from a centrally planned economy (or a subsidized economy), including the political system, the government structure, the banking system and the state enterprises under the centrally planned economy. Let M denote the set of complementary institutions that support the operation of the modern market economy highly integrated with the world economy. While socioeconomic institutions that support economic activities are a complicated mixture of various institutions, we describe the mixture of institutions as an institution I and assume that institutions I's can be ordered linearly between C and M. I is more market oriented when it is closer to M. Let us assume that I takes on a value between 0 and 1, where 0 corresponds to the institution C and 1 to the institution M. Therefore larger is the value of I, more market-oriented is the institution.

Assume that the decision-making processes and organizational routines of SEs are developed to fit the needs of the economy under the institution C and therefore SEs operate efficiently under the institution C but not under the instituion M. In contrast private enterprises (PEs) operate efficiently under the institution

M but not under the institution C. For simplicity, we include into PEs the SEs that have been restructured completely to fit the market environment M.

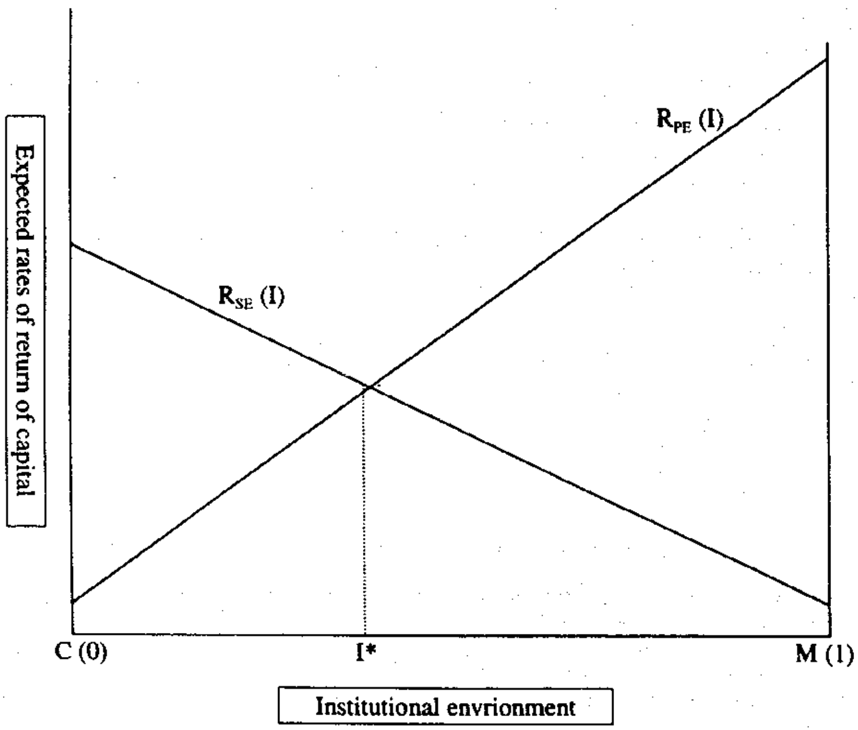
Let us formulate the above assumptions on the quality of matching between the ownership of an enterprise and its institutional environment in terms of the rate of return of capital. Let R_i (I) be the rate of return of capital of an enterprise i (= SE or PE) under the institution I. Assume that:

(A1) R_{SE} (I) is strictly decreasing in the institution I. That is, the rate of return of capital of SEs declines when its institutional environment becomes more market oriented.

(A2) R_{PE} (I) is strictly increasing in the institution I. The rate of return of capital of PEs increases when its institutional environment becomes more market oriented.

(A3) R_{PE} (M) > R_{SE} (M), R_{PE} (C) < R_{SE} (C). Private enterprises have comparative advantage in the institution M and state enterprises in the institution C.

Figure 1 Institutions and expected rates of return of capital



Social decisions over institutions

Let X be the fraction of capital employed in the PE sector. Let z be the parameter that describes the strength of the external influence on the economy. We describe the state of the economy by an institution I, the fraction X and an external condition z.

Assume that for each aggregate state (X, z) an institution exists that best supports the operation of the economy characterized by (X, z). We denote such an institution by I(X, z). Assume that I is increasing in X and z. That is, the optimal institution becomes more market-oriented when the fraction of private enterprises increase or the economy is more highly integrated with the world economy. Assume that $I(1, z) = M$ and $I(0, z) = C$.

We assume that a social process exists that selects a new institution I' to resolve the mismatch between the existing institution I and the optimal institution I(X, z) associated with the ownership structure of the economy X and the external condition z:

$$I' = F(I, I(X, z)). \quad (1)$$

The function F describes the social process of institutional reforms. It chooses a new institution I' for a historically given institution I and the optimal institution I(X, z). The speed of institutional innovations depends on the adjustment costs of institutions that include the costs of establishing new laws, new organizational structures and new decision-making processes in government and financial institutions. If the adjustment cost is zero, then the institution will be adjusted immediately to the optimal institution I(X, z).

Individual decisions how to allocate capital

The change in the state X depends on the choice of individual firms and credit institutions how to allocate capital. When the adjustment cost exists, the decision of capital allocation depends on the current and future returns and therefore current and future institutions I, I', I''.... Let us describe the outcome of individual decisions by

$$X' = G(X, R_{PE}(I) - R_{SE}(I), R_{PE}(I') - R_{SE}(I'), R_{PE}(I'') - R_{SE}(I''), \ldots). \quad (2)$$

The function G is increasing in X, $R_{PE}(I) - R_{SE}(I)$, $R_{PE}(I') - R_{SE}(I')$ and so on. When firms and individuals expect that future institutions will generate positive difference between the rates of return, then X will increase.

Equilibria when no adjustment costs exist

When no adjustment costs exist, two self-fulfilling equilibria exist in the economy. One of them is the state of the economy (M, 1, z). When every firm expects I = M from present to the future, then all capital will be allocated to private enterprises and X becomes 1. Since the optimal institution I(1, z) is the institution M, the expectation is realized. Thus the economy jumps to an equilibirum (M, 1, z) immediately regardless of the initial condition (I_0, X_0, z). The other equilibirium is the state (C, 0, z). When every firm expects I = C from present to the future, then all capital will be invested in state enterprises and X becomes 0. But the optimal institution is C when X = 0. Thus the expectation becomes true.

Equilibrium paths when adjustment costs exist: a linear example:

Let us consider the simplest linear example. Let $I(X, z) = X$ and assume that the function F is given by

$$I' = I + a(X - I),\ a > 0 \quad (3)$$

When the optimal institution X is more market oriented than the current institution I, then the institution I will be changed toward a more market oriented institution I'.

Let I* be the institution that satisfies $R_{PE}(I^*) = R_{SE}(I^*)$. Assume that the function G is given by

$$X' = X + b(I - I^*),\ b > 0 \quad (4)$$

Figure 2 is the phase diagram for the dynamic system defined by Equations (3) and (4). In Figure 2 there are one unstable steady state E_U and two stable steady states, E_M at (M, 1) and E_C at (C, 0). Except for the path toward E_U all the economy eventually converges to either E_M or E_C, depending on the initial condition (I_0, X_0) of the economy.

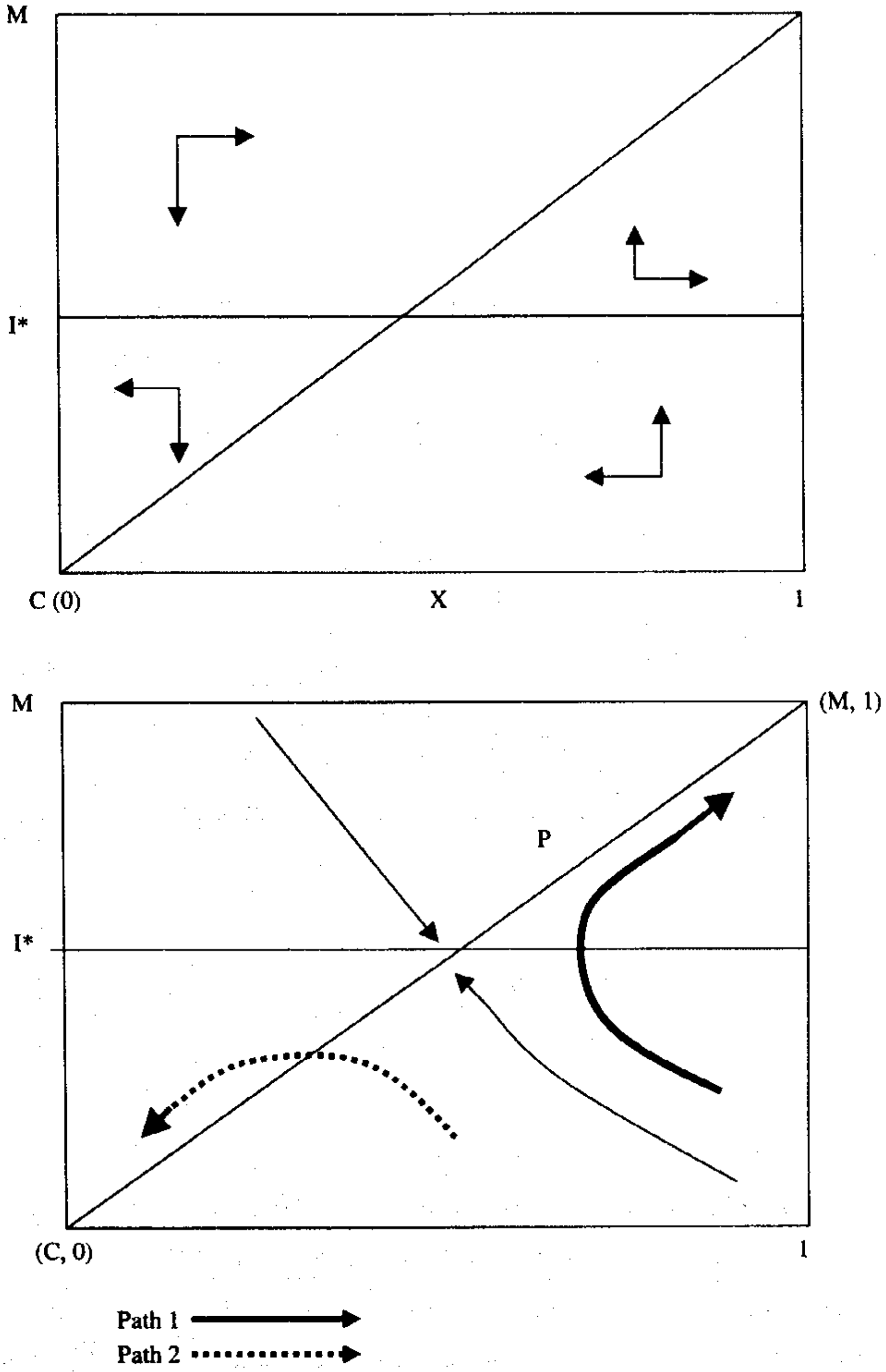
Let us consider two equilibirum paths in Figure 2 whose initial conditions satisfy (1) $I_0 < I^*$ (that is, the institutional infrastructure does not exist that adequately supports the development of the private sector) and (2) $I(X_0, z) = X_0 > I_0$ (that is, the optimal institution is more market-oriented than the existing one). Path 1 converges to (M, 1) and Path to (C, 0).

(Path 1) *Initially the fraction of capital allocated to private enterprises decreases along Path 1 because the existing institution favors state enterprises. But the institution I is reformed continuously to a more market-oriented institution, which eventually passes I* and eliminates the bias against private enterprises. Then the fraction X stops its decline and starts increasing to 1. This makes the optimal institution more market-oriented, which creates social forces to reform the actual institution more market oriented toward the institution M. The process converges cumulatively to the state (M, 1).*

(Path 2) *The fraction of capital allocated to private enterprises decreases continuously along Path 2 because the existing institution continuously favors state enterprises. While the institutional reform changes the institution I to a more market-oriented institution at the beginning, the reform process stops before it reaches I* and begins to move toward the institution C. The reversal of the reform process of institutions sharpens the bias against private enterprises and the fraction X declines further. The decline in X causes the optimal institution to be more centrally planned and drives the actual institution toward the institution C. The process converges cumulatively to the state (C, 0).*

Figure 2   Phase diagram for the linear model

X is measured against the horizontal axis.
I is measured against the vertical axis.



Long-run reform policies, external shocks and ad hoc measures

Now let us examine how long-run reform policies and ad hoc measures affect dynamics in our model.

(1) Long-run reform policies

In the present model we can describe long-run reform policies as a formulation of the optimal institution I(X, z) that responds to the changes in the external condition z. Following the linear example, let I(X, z) = X + cz, c > 0. Then the equation (3) can be rewritten as

$$I' = I + a\,(X + cz - I),\ \ a > 0, c > 0. \quad (3')$$

When the economy is more highly integrated, the optimal institution becomes more market oriented. This strengthens social forces to reform the institution toward a more market-oriented institution.

Figure 3 The effect of long-run reform policies

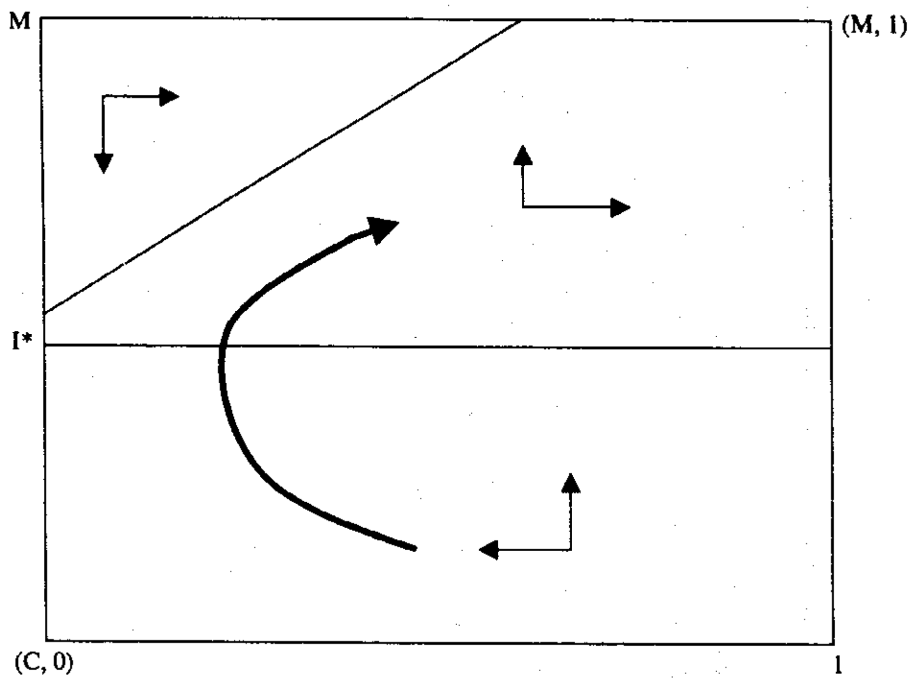


Figure 3 shows its effect when the external effect cz is very large. *The steady state is now unique and is given by the state (M, 1). The area that leads to the state (C, 0) has disappeared completely from the phase diagram. The dynamic process of the economy is characterized by continuous innovations toward the institution M,* unless the initial condition is given by an improbable state, that is, a large state sector and a highly-market-oriented institution.

(2) External shocks and ad hoc measures

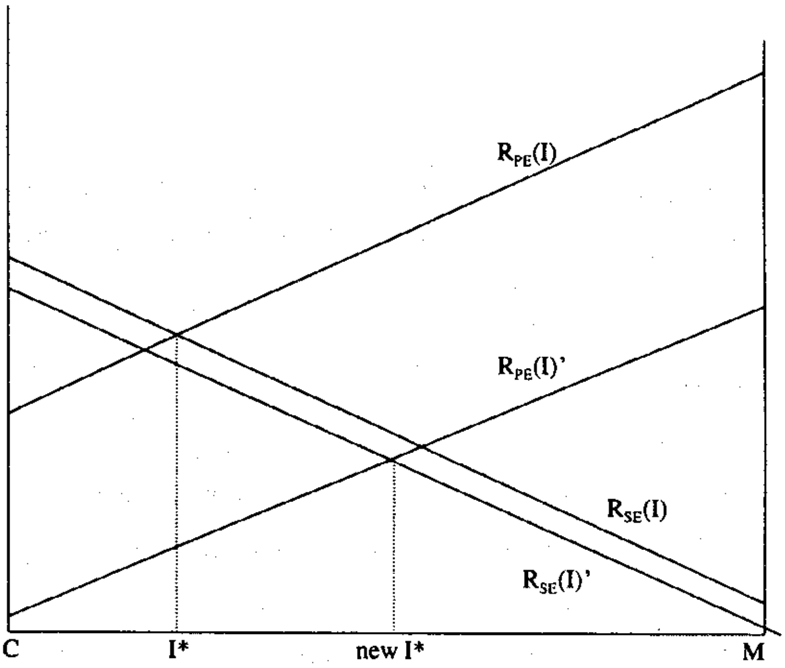
Ad hoc measures have tried to alleviate the financial difficulties of SEs caused by external shocks e. Their effect can be modeled by introducing external shocks e into the rate of return function R:

$$Ri = Ri(I, e), \ i = PE, SE.$$

The adverse external shock lowers the rate of return of capital Ri for both PE and SE.

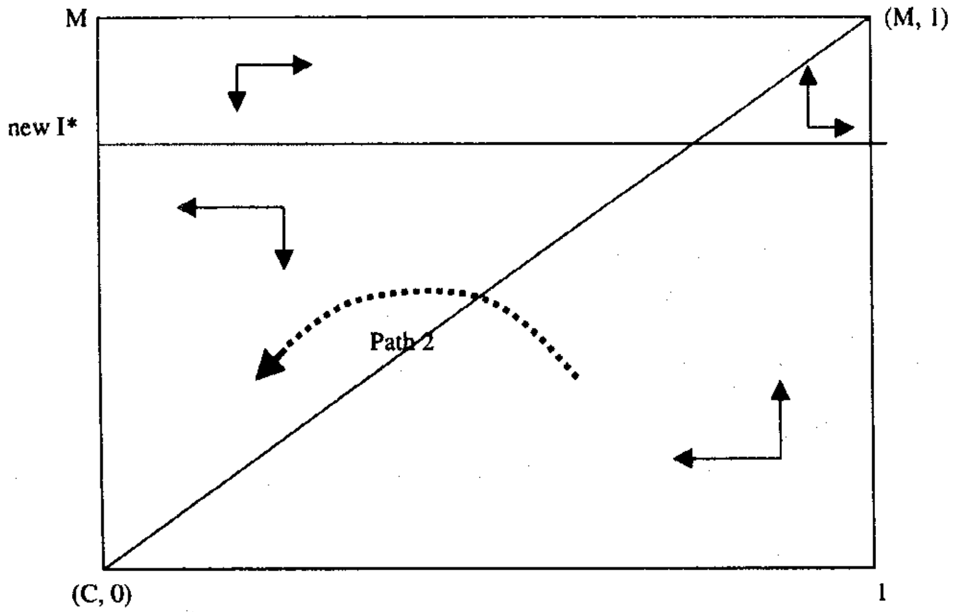
But its quantitative effect on R_{SE} is smaller than its effect on R_{PE} since a part of the adverse effect on R_{SE} is shifted from the SE to government by ad hoc measures.

Figure 4 The effects of ad hoc measures



As is shown in Figure 4 the differential effect of adverse external shocks between the private sector and the state sector causes I* to shift toward M, increasing the range of institutions under which the rate of return of capital of the state sector is higher than that of the private sector.

Figure 5 The effects of ad hoc measures



In Figure 5 *the combined effect of an adverse external shock and ad hoc measures is shown by the upward shift of the line I*, which strengthens the bias against private enterprises and increases the area that leads the economy to the steady state (C, 0).*

3. Policy implications

A possibility exists that the economy of Viet Nam is moving along the path like the one described by Path 2 in Figure 2. The private sector cannot attract capital and its relative size continues to decline. Institutional innovations toward a market oriented institution is coming to a stop since it is too costly for the society to develop and maintain institutions that support ever-decreasing private enterprises. The reversal of institutional reforms further reduces the size of the private sector, which reinforces the reversal.

Even when a market-based institution is superimposed on such an economy running along Path 2, it will not function effectively because it is not consistent with the rational incentives of firms and individuals.

In order to avoid such a risk it is necessary to reduce the area that generates the paths like Path 2. In the present model it is possible to do so by abolishing ad hoc measures that have differential effects between state enterprises and private enterprises and by establishing closer linkages between long-run reform policies and the integration with the world economy.

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Chapter 2-2 Reforms of the Fiscal Management

A. Issues of Public Finance

A－1

General Issues on Viet Nam Public Finance in Period 1991-2000

Nguyen Ngoc Tuyen
Ministry of Finance

It is a complicated work to assess Viet Nam public finance in period 1991-2000. It is the initial stage when Viet Nam economy dramatically transferred to the market economy and economic policies changed quickly and lacked stableness. This is because the State has to make new policies as well as to complete former ones in order to make them appropriate and consolidate when implementing. Moreover, Viet Nam has just experienced a long period of economic recession and a lot of social problems need immediately solving that makes it difficult for the state budget to serve a lot of purposes at the same time. Besides, it is difficult to collect information and statistics for assessing and analyzing because of inadequate and inconsistent information system. Some statistical norms and price systems are not consistent and changeable. For example, before 1995, some statistical norms were collected and calculated according to the comparative price system in 1989, but since 1995, they have been calculated according to the comparative prices in 1994. Therefore, there are shortcomings and the accuracy is limited. However, the writer has selected and made a system of tables from some published materials (attached), including:

Table 1: State budget balance 1991-2000

Table 2: Revenue from internal sources 1991-2000

Table 2a: Structure of revenue from internal sources 1991-2000

Table 3: State expenditure 1991-2000

Table 4: State expenditure structure 1991-2000

Table 5: Current expenditure structure 1991-2000

Table 6: GDP growth 1991-2000

Table 7: State capital expenditure 1991-2000 (comparative price)

Table 8: State capital expenditure structure 1991-2000 (present price)

Table 9: Structure of state capital expenditure 1991-2000

This report on Viet Nam public finance in period 1991-2000 consists of following three main parts:

1. Review on changes and trends in state revenue and expenditure, present state budget surplus and deficit.
2. Review on changes and trends in state budget: expenditure and financial sources.
3. Evaluation on state budget deficit possibility and appropriate financial measures for budget deficit financing.

Part 1 Review on changes and trends in state revenue and expenditure, present state budget surplus and deficit

Period 1991-2000 marks fundamental changes of Viet Nam state budget. The assessment on Viet Nam state budget changes in this period includes following aspects:

1. State budget balance

Before 1990, Viet Nam economy was in the depression period, there was continuous state budget deficit and it was financed mostly by the amount of money issued. Because of exceeding issue, the inflation rate had been rising continuously to three digits (the highest level at 600-700%). The budget was out of control.

According to Table 1, since 1991, state revenue and expenditure and budget balance have been settled down step by step. State budget deficit hasn't stopped but the deficit rate has been decreased. State budget situation has been better and seemed to be improved to the end of the 1990s. State budget deficit has been increasing but with a quite low rate and under control. It was 1.9% of GDP in 1991, increasing to 4.9% of GDP in 1993, decreasing gradually in 1995 and 1996 and increasing again in 1999 at 4.8%. From that situation, we can have some conclusions:

- *The deficit level is under control.* From the tables, we can see that annual deficit compared to GDP during the past ten years is not stable but always under 5%. In addition, in the early 1990s, the State did not seemed to take initiative to control state budget deficit. It arose completely from the difference between state revenue and expenditure occurring until the end of each fiscal year. However, until 1999, the deficit level of 4.8% is totally the State's intention. In 1999, the monetary and financial crisis in the region and the world affected Viet Nam, making Viet Nam economy depressed and there were signals of serious deflation. Economic growth gradually decreased from 9.34% in 1996 to 5.8% in 1998 and seemed to continue decreasing in 1999 (4.8%): Goods were in stock; consuming price index continuously decreased; credit institutions mobilized a large amount of capital from people's savings but could only give small investment loans that lead to surplus capital and increasing risks and made commercial banks' financial situation worse. Therefore, the Government carried out many "demand stimulating" measures in order to encourage economic growth and development, of which the main measure is to increase the amount of capital for infrastructure development, especially for building big projects and infrastructures. The Government "intentionally made state budget deficit" and considered it as a good measure to encourage social consumption and production. Therefore, the state budget deficit level of 4.8% is completely under the Government's control.
- *Budget deficit is mainly used for investment expenditure, not for current expenditure.* This principal was seriously obeyed during the 1990s, so that by early 1990s, inflation rate was entirely under

control. The inflation rate during the past ten years was always kept at one digit (less than 10%).

- *Stopping issuing money for financing budget deficit.* Before 1993, budget deficit was mainly financed by the amount of money issued and external debt. But from 1993, the Government has borrowed from both internal (including issuing state bonds, securities) and external sources to finance budget deficit instead of issuing money. Due to bids for state bonds, it has brought about effectiveness and helped to limit negative effects in managing and controlling state budget deficit.

2. Trends in state revenue

The trends and situations of state revenue in period 1991-2000 are reflected in Table 1 and 2. General assessment on state revenue in this period includes:

- State revenue increased continuously over the years regarding both the amount and the rate.
- Annual revenue always met demand for current expenditure and was step by step accumulated for development investment.
- Revenue from internal sources (including import-export duties) accounted for a big proportion at 95% of total revenue.
- Revenue from internal sources was relatively stable and timely met the Government's expenditure demand.
- Taxes and fees are major sources of state revenue.

When assessing state revenue situation in period 1991-2000, we must take into account two main factors that determine the total revenue: the economic development and growth; reform process of policies relating to revenue collection (tax laws, fees, state budget law...).

Economic growth and development

From Table 6 we can see that, from 1991 to 1997, Viet Nam economic development and growth rate continuously obtained high level (peaked at 9.54% in 1995). The growth rate tended to reduce in 1998 (5.76%) and fell to the lowest level in 1999 (4.8%). The main reason is that the financial and monetary crisis in the region and the World affected Viet Nam economy and made the growth rate decrease. In the year 2000, the world economy has been recovered and developed, and so has Viet Nam economy. In the first six months of the year, economic growth rate increased gradually and reached 6.2%. It is forecasted that the average economic growth rate in the year will be about 6%-6.5% or higher (7%).

High economic growth rate in the early 1990s is one of the reasons that lead to annual increased state revenue. State revenue compared to GDP was 13.8% in 1991, peaked at 24.3% in 1994 and 23.3% in 1995. However, this ratio has been decreasing since 1996 and fell to 17.8% in 1999. This can be explained as follows:

- Investment efficiency was high at the beginning of the economic transition process because advantages were utilized and it was easier for investors to improve productivity. Their investment capital was smaller but they could still get higher efficiency, i.e. ICOR index was low. Later, it was more and more difficult for them to exploit economic advantages. They had to invest more in science and technology to obtain the same efficiency, i.e. ICOR index must be higher.

- There are changes in comparative price when calculating GDP. Before 1994, GDP was calculated according to comparative price in 1989, but since 1995 it has been calculated according to comparative price in 1994.
- The inflation rate or price index was relatively high during period 1991-1995 (17.55% in 1992, 14.4% in 1994 and 12.7% in 1995) but has been falling since 1996 and reached 0.1% in 1999, i.e. consuming goods' prices almost stayed the same or increased little but GDP calculated according to fixed price increased continuously. Thus, in the early 1990s, inflation contributed a certain amount to the state revenue, which means that price is one of the factors that affect above-mentioned falling trend.

Reform of policies relating to revenue collection

The most important point about policy relating to revenue collection in period 1991-2000 is tax policy reform. It is divided into two phases: phase I from 1991 to 1995 and phase II from 1996 until now. Some key points in tax policy reform include:

- The State issued tax laws and ordinances to make it highly legal and easy for implementing.
- There are no exceptions that make it consolidate and equal between taxpayers.
- Tax policy system has been simplified and clarified. The number of tax rates has been considerably reduced in order to make it easier for implementing. It is also the objective of tax reform to increase taxpays, reduce tax rates as well as the list of tax rates.
- Tax reform process must be appropriate with tax policy of other countries in the region and the world and promote the international economic integration process.
- Mobilizing state budget revenue timely to meet State increasing demand.
- Preventing tax evasion, state revenue loss and anti-smuggling.

Besides the tax policy system, other policies such as charges and fees policy, budgetary policy, business finance policy... have been gradually completed that helped to increase state revenue. From Table 2 we know that annual revenue increased constantly and with relatively high speed. This is mainly due to tax policy reform. In 1990 and 1991, we issued and started implementing a series of new tax laws: turnover tax, import-export tax, special consumption tax, and income tax... that are applied to all taxpays. This was also the initial stage when we turned from various collecting policies to tax laws collecting policies that brought about rapidly increasing revenue.

Besides, this was also the stage when some more sources were mobilized into the state budget, especially land-related sources. There had been only agricultural land use tax before, but from 1991, there have