International Financial Integration

Contents

Foreword

Summary i

1 Overview 1
Introduction and summary of major themes 1
The dimensions of finance and of international financial integration 3
Scope and organization of report 4

2 Strategic Issues in Viet Nam 5
Thinking about capital controls 5
Averting future debt crises 14
The challenges of foreign investment 20
The role of ODA 23
Foreign and domestic savings: Getting the balance right 26
The domestic financial system and international financial integration 31
International financial integration and macroeconomic policies 38

3 Recommendations for A Strategy 41
Review and synthesis of principal strategic issues 41
The financial system and international integration: Strategic visions 43
Vision 1: Speedy and comprehensive resumption of reform 43
Vision 2: Continuation of opportunistic reform 44
Recommendations 45

Boxes
Box 2.1 Malaysia, capital controls and Asian crisis 12

Tables
Table 2.1 Viet Nam: ODA flows 24
Table 2.2 Viet Nam: Household savings allocations 30

Figures
Figure 2.1 Viet Nam: Net short-term capital inflows 7
Figure 2.2 Viet Nam: External debt ratios 14
Figure 2.3 Viet Nam: Public and publicly guaranteed share of external debt . . . 15
Figure 2.4 Viet Nam: Current account balance as per cent of GDP 16
Figure 2.5 Viet Nam: Gross FDI inflows 21
Figure 2.6 Viet Nam: ODA and FDI inflows 24
Figure 2.7 Viet Nam: Share of investment financed from domestic savings 28
Figure 2.8 Viet Nam: Domestic savings rate 28

References 47

Foreword

In April 1999 the Government requested UNDP assistance in the preparation of strategic policy-based research for Viet Nam's new Ten Year Socio-Economic Development Strategy 2001-2010. A Technical Assistance project agreement with MPI was signed in September 1999.

The Project subsequently undertook and synthesized policy-based research aimed at offering international perspectives in four key areas central to the new ten year socio-economic development strategy:

- The Role of the State and the Market
- International Economic and Financial Integration
- Rural Economic and Social Development
- Science, Technology and Industrial Development

In addition, the Project offered advice on the long-term socio-economic objectives to 2010 and provided practical principles and recommendations for the coherent implementation of the proposed strategies.

The Project also organized a series of technical workshops on the draft research papers as well as two high level Round Table Consultations between senior officials from the Government and the donor community. The first of these Round Tables was held in June 2000 and focused on the various draft research papers and related recommendations. The second high level Round Table was organized in November 2000 with a focus on the Government's draft of the new ten year socio-economic strategy.

MPI has been the national executing agency responsible to the Government and UNDP for the achievement of the Project's objectives, and DSI – the Development Strategy Institute - has carried implementation responsibility. Throughout, the research and consultation process was directed jointly by DSI and UNDP. In addition, the Governments of Australia and Sweden, as well as UNIDO contributed financing as well as technical support for the Project.

In the course of the project, twelve research reports and two Round Table Proceedings Reports were produced jointly by international and local experts.

The foreign experts who participated in the Project included Bob Warner, Keith Bezanson, James Riedel, Lars Holmstrom, Rebecca Dahele, Scott Fritzen, Garry Smith, Frank Flatters, Mia Huyn, David Dapice, Borje Lunggren, Suiwah Leung and Ari Kokko.

Local experts contributing to the Project's work included Dao Le Minh, Vu Van Toan, Vu Quang Minh, Nguyen Van Chi, Bui Tat Thang, Nguyen Van Phuc, Pham Dinh Lan,

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The research and consultation process benefited greatly from the guidance and substantive advice provided by Dr. Luu Bich Ho, President of DSI/National Project Director, Nguyen Van Vinh, National Project Manager, Bui Bich Hoa, Assistant to Project Management Board as well as by officials from UNDP Viet Nam including Robert Glofcheski, Vu Quoc Huy, Johan Fredriksson, Eliane Darbellay, Ernst van Koesveld, Michael Zuyderduyn and Klaus Greifenstein.

A listing of the reports produced by this unique initiative is provided below:

- The Role of the State and the Market in the Economy of Viet Nam
- Non-State Business Sector Development and Job Creation
- Globalization and International Economic Integration
- International Financial Integration
- Further Perspectives on the Challenges of Integration
- Agriculture and Rural Development
- Rural Development and Off Farm Employment
- A Rural Social Development Strategy
- Science, Technology and Industry Strategy for Viet Nam
- Strategic New Generic Technologies
- Choices and Opportunities
- The Synthesized Report of the Research Project

The views expressed in this research report do not necessarily reflect the official views or policies of MPI or UNDP.

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Summary

Introduction

Viet Nam's dual transformations – from a centrally planned to a market-based socialist economy, and towards greater integration with the global economy – are central to its long-term strategy to achieve *sustainable development with equity.* This is seen as the best means of developing and capitalizing on Viet Nam's many internal strengths.

The Government is also strongly committed to the goal of *stability.* Recent regional and international experience has shown that international financial integration can be risky. This is especially true in the absence of well developed domestic market institutions for the mobilization and allocation of investment resources.

The key to maximizing the opportunities and minimizing risks and instabilities arising from international integration is the development of domestic market institutions and especially a sound, transparent and market-oriented regulatory and legal framework. International financial integration – whether in the form of direct investment, lending and borrowing, or official development assistance – can be dangerous and costly without such well developed domestic market institutions. The risks are greatest with respect to short-term international capital flows.

While all domestic markets are important in shaping the contributions of international financial integration, the financial sector and its relation to capital markets is most critical. The state of the domestic financial sector is also crucial in determining how well Viet Nam will be able to mobilize *domestic* resources to finance her long-term development.

Viet Nam's financial sector and related institutions are still relatively underdeveloped. Preferential treatment of state-owned enterprises (SOEs) is an especially important barrier. A strong, market-oriented financial sector requires a legal infrastructure that clearly defines property rights, provides the basis for entering and enforcing contracts, and establishes procedures and regulations concerning bankruptcy and foreclosure. There must be well-established and transparent standards of accounting and corporate governance.

The problems of Viet Nam's financial sector are becoming increasingly well recognized, and many reforms have been or are in the process of being implemented. However, progress has been slow and uneven. Recent experience in Viet Nam and in other regional economies has exposed the risks of shallow and incomplete financial sector reform. *A major challenge in a new socio-economic development strategy will be to speed up the pace and, more importantly, increase the depth of reform of the financial sector.* This will be important both in its own right, and in its implications for international financial integration.

The pace of financial market reform will have an inevitable impact on the pace of Viet Nam's development financing. The slower the pace of reform, the smaller will be the opportunities and the larger the dangers of mobilizing external and internal resources to finance development.

Finance, international and domestic, is not just about mobilizing funds. At its heart is the gathering and processing of economic information, which is central to the task of allocating resources for development. Viet Nam's strategy for financial development and integration, therefore, will be critical in determining the success of *doi moi*, Viet Nam's unique and so far very successful programme for transforming its economy into a socialist market economy.

Major strategic themes and issues

A number of strategic issues related to international financial integration have been identified and reviewed. A few recurring and cross cutting themes have emerged as central to Viet Nam's socio-economic development strategy for the next decade.

Most of these themes relate to fundamental weaknesses in institutional mechanisms and capabilities for mobilizing and allocating investment resources.

- The foreign exchange regime is riddled with unnecessary and counter-productive capital controls and rationing mechanisms, especially on current account transactions, which distort trade and investment decisions. These controls are non-transparent, and they change frequently, in an *ad hoc* and unpredictable fashion.
- Savings rates are low, making Viet Nam more dependent than necessary on foreign borrowing. Viet Nam will certainly not be able to continue to rely on foreign sources of savings to nearly the same extent as in recent years. Only a small portion of savings flows through the formal financial system, reducing the opportunities for mutually beneficial and economically productive intermediation between savers and investors. Gaps, weaknesses and lack of trust in the banking system, together with a punitive tax regime and weak tax administration are all to blame.
- Lack of availability and unreliability of basic economic data make it difficult to determine the current level or the likely future burdens of Viet Nam's foreign debts. Banks are heavily exposed to foreign liabilities, but details are not publicly available. Due to fundamental weaknesses in the financial system and the investment regime, foreign and domestic loans are often used to finance projects of low and even negative value, further increasing the risk of future domestic and international debt crises.
- Changes in the global investment environment, and disappointment of foreign investors with the pace and effectiveness of Viet Nam's economic reforms will make it increasingly difficult for Viet Nam to attract foreign direct investment. Trade and industrial policy biases in favor of import substitution and SOEs ensure that much of the FDI that does enter Viet Nam is of low economic value to the country.

- ODA has recently overtaken FDI in importance as a source of foreign exchange inflow. Poor incentives created by the investment regime, together with rent seeking and inability or unwillingness to conduct economic analysis of projects reduce the value of ODA inflows. ODA will be effective only if it helps promote the economic reform agenda.
- The banking system is weak and vulnerable to future domestic crises. It is of very little value to the private sector. The rest of the financial system is much less developed than the banks.
- Stability of macroeconomic management is imperiled by debt burdens arising from borrowing for unproductive public investments, by potential obligations arising from future banking crises, and by excessive reliance on direct controls in foreign exchange markets.

Solutions to these problems are critical to Viet Nam's development.

Investment, the financial system and integration: Strategic visions

Successful international financial integration requires, above all, a sound domestic financial system and investment environment. The development of such a financial system and of a transparent, market based investment environment must be at the heart of the reinvigoration and acceleration of *doi moi* over the next decade.

The direction and pace of reform, of course, are sovereign, political decisions, to be made by the people of Viet Nam. They are also a matter of vision. On the basis of the discussion in the report, two alternative visions are offered.

Vision 1: Speedy and comprehensive resumption of reform

A speedy and comprehensive resumption of the reform process that began in the mid-1980s is Viet Nam's best hope for setting itself on a high and sustainable long-term growth path. It will ensure that public and private investment decisions, whether domestically or internationally financed, are made in the face of incentives that reflect Viet Nam's economic circumstances and interests. It will minimize the risk of short-term or longer-term instabilities. It will offer the best hope for poverty reduction and equitable treatment of vulnerable groups.

Under this vision, Viet Nam would quickly remove many immediate obstacles to development, such as foreign exchange controls on current account transactions for trade in goods and services, and unnecessary limitations on the activities of foreign banks. At the same time, longer-term reforms in the legal and regulatory environment for SOEs, private sector development and the financial system would be pursued as quickly and systematically as possible. This would include vigorous evaluation and improvement in implementation of reform measures already underway.

This strategy will not necessarily mean an immediate resumption of high growth. In fact, Viet Nam should be prepared to adjust to a slightly lower pace of investment and development until the regulatory, institutional and legal framework of its market system is improved. This will help avert potential financial and economic crises in the transition period. However, a clear signal of Viet Nam's renewed commitment to its process of economic reform will be well received in international markets, with subsequent increases in investment in and trade with Viet Nam.

Comprehensive reform is not "shock therapy". As has been learned in many other countries, economic reform involves systemic issues that can only be handled over a period of time. Comprehensive reform processes recognize these constraints. Viet Nam's systemic constraints require more comprehensive reform than in many other places, and so demand even greater commitment to the process of reform.

Economic and systemic reform in these circumstances is also a learning process. While general timetables can be set, and should be adhered to as closely as possible, the completion and fine-tuning of detailed blueprints will be an ongoing process.

Vision 2: Continuation of opportunistic reform

After the initial measures of the late 1980s and early 1990s, Viet Nam's reforms have become much more sporadic. This pattern is familiar from reform experiences in other countries. Political will diminishes as the "easy" reforms are completed and vested interests dig in to preserve privileges created through subsidies and market restrictions. Viet Nam's reforms are becoming more the opportunistic outcome of high level political processes rather than the result of application of a consistent strategy. The process has lost direction.

This might be inevitable; it might be politically necessary or even desirable. But it will not yield a consistent reform programme. It will create uncertainties for potential investors – domestic and foreign. This is not conducive to long-term development.

Sporadic and opportunistic reform will not necessarily mean lower growth in the short run. The government could stimulate growth by requiring banks to fund new SOE investments and public projects – cement and fertilizer plants, oil refineries, uneconomic bridges and highways, etc. This would bring short-term growth, but at the risk of financial crises and the certainty of larger government debts in the not-so-distant future.

In a sporadic and inconsistent reform environment, short-term concerns often override longer-term economic interests, and lead to policies which impede and even reverse the reform process. Capital controls provide an instructive example. Rather than adjusting monetary and exchange rate policies, the government expands and contracts the scope of capital controls in response to short-term foreign exchange concerns. This is not only bad macroeconomics; it also conflicts directly with the agenda of trade and industrial policy reform.

The more likely outcome of opportunistic reform will be a gradual weakening of Viet Nam's international financial integration and a steady deterioration of growth. In the post-crisis world, foreign investors are wary of countries with poor and/or inhospitable economic policies. Investment funds are much scarcer than before. Viet Nam is competing for direct and portfolio investment against countries that have made major reforms. Direct investors have already signaled their impatience with the poor investment environment and the lack of reforms. Portfolio investors will be extremely cautious about investing in a country with poor accounting and corporate governance practices, lack of financial disclosure and absence of basic financial laws. Donors will also become impatient with lack of commitment to reform.

Opportunistic reform might satisfy some political concerns, and protect important vested interests. But it will result, at best, in steady but low growth. It will be accompanied by a higher risk of short and long-term instability. And it will deprive the country's poorest and most vulnerable groups of the capability to exercise the basic economic choices expected from the development of Viet Nam's socialist market economy under *doi moi*.

Recommendations

Of the two alternative visions suggested, a renewed commitment to *doi moi* is the preferred option. This will require fundamental restructuring of both the investment and financial environments. This involves legal, regulatory and institutional development that cannot be accomplished overnight, and that will require strong and committed leadership at the highest levels. The fundamental reforms that are needed here can be summarized under three main headings.

- Remove as quickly as possible the barriers to the development of the private sector.
- Accelerate the restructuring of the SOE sector. In particular, eliminate preferential treatment provided under licensing laws, access to foreign exchange, to credit from the banking system and all other business activities. Create alternative social safety nets to perform the social functions of SOEs and ameliorate any short-term social costs arising from the adjustment to the new regime.
- Accelerate the fundamental reforms in the banking sector, in the development of a legal and regulatory framework, and in the creation of new financial instruments, institutions and markets.

These are the basic reforms required for successful international financial integration. A great deal of the groundwork for these programs has been prepared already. It is now a question of the government's determination to move ahead.

At the same time as these reforms are proceeding, a number of more immediate measures can and should be undertaken. The following is an illustrative list of recommendations.

- Remove capital controls and foreign exchange restrictions related to import and export of goods and services. At the same time, study the examples of Chile and other countries to determine a set of measures for discouraging short-term capital inflows, especially while the financial system remains weak.
- Place increased reliance on overall monetary policy and the exchange rate, rather than selective trade and foreign exchange controls to adjust to imbalances in the overall demand for and availability of foreign exchange.
- Cease the practice of attracting or increasing the profitability of new investment through increased import protection, whether through special import duties, import licensing privileges or any other measures.
- Establish a clear and publicly stated government policy not to guarantee commercial debts, especially those in foreign currencies.
- Improve the government's capabilities to conduct economic analysis of publicly- and ODA-funded investment and infrastructure projects, and impose a requirement that new public investments be subject to such appraisals.
- Increase and consolidate the basis for foreign participation in the banking sector and the emerging stock market and related institutions.

1. Overview

Introduction and summary of major themes

Viet Nam's dual transformations – from a centrally planned to a market-based socialist economy, and towards greater integration with the global economy – are central to its long-term strategy to achieve *sustainable development with equity.* This is seen as the best means of developing and capitalizing on Viet Nam's many internal strengths.

A major focus of this report is the close interdependence of these two fundamental transformations. International integration is one important element in the process of developing a market-based economy.

The Government is also strongly committed to the goal of *stability* as an essential element of its socio-economic development strategy. Recent regional and international experience has shown that international financial integration can be risky. This is especially true in the absence of properly developed domestic market institutions. *To reap its full benefits and minimize associated risks, therefore, international integration, must be closely coordinated with the development of the legal and institutional foundations of the domestic market economy, especially in financial markets and investment allocation mechanisms in both the public and private sectors.*

International integration and the development of the institutional framework of a domestic market economy must proceed together to achieve the country's long-term socio-economic development goals. The enormous contributions of *doi moi* to poor rural communities, for instance, arose from both the introduction of basic property rights to rural areas and the opportunities to export rice and other products to world markets. Neither the domestic market reforms nor the opening of international trading opportunities alone would have had a similar impact on rural incomes. Both were necessary.

The evidence on the importance of international integration, both from Viet Nam's own recent history and from much broader international experience, is overwhelming. International economic integration is one of the single most important pre-conditions for long-term economic success (Sachs and Warner 1995).

However, the recent Asian economic crisis (as well as earlier experiences of rapid reform in transition economies in Asia and Europe) demonstrates that international integration brings potential risks, as well as opportunities. It also demonstrates that international integration is only one part of a successful development strategy. Of

equal, if not greater and more fundamental importance, is the development of domestic markets, and supporting regulatory and legal institutions.[1]

The key to maximizing the opportunities and minimizing risks and instabilities arising from international integration is the development of domestic market institutions and especially a sound, transparent and market-oriented regulatory and legal framework. This is especially true of international *financial* integration, which is the focus of this report. The benefits from international financial integration can only be realized in the presence of complementary domestic policies and institutions. Evidence from Viet Nam and from around the world shows very clearly that international financial integration – whether in the form of direct investment, lending and borrowing, or official development assistance – can be dangerous and costly without such well developed domestic market institutions. The risks are greatest with respect to short-term international capital flows.

While all domestic markets are important in shaping the contributions of international financial integration, the financial sector and its relation to capital markets is most critical. The state of the domestic financial sector is also be crucial, of course, in determining how well Viet Nam will be able to mobilize *domestic* resources to finance her long-term development.

Viet Nam's financial sector and related institutions are still relatively underdeveloped. Preferential treatment of state-owned enterprises (SOEs) is an especially important barrier. A strong, market-oriented financial sector requires a legal infrastructure that clearly defines property rights, provides the basis for entering and enforcing contracts, and establishes procedures and regulations concerning bankruptcy and foreclosure. There must be well-established and transparent standards of accounting and corporate governance.

The problems of Viet Nam's financial sector are becoming increasingly well recognized, and many reforms have been or are in the process of being implemented. However, progress has been slow and uneven. Recent experience in Viet Nam and in other regional economies has exposed the risks of shallow and incomplete financial sector reform. *A major challenge in a new socio-economic development strategy will be to speed up the pace and, more importantly, increase the depth of reform of the financial sector.* This will be important both in its own right, and in its implications for international financial integration.

The pace of financial market reform will have an inevitable impact on the pace of Viet Nam's development financing. The slower the pace of reform, the smaller will be the

[1] See Rodrick 1999, Rodrick 2000 and Stiglitz 1999, all of which stress the importance of complementary institutions and legal frameworks to accompany standard deregulatory and other market-based economic reforms. They also stress the difficulties and the time required for successful social investments of this type, and hence advocate a gradual, but also "deep" approach to economic reform rather than simple shock therapy.

opportunities and the larger the dangers of mobilizing external and internal resources to finance development.

The dimensions of finance and of international financial integration

The extent and nature of Viet Nam's international financial integration will determine the nature of the key interface between its domestic financial system and the global economy. As such, it is a principal element in Viet Nam's socio-economic development strategy.

International financial integration takes on many dimensions and plays a number of important roles in the economy. Among them are the following:

- It serves as the financial side of the real flows occurring through transactions with foreigners – through trade, investment, tourism, etc.
- It provides the possibility of utilizing external resources to finance current economic needs, especially in the financing of investment. This can occur through many mechanisms, including licensing, borrowing, foreign direct investment (FDI), and official development assistance (ODA).
- It exercises a strong influence on domestic macroeconomic management – through the exchange rate, capital flows, the transmission of foreign shocks, etc.

Finance, international and domestic, is not just about mobilizing funds. At its heart is the gathering and processing of economic information, which is central to the task of allocating resources for development. A central reason for making the transition to a market-base economy is to utilize the power of the market to provide, process and act according to the information held by widely dispersed economic agents to make better investment decisions.

The development of a healthy and vibrant financial sector is a key to the success of this strategy. Banks and other financial intermediaries must be free of political pressures to lend to favored enterprises. There must be well developed and reliable financial and accounting standards so that information available in financial markets can be trusted. There must be an institutional and legal infrastructure to ensure that contracts are enforced, that shareholders' and lenders' rights are respected, and that problems arising from temporary illiquidity and/or long-term insolvency are efficiently resolved. Investors must be free to respond to changing profit opportunities without excessive political or bureaucratic interference.

There are broad and very important institutional and policy development issues involved in domestic and international financial integration, and in developing an efficiently functioning market economy. Viet Nam's strategy for financial development

and integration, therefore, will be critical in determining the success of *doi moi*, Viet Nam's unique and so far very successful programmefor transforming its economy into a socialist market economy.

Scope and organization of report

The purpose of this report is to provide an overview of strategic issues facing Viet Nam in the realm of international financial integration, and to provide recommendations for the design of a strategy for dealing with them over the next decade. This is only one of many inputs into the design of Viet Nam's socio-economic development strategy. The strategy is not intended to be a detailed legislative or regulatory plan. It is, rather, a framework

- for determining policy directions,
- for ensuring completeness and consistency of policy planning, and
- against which to evaluate the appropriateness, importance and sequencing of detailed policy measures.

The issues and policy strategies discussed here are closely linked to those being addressed in companion pieces being done by other teams. The discussion in this report is most closely related to and complementary to the studies on strategies for globalization of trade and investment (Warner 2000), and on the role of the state and the market (Riedel 2000).

The following item identifies and reviews some of Viet Nam's most important strategic challenges related to international financial integration at this stage of its development. The final item synthesizes the main conclusions, provides some alternative visions and makes recommendations for Viet Nam's long-term socio-economic development strategy.

2. Strategic Issues in Viet Nam

Thinking about capital controls

Global private international capital flows grew at record rates and reached unprecedented new levels in the 1990s. Net flows to developing countries tripled, from roughly USD50 billion to more than USD150 billion per year, between the late 1980s and 1995-1997 (IMF 1999b, World Bank 1999a). While world trade has also grown considerably over the same period, the increase in international capital flows is arguably the single most important manifestation of globalization and integration of world markets over the past decade.

International financial integration has brought many benefits, providing unprecedented opportunities for diversification of risk and for channeling resources and knowledge to their most productive and profitable uses. Viet Nam was the recipient of huge inflows of foreign direct investment (FDI) in the middle 1990s, at levels unmatched almost anywhere else in the world.[2]

International financial integration brings risks as well as opportunities. Large capital inflows can be matched by equally large and sometimes much more sudden outflows. Capital markets can impose harsh discipline on countries that are subjected to adverse shocks and/or that commit major policy errors.[3] International lenders and portfolio investors often behave according to what appears to be a herd mentality rather than rational economic calculation. Chief among the causes of private market excesses has been the belief by investors that government guarantees to financial institutions will save them from adverse consequences of lending decisions. This "moral hazard" encourages excessive risk-taking.

These conflicting messages about the risks and opportunities of international financial integration have provoked a vigorous debate about both the future architecture of the international financial system and appropriate domestic policies with respect to inflows and outflows of international capital. Among the most contentious of the issues has been regulation and control of international capital flows.

Although there remain considerable disagreements over details of domestic and global strategies for international financial integration, there is also general consensus on certain broad lessons of particular relevance for countries like Viet Nam .[4]

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[2] FDI is discussed in more detail in a separate section.

[3] While this disciplinary effect of international capital flows is "cost" in terms of the constraints it imposes on domestic policy independence, many observers regard this as a major benefit of international financial integration. The discipline of international capital markets protects a country's citizens from the unintended costs of macroeconomic policy errors by their central bankers and by their finance and planning ministries.

[4] See Eichengreen, Mussa *et al* 1999b for a brief summary of recent findings. Eichengreen and Mussa 1999a provides more detailed discussion and analysis.

- Financial liberalization is a necessary condition for benefiting from participation in the world economy. This participation helps to achieve higher and more productive investment, and as a result rapid growth and rising living standards.
- Most of the inefficiencies and risks of international financial integration arise from asymmetric information – situations in which parties to financial transactions have unequal access to information. Government policies can play a key role in minimizing or aggravating such asymmetric information problems. Transparent rules and regulations, wide and timely dissemination of basic economic data, and clear schedules and commitments regarding changes in economic rules and regulations are among the basic requirements of governments in this regard. Adherence to widely applied accounting rules, and standards of corporate governance play a similar role for firms in both the public and private sectors.
- Distortions of financial markets due to inadequate risk management by banks, weaknesses in bank supervision and regulation, and government guarantees of liabilities of certain market participants are especially dangerous.
- In the presence of weak domestic financial systems, sequencing of reform is very important. *Strengthening of domestic financial institutions and systems must precede both domestic and international financial market liberalization.* Both internal and external financial liberalization threaten financial stability in identical ways in the presence of weak financial sectors.
- While international financial integration should not precede strengthening and liberalization of domestic financial markets, certain aspects of international integration can be highly complementary to the domestic reform process. Participation of foreign financial institutions in domestic markets can be an important source of technology transfer and of beneficial competition. It can be very helpful in overcoming inertia due to resistance to reform on the part of domestic vested interests.
- In a highly integrated world, capital controls are increasingly difficult to enforce. The more pervasive and less transparent they are, the greater is the incentive to avoid them, and the greater is the corruption they induce. Capital controls, therefore, should have no more coverage then necessary, and they should be as simple as possible. Highly mobile short-term debt is the most dangerous form of international capital flow in a country with a weak financial system. The most appropriate tools are measures that discourage inflows of such capital. Mandatory minimum holding periods, enforced through deposit requirements, or taxes on a sliding scale based on the length of the term of the debt, as in Chile, are much more effective than attempts to control outflows (Ariyoshi *et al* 2000).

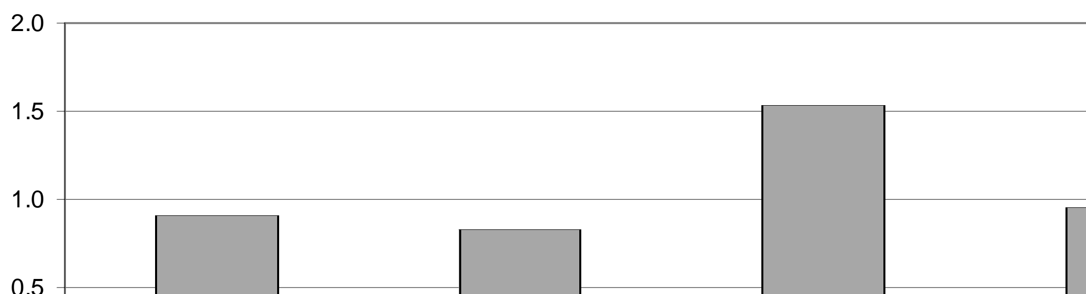
Relative to many other countries, especially in this region, Viet Nam has very weak and underdeveloped financial markets. As a result, the market instruments and opportunities for short-term international capital flows are still quite limited, and Viet Nam has not suffered (or benefited) from significant inflows or outflows of short-term capital. As can be seen in Figure 2.1, net short-term capital flows from 1993 to 1996 never exceeded 1.5 per cent of GDP. In 1997 and 1998, Viet Nam experienced a net outflow of short-

term capital, in the amount of about 2.5 per cent of GDP, far smaller than that experienced in Thailand and other Asian crisis economies.

The relative unimportance of short-term capital flows in Viet Nam to this point in time reflects both the relative underdevelopment of its financial markets and relatively strict direct controls over foreign exchange markets. The dangers of short-term capital market deregulation in the absence of a well developed and well regulated and monitored domestic financial market have been amply demonstrated by the regional crisis. These are risks that the government of Viet Nam wishes to avoid. The only long-term solution, other than an indefinite continuation of direct regulation of capital and financial markets, is deepening of domestic financial markets and of the corresponding regulatory environment. The key subject of financial sector reform is dealt with in a separate section below.

Figure 2.1 Viet Nam: Net short-term capital inflows (percent of GDP)

Figure 1
Vietnam: Net Short Term Ca
(Percent of GDP)



Source: Calculated from data in IMF 1999a, Statistical appendix, Table 27.

However, it also must be recognized that, relative to many other countries in the world, and especially most of her ASEAN partners, regulation of Viet Nam's international capital markets suffers from a serious lack of transparency, consistency and predictability. There is a considerable amount of implicit and explicit regulation of international capital flows. Much of this regulation is informal and poorly documented. Recent studies of non-tariff trade barriers in Viet Nam, for instance, have alluded to but have been unable to provide very complete documentation of the use of exchange controls (and special privileges for SOEs and other preferred importers and exporters) on current account transactions (Centre for International Economics 1999 and McCarty 1999). This lack of transparency and the resulting uncertainties about capital and exchange control policies is, in itself, a major barrier to capital flows. This affects not just volatile short-term capital, but also, and much more importantly, longer-term investment.

Capital controls in Viet Nam are used for a wide variety of purposes that are unrelated to and not necessary for dealing with risks of short-term capital movements. Both formal and informal capital controls are employed, often on an *ad hoc* basis, for a wide variety of purposes, ranging from regulating the exchange rate to controlling "undesirable" imports, and to protecting certain domestic markets from international and/or domestic competition.[5]

Until 1998, even the most basic rules and regulations on permissible uses of and access to foreign exchange were unavailable and/or indiscernible. Decision 63 (August 17, 1998), Prime Minister's Decision 173 (September 12, 1998), and State Bank Circular 8 (September 30, 1998) provided some clarification on issues related to

- rights to make payments in foreign currency,
- obligations to repatriate foreign earnings,
- obligations to sell foreign currency, and
- rights to convert domestic into foreign currencies.

However, many of the rules were highly restrictive (such as the obligation to convert 80 per cent of foreign currency earned in current transactions), and others left room for considerable arbitrariness and heavy bureaucratic costs in implementation. Basic issues related to the availability of foreign exchange and security even of the limited rights provided in these laws and regulations were not dealt with. Experience has verified that foreign exchange availability has been manipulated to deal with unrelated issues such as promotion of priority industries and favored companies. For instance, only a limited set of companies, principally those investing in "essential import substitutes" and other significant projects were able to obtain foreign currency convertibility permits.

A recent and informative survey of foreign exchange related import controls in Viet Nam (McCarty 1999) concludes that such controls are implemented on a highly discretionary and non-transparent basis, and that their importance have been *increasing,* at least up to the time of writing of the report. Foreign exchange regulations had to a large extent replaced other mechanisms for imposing selective non-tariff controls on imports.

There have been several recent attempts to clarify ambiguities and uncertainties arising from Decision 63, most notably State Bank of Viet Nam Circular 1 (April 16, 1999). Unfortunately the circular was not very successful in meeting this purpose. More importantly, it did nothing to limit the range of direct controls, restrictions and required per-

[5] One of the best and most up-to-date sources of information on details of the exchange control regime in recent years is Freshfields *Indochina Notes*, a commercial newsletter prepared for private investors in Viet Nam and the region. The newsletter provides an invaluable service by describing the changing structure of foreign exchange and other regulations and, even more importantly, of the details of their implementation (or non-implementation, as the case may be). The discussion in this and the following paragraphs owes a great deal to the insightful and informative commentaries in recent issues of this newsletter.

missions on foreign exchange transactions and use. Government Decision 180 (August 30, 1999) relaxed the foreign currency conversion requirement from 80 to 50 per cent, reflecting a sense that other forms of import controls had compressed imports sufficiently to allay previous fears about the balance of payments. But there is no guarantee that the requirement will not be tightened again in the face of future balance of payments concerns. In an earlier decision (OC 814 of August 5, 1999) the government had also extended the range of companies eligible to apply for foreign currency convertibility permits. However, permission must still be granted by the State Bank of Viet Nam, on a case by case basis, and depends in part on the Bank's "foreign currency capabilities."

It is clear that there remains considerable scope for the reform of the regime of capital controls in Viet Nam.

There are some that might argue that the recent financial crisis, and Malaysia's decision to employ capital controls, provides vindication to Viet Nam's exchange control policies. This inference is completely incorrect. (see Box 2.1). Malaysia's policies were broadly similar to those of its ASEAN neighbours. Its capital controls were imposed very late in the programme, and have already been relaxed substantially. Thailand also employed some mild capital controls on offshore swap transactions, which proved to be unsuccessful and which were subsequently relaxed.[6]

Almost all countries in the world impose some constraints on international capital transactions (Aiyoshi *et al* 2000). Recent events have highlighted the need for further consideration of the proper role of tax and other regulatory policies on international capital flows. Although this remains an area of intense discussion, there is an emerging consensus on at least a number of important issues of relevance for Viet Nam.

- There remains a general consensus in favor of open capital markets, staring with current account transactions, but including as well most other capital market transactions. It is recognized that the way to achieve this goal is, not through immediate shock therapy measures which eliminate all regulatory controls, but rather through "an orderly process of progressive integration" (Obstfeld 1998).
- In light of certain risks presented by open capital markets, there is recognition of the need for a number of regulatory and institutional safeguards. Such safeguards are necessary at both the national and multilateral levels.
- At a super national level, there must be some institutional "lender of last resort" to offer assistance to countries facing unexpected and difficult-to-manage massive capital flight. To minimize risks of "moral hazard", there must be agreements and institutional arrangements in place to ensure "bail in" of international creditors when private investment and lending decisions go awry due to failed profit expectations. Greater information sharing among creditors at the international level would help to prevent certain such situations from ever occurring.

[6] See Flatters 2000 for a brief description.

- The greatest risk, especially for countries with underdeveloped financial markets and institutions, is with respect to volatile short-term capital flows. The first best solution is an effective system of prudential behavior and supervision of borrowers. This relates to the development of domestic financial markets, which is dealt with in a separate section below. The second best alternative, until the first best can be attained, is restrictions on short-term capital inflows. These could take the form of taxes which vary inversely with the length of the term of the inflow, deposit requirements which are refundable only after the funds have remained in the country for a specified time, or other similar measures.

- Other domestic measures which would serve to reduce the risks arising from open capital markets include:

  - maintaining at least a certain amount of exchange rate flexibility to encourage borrowers to hedge and otherwise take proper account of foreign exchange risk and thus avoid the moral hazard problem arising from false expectations about unsustainable levels of "fixed" exchange rates;
  - for the same reason, ensuring that the exchange rate remains at a value that can be maintained and supported by market forces in the absence of exchange controls;
  - greater equity ownership on the part of foreign investors, especially in the banking sector;
  - development of competitive domestic capital markets which are free of government favoritism towards selected borrowers and investors;
  - encouraging prudential risk management and diversification on the part of investors and borrowers.

Relative to these criteria (and indeed to most other countries in ASEAN), Viet Nam's capital controls regime is non-transparent and excessively intrusive, restrictive and unstable. Capital controls on current account transactions are widely used, and are imposed and modified in light of transient foreign exchange "shortages". They are also employed in support of industrial policy goals related to achieving self-sufficiency in particular sectors or protecting particular industrial activities or enterprises, often SOEs (McCarty 1999).

To the extent that preferential and selective industrial policies are needed to promote certain firms or sectors, this is the role of import tariffs and budgetary subsidies, not foreign exchange allocation mechanisms (Centre for International Economics 1999, McCarty 1999, Warner 2000). Shortages of foreign exchange reflect a need for monetary and/or exchange rate policy adjustments, not for controls on particular transactions.

Viet Nam's regime of capital controls and foreign exchange regulations increases the cost of a wide range of economic activities. It interferes with and unnecessarily distorts production and investment decisions, which, because of exchange regulations, often are made, not on the basis of their contributions to the economy, but instead because of bureaucratic and regulatory decisions on access to foreign exchange. This reduces economic growth and unnecessarily increases risk and uncertainty in the economy. One

unintended effect of foreign exchange controls and associated uncertainties has been to cause a substantial part of savings to be held in dollars and other foreign cash, thus dollarizing a significant part of the economy and even more importantly, keeping these resources out of socially productive uses in Viet Nam.[7]

The question for Viet Nam is not whether to continue to control and regulate international capital flows. Rather, it is how to rationalize the existing system of regulations and controls, and how to develop a coherent strategy for reducing them. This is not just an issue of changing particular laws and regulations, but also overhauling *ad hoc* implementation practices and undertaking a credible commitment to stability of the policy environment.

It is not sufficient of course, simply to phase out the use of unnecessary and counter-productive capital and foreign exchange controls. The strategy must also include measures to avoid unnecessary economic costs and instabilities arising from capital flows in a weak domestic financial sector.

The following are the basic elements of a strategy that would meet these requirements.

- The long run strategy should be to strengthen the domestic financial sector as rapidly as possible so that Viet Nam can take best advantage of the opportunities of international financial integration.
- While that goal is being achieved, policies must be designed to minimize potential damage from capital inflows, especially those of a short-term nature. Such policies would include the following.
- The government should impose a withholding tax or deposit requirement on short-term capital inflows, with full refund of the tax or deposit after the capital has remained in the country for a specified period of time (e.g. one year). This fiscal device should replace all direct controls on short-term capital flows.
- Limits should be placed on commercial banks' exposure to unhedged foreign denominated liabilities of a short-term nature. These liabilities would include not only foreign denominated loans on their own account, but also dong-denominated loans to borrowers with significant amounts of unhedged foreign currency liabilities.
- The government should enunciate a clear and credible policy regarding the guarantees it will and will not provide with respect to foreign debts of private firms and SOEs, inside and outside of the financial sector. The first best policy is to clearly state a policy not to guarantee private debts. Any such policy with respect to SOEs is unlikely to be credible. Policies with respect to SOEs, therefore, must focus on equitization, privatization and improved governance practices in this sector. Where guarantees are provided, the policy should include a clear statement of implications for management and shareholders in the event that guarantees must be honored.

[7] See further discussion of the savings issue below in the section on the balance between foreign and domestic savings.

- Exchange rate and monetary policies must be executed so as to ensure the exchange rate reflects the underlying fundamentals in the economy, and is not maintained at unrealistic and unsustainable levels through the use of capital controls and artificial restrictions of trade.
- While there might be considerable justification for regulation of short-term capital flows in the presence of underdeveloped and poorly regulated domestic financial markets, there is no such justification for capital controls on current account transactions. The government should eliminate as quickly as possible the use of exchange controls as a means of regulating imports and exports of goods and services. It should remove all restrictions and regulations that have the effect of allocating foreign exchange according to types of imported and exported goods, or the identities of their buyers or sellers. Foreign exchange allocation rules, regulations or informal practices should not be used to favor particular types of investors, producers or consumers (e.g. SOEs). This should be done in a manner that is as permanent and irrevocable as possible. Only in this way can existing and deeply ingrained uncertainties about the policy environment be eliminated.
- Uncertainties arising from frequently changing foreign exchange requirements on long-term investors need to be reduced. There will be some beneficial fallout in this regard from adoption of the previous recommendations. Nevertheless, there needs to be a thorough review of the existing laws and their implementation to determine what social and economic purposes they serve. Changes in remission requirements, for instance, seem more often than not to reflect concerns about the current state of the balance of payments rather than strategic views about the appropriate investment regime. As with foreign exchange rules on current account transactions, this is an inappropriate and costly way to deal with balance of payments concerns.

The policy directions suggested in this section represent a major overhaul of the capital controls regime in Viet Nam, and should be a central element in Viet Nam's strategy for international financial integration.

Box 2.1 Malaysia, capital controls and the Asian crisis

Malaysia's approach to the Asian financial crisis has differed from that of its immediate neighbours. Most notable were its decisions not to ask for IMF financial assistance and to impose controls on the capital outflows and on offshore trading in Malaysian stock market shares. It is argued by some that this distinctive approach was much more successful than that of its neighbours, and the Malaysia's rejection of the IMF "formula" and of open capital markets might be a much more appropriate model for Viet Nam and other countries.

What are the facts?

Pre-Crisis Vulnerability

Malaysia's balance of payments and its financial system were much less vulnerable than its neighbours in the period leading to the crisis. Malaysia's stock market was much more heavily capitalized than those of Indonesia and Thailand, even before correcting for Malaysia's much smaller population. For that and other reasons, Malaysia's short-term external debts were much smaller (as a per centage of GDP) than in Indonesia and Thailand. Malaysia's banking system was also much less vul-

nerable, with a much lower proportion of non-performing loans. All of these strengths had been achieved under free and open international capital markets. Indeed international flows of portfolio capital and direct investment have been absolutely central to Malaysia's strong economic performance over the past two decades.

It is worth noting that were other important differences, not only between Malaysia and the others, but also among the other Asia crisis countries. For instance, while both Indonesia and Thailand were more highly leveraged with short-term private debt than Malaysia, the patterns were quite different. While most of Thailand's short-term foreign debt was held by domestic banks, Indonesia's was much more heavily concentrated in the non-bank corporate sector. In another key difference, Korea had relied much less than any of the other Asia crisis economies on foreign direct investment.

In considering the advantages that Malaysia had over the other Asia crisis economies in the lead up to the crisis, it is actually quite surprising that her economic performance during the crisis and the subsequent recovery was not significantly superior to that of her neighbours.

How radically different was the Malaysian approach to the crisis?[8]

Except for the imposition of capital controls, Malaysia's response to the crisis was broadly similar to other crisis affected countries. Immediate policy responses included initial attempts to defend the currency through foreign exchange market interventions (unlike Thailand, however, Malaysia did not attempt to restrict offshore swap or forward transactions), interest rate hikes, and eventual floating of the currency. This was followed by continued monetary stringency, fiscal tightening, and a broad range of structural reforms. Relative to Indonesia and Thailand, interest rates were not pushed as high. On the other hand, tight monetary policies were pursued for a longer period in Malaysia than in the other countries, with interest rates peaking only in August 1998, compared with March in the cases of Korea and Thailand.

Capital market controls were not imposed until September 1998. The exchange rate was pegged at 3.8 ringgit to the US dollar (implying a slight appreciation) at the same time. This was long after capital flight had abated. By that date the exchange rate had more or less stabilized as well. In February 1999, the strict limits on capital outflows were replaced by a graduated tax based on the length of time the relevant assets had been held.

Most of the broad economic indicators of recovery, including their timing, have been broadly similar across Korea, Malaysia and Thailand. One interesting difference appears to be showing up in portfolio and direct investment flows – portfolio flows to Malaysia have been much slower to recover than in Korea and Thailand, and FDI inflows have declined relative to the same two countries.

Summary

While there have been many differences in initial circumstances and in the details of the crisis programmes, the similarities in policy strategies and in subsequent economic patterns across the countries can be considered to be quite surprising. In light of the lateness with which the capital controls were imposed, their relatively mild and temporary nature, and the similarities in other aspects of the crisis programmes, it is certainly very difficult to make a case that capital controls have been a decisive difference between Malaysia and the other countries.

What is the significance of Malaysia's decision not to call for IMF assistance? As Indonesia and Thailand were acutely aware, a call to the IMF is a clear market signal of domestic economic difficulties. Since most of Malaysia's pre-crisis fundamentals were more sound than those of the other countries, she was justifiably reluctant to give the "wrong" signal to international and domestic markets. This did not stop Malaysia from following broadly similar policies. And the decision to impose capital controls was at least as strong a market signal of the economy's vulnerability as would have been a decision to call in the IMF.

[8] This section draws on IMF 1999b, Box 2.4.

Averting future debt crises

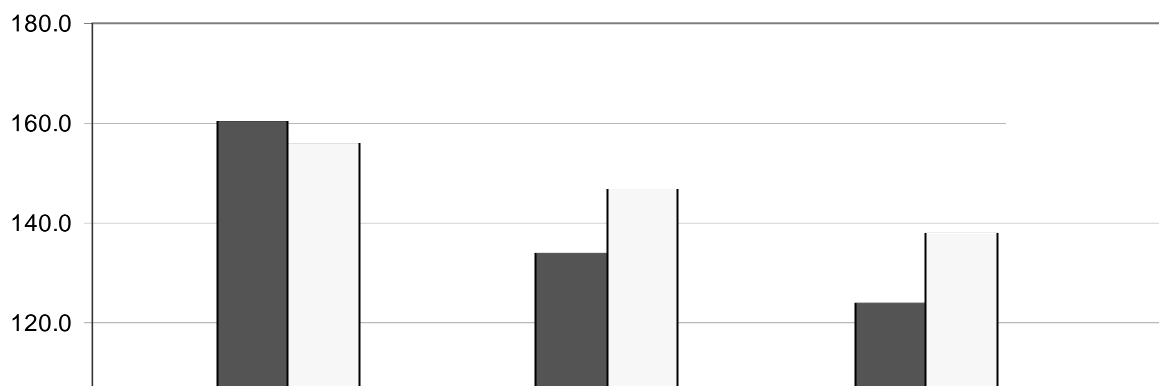
Is Viet Nam now facing in any danger of facing a debt crisis?

Foreign debt difficulties arise when the magnitude of a country's external debt and associated repayment obligations grow very large relative the resources available to meet these obligations. Among the standard indicators used for this purpose are ratios of debt (or debt service) to a country's GDP, exports, or government revenues. Under the IMF/World Bank Heavily Indebted Poor Countries (HIPC) Initiative, targets of acceptable levels of debt have been set at 150 per cent of a country's exports and 250 per cent of government revenues.

Figure 2.2, based on data in the most recent IMF survey of the Vietnamese economy (IMF 1999a), shows three commonly used external debt ratios for Viet Nam between 1994 and 1997. The data refer to external debt in convertible currencies. From this figure it appears that Viet Nam is not facing any immediate external debt crisis; the standard debt ratios shown here are comfortably outside the usual danger zones. The ratio of debt to export revenues has been falling and that of debt to GDP was about the same in 1997 as in 1994. Only the ratio of debt to government revenue has risen in recent years, and that is due primarily to the declining share of government revenues in GDP (from about 25 per cent in 1993 and 1994 to 21-22 per cent in 1997 and 1998). Furthermore, the share of Viet Nam's external debt that is public or publicly guaranteed has declined significantly in recent years. See Figure 2.3. The falling share of public and publicly guaranteed debt is due primarily to the rising importance of external loans made in connection with foreign direct investments.

Figure 2.2 Viet Nam: External debt ratios (%)

Figure 2
Vietnam: External Debt Ratio



Source: Calculated from data in IMF 1999a, Statistical Appendix, Tables 18, 27, 34.

Figure 2.3 Viet Nam: Public and publicly gururanteed share of external debt (%)

Figure 3
Vietnam: Public and Publicly Gururanteed Sh

Source: Created from data in IMF 1999a, Statistical Appendix, Table 34.

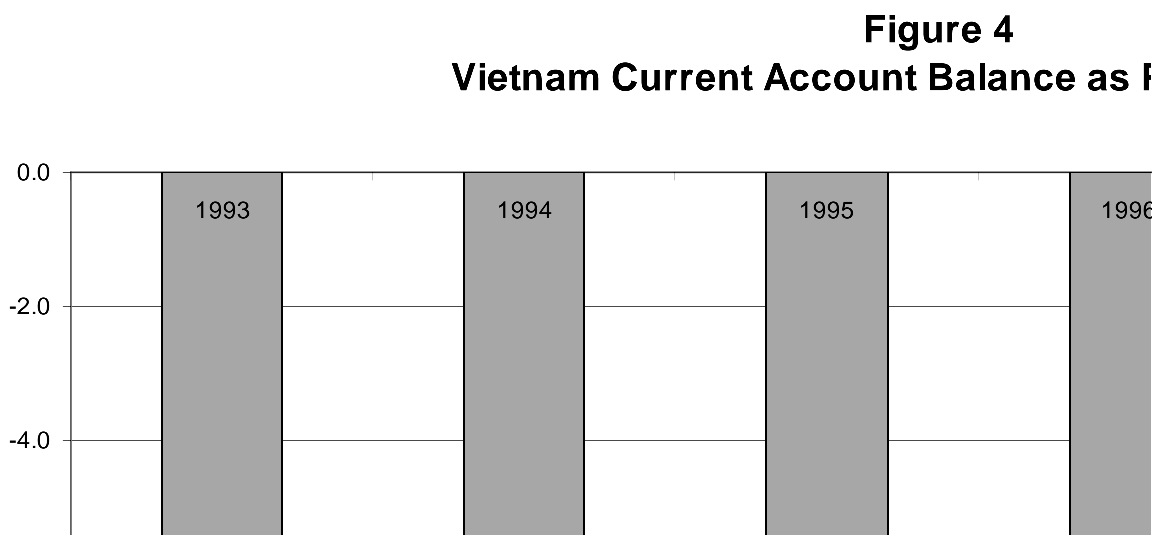
Another barometer of emerging debt problems is the current account balance of the country's balance of international payments. Incipient external debt problems are almost always preceded by a widening current account deficit. Figure 2.4 shows Viet Nam's current account deficit as a per centage of GDP from 1993 to 1998, according to official Vietnamese data as provided to and interpreted and reported by the IMF (IMF 1999a). Once again the data provide little basis for concern about incipient external debt problems. The current account deficit is not only low, but it has also been falling quite rapidly over 1996-1998, just the opposite of the patterns seen in neighboring Asian crisis economies over the same period. While this pattern might reflect many possible difficulties with macroeconomic policies, and especially the use of "brute force" direct controls on foreign exchange related transactions, it does not seem symptomatic of an emerging external debt crisis of the traditional type seen in Latin America and Southeast Asia recently.

The discussion to this point has been predicated on the data underlying Figures 2.2 to 2.4. These data are among the basic elements necessary to diagnose and anticipate emerging economic problems related to foreign debt. Unfortunately, official Vietnamese data are difficult to obtain, and even more difficult to reconcile with counterpart data from other sources.[9] Unlike most other countries in the world, even some of the most basic data that might be needed to analyse potential debt problems are treated as state secrets in Viet Nam. Furthermore, publicly available official data on aggregate imports and exports, which would give some warnings of unsustainable accumulations of foreign liabilities, are at odds with counterpart data published by the IMF. Recent

[9] For more detailed discussion of the data issues raised in this paragraph, see Dapice 1999.

trends in trade balances shown in the IMF data (IMF Direction of Trade Statistics) suggest the possibility of much more alarming trends than are revealed by Viet Nam's official trade statistics and those underlying the figures shown above. Dapice 1999 argues that, based on IMF Direction of Trade Statistics, twice as many foreign debt liabilities may have accumulated over the past three years (USD12 billion, or 50 per cent of GDP) than are revealed in official Vietnamese data.

Figure 2.4 Viet Nam current account balance as percent of GDP



Source: Created from data in IMF 1999a, Statistical Appendix, Table 27.

Dapice has presented an extremely pessimistic interpretation of the data available from various sources, and he could certainly be proved wrong in his specific predictions about future debt problems. But regardless of the accuracy of his diagnosis and predictions, he raises an extremely serious point about macroeconomic data in Viet Nam. Deliberate suppression of data makes informed discussion and formulation of policy impossible. This increases the risk of policy errors. It also increases the risk aversion of investors, foreign and domestic. This increases the cost of capital and impedes access to investment, new technologies, markets and employment growth. Furthermore, as we have seen in the earlier discussion, lack of transparency is a critical risk factor in causing financial crises.

An essential element of Viet Nam's socio-economic development strategy for the coming decade must be to improve the accuracy, availability and credibility of its basic macroeconomic data.

The remainder of this section presents a discussion of relevant international experience with international and domestic debt crises, and some of the principal lessons for Viet Nam.

International debt crises

International debt crises can arise for many different reasons. For our purposes, they can be divided into two categories:

- those arising from chronically high levels of long-term indebtedness, usually on the part of the public sector, and
- short-term macroeconomic crises, usually arising from rapid build up and/or high levels of short-term indebtedness, resulting in capital flight and massive exchange rate pressures.

Chronically high levels of public sector foreign indebtedness typically result from excessive borrowing to finance current expenditure needs and/or unproductive public sector investments. Low rates of economic growth then provide insufficient resources to meet debt service requirements. To meet debt service needs, resources must be secured through ever-increasing domestic taxation and/or reduced levels of essential public services. Resulting foreign exchange and political risks make it increasingly difficult to attract private investment and other capital inflows.

This syndrome describes a classic low income equilibrium debt trap. Following the debt crisis of the early 1980s, the international community has launched a number of programmes to assist countries deemed most vulnerable to such debt traps. Measures have included concessional financing and debt relief, at multilateral and bilateral levels. Despite such measures, a number of countries continue to suffer from unmanageably high debt burdens, for reasons which are both domestic (imprudent debt-management policies, poor governance, lack of commitment to economic reform, and other social and political factors, including civil strife) and external (principally deterioration in their terms of trade).[10]

The IMF/World Bank Heavily Indebted Poor Country (HIPC) Initiative, launched in 1996 and further enhanced in 1999, is an attempt to reduce long-term debt levels for these countries.[11] This is to be accomplished by integrating debt relief with credible and effective policy reform directed at promoting sustainable development and poverty reduction.[12]

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[10] See Brooks *et al* 1998 for an analysis of the experiences of ten such countries.
[11] Forty-one developing countries were initially classified as HIPCs. This included 32 countries with a 1993 GNP per capita of USD695 or less and a 1993 present value of debt to exports higher than 220 per cent, or present value of debt to GNP higher than 80 per cent. Also included were nine countries that were eligible for, concessional rescheduling from Paris Club official creditors. The 41 countries were Angola, Benin, Bolivia, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Congo, Côte d'Ivoire, Democratic Republic of the Congo, Equatorial Guinea, Ethiopia, Ghana, Guinea, Guinea-Bissau, Guyana, Honduras, Kenya, Lao PDR, Liberia, Madagascar, Mali, Mauritania, Mozambique, Myanmar, Nicaragua, Niger, Nigeria, Rwanda, São Tomé and Principe, Senegal, Sierra Leone, Somalia, Sudan, Tanzania, Togo, Uganda, Viet Nam , Yemen, and Zambia. Malawi was added to the group later.
[12] See David Andrews *et al* 1999 for an accessible review and description of the HIPC initiative.

The problems of the HIPCs illustrate, in the extreme, the costs of international borrowing when domestic policies are not conducive to corresponding investments in long-term growth. While a realistic valuation of Viet Nam's foreign debts does not put this country in the same league as the most other HIPCs, it is important to realize that long-term debt burdens even at the level in Viet Nam, can impose a significant cost. long-term debt burdens can grow (or shrink) rapidly in response to changing domestic and international circumstances. There are a number of risk factors in Viet Nam, which include

- public sector investments in infrastructure and industrial projects that are of questionable profitability or long-term economic value to the country,
- the heavy role of the state in directing bank lending to SOEs for reasons that are, at best, only loosely related to economic profitability,
- implicit and explicit guarantees on the debts of SOEs, regardless of their financial or economic profitability,
- similar guarantees to private investors through involvement of SOEs, licensing restrictions on potential competitors, and protection of domestic markets served by these investments,
- weak capabilities of banks, especially those in the state sector, in evaluating prospects and risks of investment loans,
- absence or underdevelopment of other financial instruments and institutions for evaluating and financing investment projects.

Reducing Viet Nam's vulnerability to the heavy debt/low growth syndrome requires the development and improvement of domestic financial institutions, improved public sector investment procedures, and continued development of market-oriented policies and programmes. Borrowing and investment need to be guided less by arbitrary and politically or bureaucratically motivated decisions of the state and its enterprises, and more by the responses of profit-oriented market participants to undistorted prices and other market signals.

The Asian financial crisis drew the world's attention to the other kind of international debt crisis – an acute macroeconomic crisis arising from the sudden reversal of short-term foreign debt inflows. This crisis continues to be analysed and discussed. Many of its lessons for Viet Nam are already quite clear; several of the most important ones are discussed in more detail elsewhere in this report. Among the most important is that liberalization of financial markets and of short-term international capital flows must be undertaken with great care, and must be preceded by the development of domestic institutional capabilities in financial analysis and management, corporate governance, and the legal framework.

Domestic debt crises

Debt crises do not have to arise from *foreign* borrowing. As current difficulties in China illustrate, bank lending to unprofitable *domestic* SOEs, and for unproductive *domestic*

infrastructure and industrial projects, can also impose large long-term burdens on the economy.

In 1998, in response to deflationary effects of the Asian financial crisis and fears of being unable to meet ambitious growth targets, the government of China launched an investment programme in infrastructure projects and SOEs. The effect was an enormous increase in state investment expenditures across the entire SOE sector. These investments were financed, not from increased government revenues, but primarily from state bank lending. This contradicted previous directives to state banks to base lending on commercial rather than political criteria. The result has been a rapid expansion of loans to "value-subtracting companies that can not cover their operating costs from their income. Most of these should have been closed years ago."[13]

More importantly, it has led to a further large deterioration in the asset portfolios of the state banking sector, laying the groundwork for a potential future financial crisis. The inability of borrowers to meet loan repayment obligations will further weaken an already precarious financial system. While the government is unlikely to allow a full-fledged financial crisis to develop, it will be at the cost of costly bailouts and inflationary pressures as funds are lent to state banks to protect against the danger of deposit runs.

Meanwhile, the Guangdong International Trust and Investment Company (GITIC) collapse in late 1998, together with increased international awareness of financial system weaknesses, have significantly impaired China's access to international capital markets.

China's recent experience with excessive and unproductive bank-financed investments illustrates the genesis and dangers of domestic debt crises. Such crises can be as costly as international debt crises.

Some lessons for Viet Nam

Heavy controls on and regulation of short-term capital inflows and outflows, on current account (export and import) transactions and on longer-term capital flows, together with underdeveloped financial markets and institutions, mean that a short-term "Thai style" debt crisis does not pose an immediate threat to Viet Nam. Official data on debt levels and on the current account of the balance of payments reinforce the view that Viet Nam is not facing an incipient external debt crisis.

However, based on lessons from the regional crisis and from other recent international experience, Viet Nam faces several significant domestic risk factors in managing its long-term international and domestic debts and the associated macroeconomic framework.

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[13] Nicholas Lardy 1998b. See also Lardy 1998a and 1999.

- Current macroeconomic data are not widely available, and what is available is of questionable quality. Major improvements in the timeliness, quantity and quality of basic macroeconomic data would reduce market uncertainties, increase public understanding of and (hopefully) confidence in the state of the economy, and improve the information base for the formulation of macroeconomic and debt management policies.
- As has been stressed earlier in the context of the discussion of capital controls, Viet Nam must make major improvements in the structure and legal framework of its financial system if it wishes to take advantage of the many positive opportunities and benefits available through greater integration with the international financial system. Failure to undertake these fundamental structural reforms will expose Viet Nam to increased risk and reduced opportunities in its long-term socio-economic development. This topic is discussed further in the section of financial sector reform below.
- Another important lesson relates to the burdens arising from domestic or international debt finance of infrastructure projects and industrial investments with low economic returns. Most of Viet Nam's state-directed investments in recent years have very low economic rates of return.[14] This is true of heavily subsidized and protected industrial investments in cement, autos, sugar, steel, petrochemical oil products, fertilizer and paper, and reflects the basic flaw in the government's high-cost import substitution policies in these sectors. (See also Belser 1999, Flatters 1997, Warner 2000 and World Bank 1999c for further discussion of these issues.) The same is true of many infrastructure investments. Failure to deal with these systemic issues related both to long-term trade and industrial policy and the choice and financing of infrastructure and other public investments will magnify financial sector weaknesses and be a serious impediment to Viet Nam's socio-economic development. Some of these questions are dealt with in more detail in subsequent sections.

The challenges of foreign investment

In the mid-1990s Viet Nam was almost unique in its ability to attract FDI. In 1994 and 1995 gross FDI inflows exceeded 10 per cent of GDP. They averaged 9.1 per cent of GDP from 1993 to 1997. (See Figure 2.5.) This FDI performance is unmatched virtually anywhere else in the world, and is almost certainly unsustainable.

FDI inflows to Viet Nam have fallen sharply. This is in part in line with global trends. It is also a side effect of the regional crisis, since a large share of previous FDI inflows have been from the crisis-affected countries. However, the global investment environment is also changing. The crisis has made investors more risk averse. Structural reforms as a result of the crisis are further improving the investment environment in other regional countries. Viet Nam will have to match these reforms in order to remain competitive.

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[14] See Dapice 1999 for a concise review.

Figure 2.5 Viet Nam: Gross FDI inflows (percent of GDP)

Figure 5
Vietnam: Gross FDI Inflov
(percent of GDP)

Source: Calculated from IMF 1999a, statistical appendix, Table 27.

The unusually high rate of FDI inflows in the early and mid 1990s and their subsequent decline in recent years have been due more to domestic than international causes. The early inflow was due to primarily to investors' perceptions of the promise of *doi moi* – in terms of its improvements in the regulatory environment and the growth of the domestic market. The deceleration of the reform process, and the many bitter lessons learned from actual investor experience in Viet Nam in recent years has soured these perceptions.

Policy recommendations to deal with these problems have been provided elsewhere (FIAS 1999). Among the required measures are:

- simplification of licensing and establishment procedures,
- elimination of restrictions on corporate form,
- improved access to land,
- more reliable and transparent access to foreign exchange,
- elimination of the dual pricing system for foreigners,
- reduction of excessively high income taxes on Vietnamese employees of foreign invested firms, and
- elimination of the requirement to denominate wage contracts in foreign invested enterprises in dollars.

A number of steps have already been undertaken, and others are reportedly in the planning stages. However, much more progress on these and other more fundamental issues is required, especially with respect to the role of the state in the market.

In the long run, FDI cannot and should not be thought of principally a source of long-term foreign exchange.

- Many valuable "foreign investment" activities can take place with little or no cross border transfers of financial resources – for example, companies like Nike and many garment and textile buyers provide considerable technical and marketing expertise without actually investing in local production.
- Significant portions of foreign investment can be financed through debt rather than equity – issued abroad or in the local (host country) market.[15]
- In the long run, foreign investment inflows are eventually matched by corresponding outflows as profits are repatriated. If the projects are successful and earn "normal" rates of return for FDI projects, the present value of outflows will exceed that of inflows.

FDI should be thought of, therefore, not principally as a source of foreign exchange, but rather as contributor to growth in Viet Nam's long run productive capacity. This perspective turns the focus of attention of FDI policy to the overall domestic investment environment and to related incentives.

Under the current investment environment in Viet Nam, FDI has tended to be associated primarily with SOEs and has been heavily concentrated in non-tradables and protected import substitution industries (Flatters 1997, IMF 1999a, FIAS 1999, Warner 2000). Rather than enhancing openness and long run international competitiveness, FDI has become part of a growing constituency for protection.[16] Investments in Viet Nam's upstream steel and petrochemicals industries, for instance, have taken place under the protection of substantial tariff and non-tariff import barriers. Foreign investors have teamed up with their large domestic SOE partners to become a formidable new lobby for anti-competitive market incentives and regulations. Rather than enhancing Viet Nam's international competitiveness, these investments have raised the costs and hindered the development of labour intensive downstream sectors, in which Viet Nam had already demonstrated substantial success against import substitutes and in international export markets. In the more labour intensive garments and textiles sector, preferences for SOEs in the allocation of export quotas has a similar counter-productive effect by biasing foreign investors and buyers in favor of large and politically well-connected SOEs.

[15] There are significant shortcomings in official data on FDI, and on its debt component, in Viet Nam (IMF 1999a, Box II.1). However, it is apparent that 40 to 50 per cent of cumulative FDI disbursements to 1998 were in the form of debt rather than equity (IMF 1999a, Table II.3). Debt repayment burdens on FDI-related loans in 1999, for instance, amounted to USD700 to 900 million (IMF 1999a, Table II.3).

[16] For a more detailed discussion of the economic costs of protected investments in upstream industries in the Vietnamese and regional context, see Flatters 1997.

FDI is neither inherently good nor inherently bad. There is no doubt that it has the potential to yield many long-term benefits to Viet Nam. But reaping the benefits of FDI requires a policy environment that encourages competition and openness. Viet Nam has relied too much on tariffs, NTBs, other regulatory restrictions, and the political connections of large SOEs to attract FDI. This is a dangerous path. It is likely to reduce the long-term flow of FDI into Viet Nam. At the same time, it will certainly raise the costs to Viet Nam's long-term competitiveness of any FDI that does come into the country.

In the language of a recent report, it is necessary for Viet Nam to get not just *more* FDI, but *good* FDI.[17] This is *not* an invitation to bureaucrats, politicians and planners to scrutinize, evaluate and regulate FDI inflows. Rather, it is a prescription to accelerate fundamental economic reforms, so that the decisions of all investors – foreign and domestic, private and public, small, medium and large – are made in an open, transparent and competitive framework, and on the basis of market signals and incentives that reflect international costs.[18] Required measures include

- acceleration of reform of the trade and industrial policy regime, on the basis of Viet Nam's own self interest, independently of obligations under any international agreements,[19]
- strengthening of the legal and regulatory foundations of the financial sector and the legal system,
- development of a strong and diversified financial sector, and
- elimination of unnecessary formal and informal regulatory barriers to the development of the private sector.

The role of ODA

In the mid-1990s Viet Nam was the recipient, not only of significant FDI inflows, but also of substantial official development assistance (ODA). In every year but one between 1993 and 1998, donors' ODA pledges exceeded Viet Nam's very sizeable gross FDI receipts.[20] Actual ODA disbursements, however, have always lagged considerably behind pledges (see Table 2.1).

Figure 2.6 compares actual ODA and FDI disbursements, as a percentage of GDP, from 1993 to 1998. In 1998, at 3.8 per cent of GDP, ODA disbursements exceeded FDI inflows for the first time in the 1990s. This is a startling reversal of earlier patterns considering

[17] See Foreign Investment adviser y Service 1999.
[18] See item 1 of Webster 1999 for an entertaining review of regulatory barriers to private sector development, presented particularly in the context of small and medium sized firms.
[19] See Flatters 1997 for elaboration.
[20] The exception was 1995, which was the absolute peak of the period of FDI inflows.

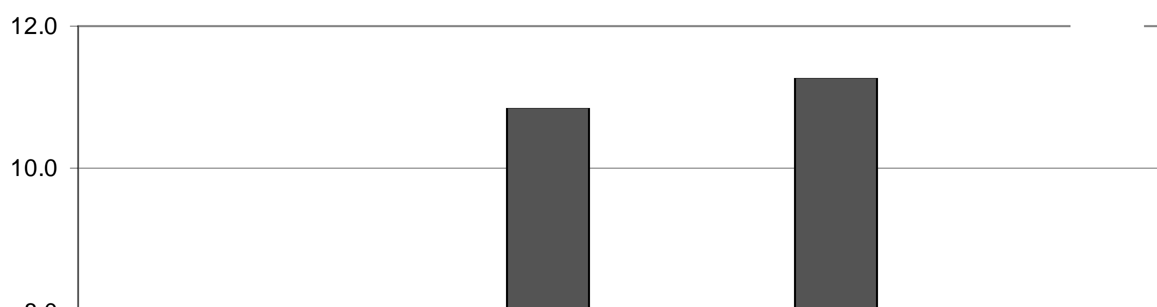
that the average level of FDI inflow over 1993-1997, 9.1 per cent of GDP, was five times higher than that of ODA (1.8 per cent of GDP) over the same period.

Table 2.1 Viet Nam: ODA flows

	Pledges (USD millions)	*Disbursements (USD millions)*
1993	1,900	270
1994	1,860	581
1995	2,000	724
1996	2,300	922
1997	2,400	944
1998	2,200-2,700	1,190
1999	2,100-2,800	1,450

Source: UNDP estimates; see also UNDP 1999.

Figure 2.6 Viet Nam: ODA and FDI inflows (percent of GDP)



Source: Calculated from IMF 1999a, statistical appendix, Table 27.

As with FDI, the acceleration of ODA in the 1990s was based on the normalization of diplomatic relations with the West and on the generally perceived promise of the ambitious economic reform programs launched under *doi moi*. ODA was seen as a means of supporting and reinforcing the "self-help" provided by these reforms.

The contributions of ODA flows are difficult to measure. Their magnitudes alone suggests that they may have been of considerable importance to Viet Nam's development. It is worth noting, however, that Viet Nam's most fundamental policy reform efforts took place long before any of this recent surge of ODA inflows. The collapse of trade

and aid links arising from the failures of the Russian economic system posed a considerable threat to the Vietnamese economy. But in the end, it served to reinforce and show the wisdom of the *doi moi* efforts.

A recent review of international aid programmes concludes that their effectiveness does not necessarily depend on the magnitude of their financial contributions (World Bank 1998, and Burnside and Dollar 1997). Technical assistance to Viet Nam in the early 1990s, involving very low cost seminars and visits to inform senior political and economic leaders about policy lessons and experiences of neighbouring countries was judged to have made a major contribution in shaping the evolution of Viet Nam's economic reform programme. Large expenditures are not necessarily required to make aid effective.

The World Bank review found no general relationship between aid flows and socio-economic development. The principal determinant of the success of ODA was found to be the domestic policy environment in the recipient country. Aid is successful in promoting long-term development in countries where governments pursue strong, market-oriented economic reform programmes, and where policy-makers are able to make and implement sound economic decisions. Aid that supports poor economic policy regimes, on the other hand, was found to be ineffective in promoting socio-economic development. These are strong, even if not very surprising, conclusions.

It is more difficult to uncover the determinants of good economic policies, and their relationship, if any, to ODA. Unlike foreign investors, whose decisions must be appraised against their profitability, donors are driven by diverse motives, and are hampered by the absence of simple success indicators. Thus, on the supply side ODA suffers from the absence of the market-based self-correcting mechanisms that operate with FDI. Similarly, without transparency and accountability in domestic policy determination, aid can be used in recipient countries to sustain unproductive rent-seeking, political and other activities, to the detriment of socio-economic development. International experience shows that aid can be used to support governments in deferring hard policy choices and thus sustain bad development policies.

There is at least a certain amount of waste in ODA spending in Viet Nam. Recent MPI-approved and ODA-funded[21] investments in sectors ranging from transportation infrastructure to cement appear to have very low, if not negative, economic returns for Viet Nam. According to Dapice (1999),

> "…the project selection process within the Vietnamese government is…a continuation of that which existed under Soviet aid. Economic returns were not a factor in planning or evaluation. Issues such as self-sufficiency or the importance of the industry were paramount, as to some extent was the political strength of the province or ministry or state enterprise supporting the project" (p.3).

[21] Agencies specifically identified with poor projects of this sort include the ADB, IFC and Japan's OECF (Dapice 1999).

These problems arise in part from the incentives of Viet Nam's inward looking and import-substitution based industrial policy regime. But they are also due to the weight of SOE and other political interests in the policy process, the lack of trust in and understanding of market-based economic outcomes, and bureaucratic weaknesses in economic policy-making.

ODA inflows now account for a significant account of Viet Nam's inflows of foreign capital, and also of her total investment, especially in the public sector. They represent a major opportunity to improve Viet Nam's development prospects and the long-term welfare of her people. Waste and improper management of such resources, regardless of their source, represents an enormous cost to Viet Nam. Management of these resources represents a challenge to the country's system of public administration and economic policy making. The move towards a market economy should increase, not decrease, the standards and expectations applied to public administration.

A minimal first step in this direction is for the government of Viet Nam to insist on proper economic appraisals of public sector investment projects, including those funded with international assistance. This will require a major upgrading of analytical capabilities in MPI and other departments and agencies.[22] Until this occurs, and until other deficiencies in the policy environment are corrected, Viet Nam should be very cautious in taking on new ODA projects.

Even concessional loans eventually need to be repaid. If projects do not have sufficient economic returns, ODA will be a long-term burden rather than a source of assistance in achieving Viet Nam's socio-economic development goals.

As with private debt and FDI, ODA is neither inherently good nor bad. The long-term benefits of ODA depend on decisions and policies that must be made in and by Viet Nam. In order to reap all the potential benefits of international financial integration, continuation and acceleration of economic reforms under *doi moi* must include public administration reform in the area of techniques and capabilities for evaluating assistance projects.

Foreign and domestic savings: Getting the balance right

The appropriate balance between foreign and domestic savings cannot and should not be determined by a planning or regulatory agency. The role of the government should be to ensure that social risks and benefits from savings from all sources are properly taken into account by market participants, and that artificial and unnecessary legal and regulatory barriers do not distort their decisions. In addition, the government must ensure security of property rights, so that savers do not fear theft or confiscation of their wealth, and the development of financial market institutions that provide the opportu-

[22] This would be an excellent and highly productive role for an international technical assistance project.

nity for savings to be channeled to where they will yield high economic returns. Finally, a stable macroeconomic environment, with low and predictable inflation and no major exchange rate surprises is another necessary form of security for savers.

The "right" balance between foreign and domestic savings is not something that can be determined by an outside observer or even by a well-informed planner or policy maker. The role of policy makers is to remove distortions that are amenable to being eliminated, to design policies that compensate for irremovable distortions, and to assist in the creation of an institutional, legal and macroeconomic environment in which savings and associated investment decisions can make the best possible contribution to long-term development. In this sense, there is no "right" balance between foreign and domestic savings. But there are better and worse policy environments for influencing this balance within a market economy.

As we have seen in earlier sections, Viet Nam has had the good fortune in recent years to benefit from high levels of capital inflow to supplement domestic savings as a source of investment. Figure 2.7 shows that, except for one year between 1992 and 1996, domestic savings have accounted for between 61 and 67 per cent of gross investment in Viet Nam. In other words, over this period, Viet Nam depended on foreign sources for 33 to 39 per cent of total investment. The peak of 39 per cent was reached in 1996. Since then, with the gradual decline in foreign sources of finance, this ratio has declined, reaching an estimated 25 per cent in 1998. Such a high dependence on foreign savings is highly unusual and is also very risky. A recent review of international experience (Rodrik 1998) concluded:

> "In practice, there have been few cases, perhaps none at all, of high investment economies where foreign saving has accounted for more than 20 per cent of investment over any long stretches of time. In an economy investing, say, 30 per cent of its GDP, relying on foreign saving beyond this limit would imply running a persistent current account deficit in excess of 6 per cent of GDP, which would be courting disaster" (p.1).

It is highly unlikely that Viet Nam will ever be able to depend on foreign savings to such a large extent as was possible in the early to mid 1990s. As indicated by Rodrik, it would also be very risky. In order to maintain the investment that will be necessary to finance development over the coming decades, Viet Nam will have to examine how to become more reliant on domestic savings.

It is not unusual, of course, for an economy to rely relatively heavily on foreign sources of finance in the early stages of development. Investment is necessary to get growth started. At low levels of income, national savings cannot be expected to be sufficient to finance the investments necessary to stimulate initial growth. Without attracting external sources of savings, or being the beneficiary of some other outside push, a country could be stuck for a long time in a low savings, low investment poverty trap.

Figure 2.7. Viet Nam: Share of investment financed from domestic savings (%)

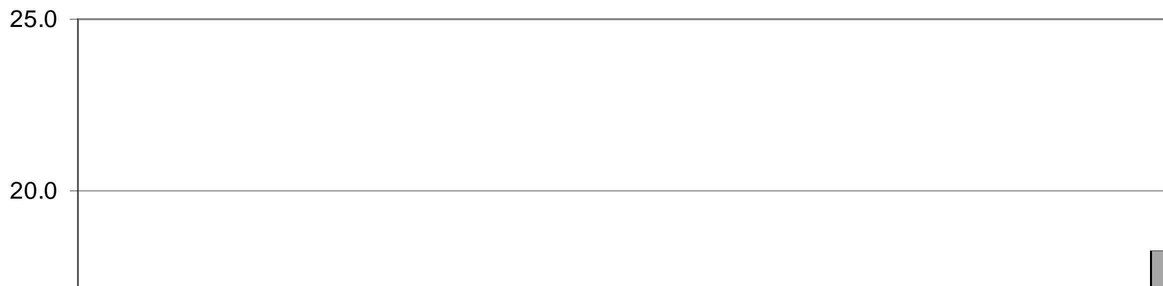
Figure 7
Vietnam: Share of Investment Financed from

Source: Calculated from data in IMF 1999a, statistical appendix, Table 1.

Figure 2.8 shows that in the early 1990s, soon after the launching of *doi moi*, Viet Nam's savings rate was very low. One of the great accomplishments of *doi moi* was its success at attracting foreign-sourced savings. The other great early accomplishment of the initial economic reforms was their success at gradually raising domestic savings. As can be seen in Figure 2.8, the domestic savings rate rose steadily from less than 3 per cent of GDP in 1991 to over 18 per cent in 1995. This reflected greater security of property rights, increased opportunity for productive investment in small business outside of the state sector, and rising incomes.

Figure 2.8. Viet Nam: Domestic savings rate (percent of GDP)

Figure 8
Vietnam: Domestic Savings
(percent of GDP)



Source: Calculated from data in IMF 1999a, statistical appendix, Table 1.

The data show promising indications that Viet Nam has begun the transition from a low-income, low-savings economy to a high savings, high growth economy. Can this transition be sustained? Figure 2.8 shows that, although there was a rapid increase in the savings rate in the first half of the 1990s, it remained more or less constant at about 17 per cent from 1993 to 1996. In the two most recent years for which data are available, it has begun to increase again, reaching 21.4 per cent in 1998.

Viet Nam's savings rate is still low compared with other countries in the region. China's domestic savings rate has been in the neighbourhood of 40 per cent. Indonesia's, Malaysia's, Singapore's and Thailand's have been well over 30 per cent, and have often exceeded 40 per cent through the 1990s. If Viet Nam wishes to emulate the investment performance of these economies, especially in light of the inevitable reduction in foreign-sourced saving that is now under way, it will be necessary to continue to increase domestic savings rates.

International experience indicates that the relationship among domestic savings, investment and growth is relatively complex (Rodrik 1998). There is certainly not a simple one way chain of causation from higher savings, through higher investment to higher growth. Countries that have experienced transitions to significantly higher savings rates typically experience increases in growth, at least for a period of time. But this higher growth is not always sustained over longer periods of time; more often than not it is not. On the other hand, transitions to significantly higher growth are typically followed by similar transitions in savings, and the higher savings rates are typically more permanent.

The implication of international experience to date seems to be that focusing on increased savings alone is not sufficient to ensure sustained high growth. Of much greater importance is the overall policy environment for economic growth and for productive investment. The emphasis needs to be at least as much on the stimulation of entrepreneurial spirits and the creation of an environment for the accumulation and productive employment of human and physical resources. The mechanisms and institutional framework for the market are critical in this regard. (See also Riedel 2000, in which the role of the market is the central theme.) As will be seen further below, financial markets are especially critical in this regard.

To this date, only a small portion of Viet Nam's savings has been mobilized through the formal financial system. Table 2.2 shows that, while the share of savings held in the form of bank deposits almost doubled after 1993, banks still accounted for less than 14 per cent of total savings in 1997. The share held in other financial instruments (PCF and bonds) remained at the very low level of 0.6 per cent. Thus the proportion of household savings held in the formal financial sector in 1997 was only 14.5 per cent, a substantial increase over the level of 8.3 per cent in 1993, but still extremely low. The proportion of savings held in cash (VND and USD) rose over the same period from 13.8 to 19.2 per cent.

The inability of the formal financial system to attract savings has two major implications. First, it represents a serious barrier to the mobilization of savings as the economy

matures into a more complex system. A modern economy requires a variety of financial instruments to attract savers. Absence of these instruments reduces the avenues and the financial returns available to savers. Second, an underdeveloped banking and financial system limits the possibilities for channeling the country's savings into their most productive economic uses. The lack of such financial intermediation reduces returns available to savers.

Systemic issues related to development of the financial system, and especially its role in intermediating savings between lenders and borrowers, are dealt with in the following section. Here we draw attention only to the inability of the banking system to attract a larger portion of the country's savings.

For a variety of historic and systemic reasons, related to the banking system itself, and to enforcement of taxes and other policies, there is a heritage of distrust in the banking system. The implementation of the new deposit insurance scheme, while possibly aggravating other financial sector risks, will hopefully assist in removing some of the historical stigma attached to bank savings. But this must be part of an accelerated reform of the financial system that places banks and other financial institutions in a sound legal framework where success depends primarily on commercial achievements, unimpeded by political and bureaucratic considerations.

Fears of arbitrary tax implications of formal sector savings, and of other forms of unofficial harassment arising from signs of visible wealth are another historical impediment to household savings, especially in the formal financial sector. To the extent that this remains a problem, it can be overcome at least in part through changes in tax structure and tax administration, at all levels of government. High marginal income tax rates will have to be decreased. A multitude of other tax and regulatory incentives to accumulate illegal incomes will have to be removed. Tax assessments will have to be made on an objective and systematic basis. This, together with rate structure and other regulatory reforms, will encourage more forthcoming and honest self-assessments of tax liabilities.

Table 2.2 Viet Nam: Household savings allocations

	1993	***1997***
Deposits at State Banks	7.4	11.9
Deposits at Other Banks	0.3	2.0
Total Bank Deposits	7.7	13.9
Savings Book at PCF	0.2	0.2
Bonds	0.4	0.4
Share, ROSCAR Contribution	4.0	2.1
Cash	10.1	17.3
US Dollars	3.7	1.9
Gold	44.0	18.7
House	20.1	32.5
Durable Goods	2.1	1.4
Paddy and Grains	3.0	0.1
Other	4.7	11.5
Total	**100.0**	**100.0**

Source: UNDP calculations from VLSS.

The domestic financial system and international financial integration

Financial markets and financial institutions are qualitatively different from most other markets, and are central to the economic development process. They serve a key role in mitigating the costs of information. In particular, they provide the framework through which widely dispersed information necessary for the allocation of investment resources is collected, scrutinized, verified, evaluated and disseminated. It is this central role of information that makes financial markets so important.

Within this framework, an economy's financial system performs a number of important functions, including facilitating the diversification and pooling of risk, allocating capital, monitoring managers and exerting corporate control, mobilizing savings, and reducing the costs of trade in goods, services and financial contracts.[23]

How can savers verify borrowers' claims about the likely profitability of their projects without large investments in information? How can they be satisfied that subsequent management of the projects will ensure that the returns are realized, and that an appropriate share returns to them when this happens? This is the function of the financial system. Financial contracts, banks and other financial intermediaries, and stock and other securities markets all play a role in performing these critical informational and monitoring functions. The greater the depth and strength of these markets, the greater will be their contribution to economic development.

In order for financial markets to perform these functions, banks and other financial intermediaries must be free of political pressures to lend to favored enterprises. There must be well developed and reliable financial and accounting standards so that information available in financial markets can be trusted. There must be an institutional and legal infrastructure to ensure that contracts are enforced, that shareholders' and lenders' rights are respected, and that problems arising from temporary illiquidity and/or long-term insolvency are efficiently resolved. Investors must be free to respond to changing profit opportunities without excessive political or bureaucratic interference.

There are broad and very important institutional and policy development issues involved in domestic and international financial integration, and in developing an efficiently functioning market economy.

The evolution of financial systems is a complex process and involves the development of skills, institutions, and appropriate legal and regulatory frameworks. There are different models of such systems, reflecting varieties of historical experience, comparative

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[23] Levine 1997. See also Stiglitz 1999 for a wide-ranging discussion of these functions of the financial system in the specific context of the experience of transition economies.

advantage and many other factors.[24] Nevertheless, there are a number of basic requirements that must be satisfied in any modern financial system. Among these requirements are:

- widely accepted and utilized accounting standards which are transparent, reliable and accurate,
- codes and practices of corporate governance which ensure that managers and majority owners and shareholders operate in the interests of minority shareholders and creditors,
- legal guarantees for the enforcement of financial contracts, including effective laws regarding foreclosure, bankruptcy and other forms of corporate reorganization to resolve issues arising from financial stress, and
- prudential rules for regulating risk-management practices of banks and other financial institutions.

Underlying all of this must be an investment environment in which the financial consequences of investment decisions are based primarily on market outcomes rather than arbitrary bureaucratic or political decisions.

Financial markets and institutions not only fulfill a critical role in the mobilization and allocation of savings and investment; they are often central to the transmission, and often even the initiation, of macroeconomic disturbances. Downturns of demand or sharp interest rate increases can impair bank balance sheets, leading to a sequence of events that aggravates the initial disturbance and precipitates a cyclical economic downturn. Fiscal and monetary reactions intended to forestall this chain of events can cause inflationary spirals and at the same time aggravate underlying financial system weaknesses.

Empirical evidence on the importance of financial sector development for economic growth is strong (Levine 1997). Historical cross-country studies reveal that, even after controlling for other principal determinants of growth, there is a close statistical relationship between long-term growth and depth and development of the financial sector. Case studies of particular countries, over various periods of time, reach the same conclusion. Our earlier discussion showed how structural weaknesses in the financial and banking system are threatening China's prospects for continued rapid growth.

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[24] The most common distinction is between "bank-based" systems (also known as the German or Japanese model), and "securities market-based systems" (or the Anglo-Saxon, or British, or American model). The former is based on stronger and longer-term relationships between banks and their large industrial borrowers, while the latter is more diversified, with banks generally having shorter-term relationships with borrowers, and with greater reliance on stock and securities markets for longer-term investment finance. The bank-based system allows bankers to invest more heavily in relevant investment information on borrowers, thus, in principle, permitting more informed and longer lending decisions. On the other hand, the much more credible threat of takeovers under the Anglo-Saxon system, together with the likelihood of conflict of interest that arises under the German system, tends to make the Anglo-Saxon system more effective at enforcing corporate governance practices, and more flexible in financing risky startup companies. No general conclusion has emerged on the relative merits of the two systems as models for developing countries. In fact, a clear choice between these two models is seldom necessary.

Financial sector development is critical in determining the prospects for and risks of a country's international financial integration. As seen above, weak banking systems played a key role in precipitating the Asian financial crisis. They also have aggravated its effects and delayed economic recovery. In the absence of a strong financial system, FDI and ODA will also be misallocated and thus make only weak, and maybe even negative, contributions to development. Poor financial systems also decrease a country's attractiveness to foreign investment.

Viet Nam's banking system has already undergone several major transformations since the beginning of *doi moi.* The reform process has not always been smooth, and the authorities have been faced with a number of financial sector crises over the past decade. This experience, plus recent difficulties with financial sector liberalization in neighboring countries, make decision makers justifiably cautious in approaching this important issue.

Nevertheless, continuing weaknesses in Viet Nam's financial system now stand as one of the most important barriers, not only to successful international financial integration, but also to achieving the central goals of the *doi moi* reform process. Completion of the process of financial sector reform is among the most important items on the policy agenda over the coming decade.
The general nature of the problem is now quite well understood (IMF 1999a, item III). Viet Nam's financial sector is still very underdeveloped. Banks are the principal financial institution, and bank deposits and loans are the main financial instruments in use in the formal financial sector. The formal financial sector's overall role in the economy is still relatively small.

The banking sector is still dominated by four state-owned commercial banks (SOCBs). These were the main commercial financial institutions created when the earlier monobank system was transformed by splitting the monetary policy and regulatory functions of the central bank (the State Bank of Viet Nam or SBV), and the commercial banks. As of the end of 1998 there were, in addition, 51 joint stock banks (JSBs) whose shareholders include SOEs and private entities, 23 foreign bank branches and 4 joint venture banks. The four SOCBs account for 82 per cent of total bank assets, the JSBs 10 per cent, and the other banks the remaining 8 per cent.

Among the most immediate symptoms of the vulnerability of the banking system are the following risk factors:

- high levels and a rapid rate of increase in the incidence of non-performing (or "overdue") loans, even according to Viet Nam's weak criteria for defining these problem loans,
- lack of prudential practices to make financial provision for such bad debts,

- surprisingly large amounts of uncovered foreign exposure by banks and their borrowers,[25]
- low profitability and weak capitalization of banks, especially those in the state sector, even after recapitalization provided by the State Bank of Viet Nam in 1998.

Very few other financial instruments, institutions or markets exist yet in Viet Nam. The private sector is especially poorly served by the banking system. A stock market is due to be opened this year, but has been delayed several times already.

Underlying the lack of depth of the financial sector and the weaknesses of the country's banks is an environment in which SOEs still are the dominant players, and lending decisions are still subject to strong influence from official sources. Large numbers of SOEs, which are still the main clients of the banking system, and especially the SOCBs, continue to perform poorly and suffer from weak financial discipline. And yet, at the urging of the authorities, they continue to be supported by banks with new credit lines and easy rollovers of bad loans.

This policy of supporting weak SOEs and patching over the problems of SOCBs has been felt necessary in order to avoid economic instabilities arising from restructuring of SOEs, displacement of workers and bank failures. While this might preserve stability in the short run, it creates a potential fiscal and financial time bomb that, without extremely careful management and even greater structural reforms in the future, will eventually explode, causing much greater costs and instability. It also induces correspondingly loose monetary and fiscal policies which threaten overall macroeconomic stability. The potential fiscal burden that has accumulated from the ongoing operation of weak banks and SOEs is already very large, and it continues to grow. This is a threat to future macroeconomic stability and to the ability of the state to meet critical infrastructure and social requirements of future socio-economic development plans.

While hard evidence is weak (and this lack of basic accounting information is a basic structural problem of the system), there is general agreement that bank balance sheets have been deteriorating steadily in recent years. JSBs might be at greatest risk. The banking and financial system is in a fragile state. Firm action is required both to solve immediate problems and to send clear signals about institutional and legal reform. It is necessary to implement reforms and adjustments that will avoid long-term problems of moral hazard, in which lenders and borrowers grow to expect bail outs by a government intent on avoiding short-term instabilities at almost any cost.

[25] About 30 per cent of bank credit is in foreign currencies, a major share of which is to SOEs. The greatest degree of uncovered exposure to foreign exchange risk is in the JSBs. The defaults on deferred letters of credit (L/Cs) by a number of JSBs in 1998, and the failure of the Supreme Court to enforce payment of the overdue obligations was one of the most alarming recent symptoms of foreign exchange problems facing the banking system.

Underlying the symptoms of financial sector weakness lie serious governance problems in banks, among borrowers (especially SOEs) and in supervisory bodies.[26] This reflects inadequate legal, accounting and regulatory regimes, absence of competition, and lack of incentives to improve performance. It is reinforced by lack of skills and experience in financial management and supervision, which is not surprising in light of historical circumstances and the ongoing structure and regulation of the financial system.

The institutional development and economic reform required to develop a sound, market-oriented financial system, which is not held captive by the state sector and which is able to meet the growing needs of the private sector is a key challenge for Viet Nam's socio-economic development strategy. This reform and institution-building process is complex and cannot be accomplished overnight. It is similar and highly complementary to ongoing efforts at private sector development and SOE reform. It lies at the heart of *doi moi* and, as such, it requires a strong commitment at the highest policy levels, it is the key to Viet Nam's socio-economic development, and it will be resisted by many vested interests.

The government, with the assistance of the World Bank and the IMF, has already begun the process of financial market reform and development.[27] This must remain at the forefront of the country's socio-economic development plan. Measures undertaken since 1998 include:

- the commencement of a restructuring programme for joint-stock banks,
- the launching of comprehensive audits and the design of a restructuring programme for state-owned commercial banks,
- development of plans for the creation of separate "policy banks" to relieve commercial banks from obligations to meet political objectives, and at the same time to introduce more comprehensive economic evaluation of "policy lending",
- the launching of a comprehensive programme to improve banks' business practices and to develop an improved legal, regulatory and supervisory framework, including prudential regulations, for the banking sector, and
- the development of a legal framework to broaden the set of financial instruments and markets (including stock markets) available in Viet Nam.

This is an ambitious but essential reform programme. Financial sector liberalization in neighbouring countries illustrates the risks of incomplete and inappropriate reforms. But the costs of delaying reform, and of retaining a weak and underdeveloped financial sector, are certain: slow growth, stunted economic development, and inability to benefit from international financial integration.

An important tool in ensuring the success of the reform process will be to keep it as open and transparent as possible. This will parallel one of the important goals of the

[26] For further elaboration see IMF 1999a, ch. III.
[27] See IMF 1999a, ch. III, and World Bank 1999b, ch. 3 for the most recent reviews of the problems and of plans and progress on reform of the financial sector.

reforms, which will be to ensure greater accountability and transparency in the financial system.

This report on international financial integration is not the appropriate place to provide a blueprint for domestic financial sector reform. Furthermore, such blueprints are already available from other sources, most notably in connection with the donor-assisted ongoing financial sector reform programme. Nevertheless, there are a number of observations that should be made in the specific context of Viet Nam's international financial integration.

- Uncovered foreign currency exposure is apparently a major risk factor for many banks and their borrowers. This is in part a legacy of the unintended effects of direct controls and tight regulations on credit allocation and interest rates. It also arises from poor risk management practices of banks and their borrowers, as well weaknesses in prudential regulations and in their enforcement. Liberalization of credit controls and interest rates, together with sensible and prudent exchange rate management should help to overcome many of these problems. At the same time, however, there needs to be a major improvement in prudential rules regarding foreign currency exposure, acceptable means of covering such risks. All such rules need to be strictly enforced. This will require significant improvements in accounting and financial reporting standards.
- Over the 1990s Viet Nam has been engaged in the process of building a market-oriented financial system almost from scratch. This is an enormously difficult task. Laws and regulations could, in principle, be borrowed from elsewhere. But many choices of system types would still have to be made. More importantly, they would have to be adapted to the specific conditions and historical legacies of Viet Nam. Of even more fundamental concern is the human capital, skills and experience necessary to operate and regulate a modern financial system. The development of a whole set of new market institutions places heavy demands on what is necessarily, for historical reasons, a very narrow and limited base of skills and experience in Viet Nam. With the opening up of the economy to foreign trade, investment and other forms of information and technology transfer under *doi moi* Viet Nam has the opportunity to tap into and take advantage of foreign skills and experience. This can be used not only for immediate purposes of implementing new financial systems, but also by training new generations of Vietnamese specialists in this area. This is already being done under a variety of technical assistance schemes, and should be encouraged. Of even greater value, however, would be to find ways to engage foreign bankers and other experts directly in the Vietnamese financial system. As has been demonstrated in many manufacturing sectors already, among the most effective means of technology transfer is through partnerships with foreign companies. This kind of partnership would be equally effective in the financial sector. Among the principal means of doing this would be either to allow foreign banks in Viet Nam to broaden their range of activities in Viet Nam, or to encourage strategic partnerships between domestic and foreign banks. This might even be required as part of the restructuring

and recapitalization of SOCBs.[28] This would serve not only to transfer vital technologies and knowledge to Viet Nam, but also to increase beneficial competition and raise the level and quality of financial services available to the economy.

- Although it has been delayed several times already and the date is still uncertain, Viet Nam is committed to opening a stock market in the near future. This will be an important part of a long run strategy for improving and broadening capital markets in Viet Nam. It will relieve some of the burden on and otherwise complement the activities of banks in assessing and providing funding for long-term investment needs of the private sector. It will also assist in the process of privatizing SOEs. A number of important questions regarding the role of foreign participants in the stock market remain to be resolved. Among the most important is the extent of foreign ownership of shares that will be permitted. Despite earlier commitments and laws that specified 30 per cent as the upper bound on foreign ownership of listed shares or funds, a recent announcement has indicated a change of policy to lower this limit to 20 per cent.[29] This apparent indecisiveness and inconsistency of stock exchange policies is perceived by foreign investors as another indication of the government's inability to make credible commitments in this important area. It increases perceived political risks of investing in Viet Nam and hence raises the cost of funds and of doing business in the country. The more fundamental issue for Viet Nam , however, is what is the role and appropriate level of foreign involvement in Viet Nam's capital markets. Foreign participation in stock market should be viewed not only as source of funds, but more importantly as a source of pressure and capabilities for improved governance practices that are necessary for the smooth and productive operation of capital markets. Foreign participants cannot generally rely on political and bureaucratic connections to ensure the security of their investments in Viet Nam. Therefore, they must rely on disclosure of reliable financial information and on a framework of laws on accounting practices, auditing requirements, contracts and property rights. Foreign participation, not only as buyers and sellers of shares, but also as brokers, auditors, accountants and financial advisers has the potential to make significant contributions to capital market development in Viet Nam , with benefits that will accrue to all investors and to the long-term development prospects of the country.

In a recent review of Viet Nam's four main state-owned commercial banks, Standard and Poor's Ratings Group (S&P) gave very cautious support to the goals of the current banking reforms.[30] SBV loans to assist in the recapitalization of these banks, planned

[28] As long as these four large banks remain under state ownership and control, there will continue to be fundamental conflicts of interest among the needs of SOEs (the major clients of the SOCBs), the requirements of prudential regulation of the financial system, and budgetary and other bureaucratic needs of the government. The possible formation of separate policy banks is an attempt to overcome some of these conflicts; but it will be, at best, a partial solution. A far more complete long run solution would be to privatize the SOCBs. Whether or not they are privatized, however, some form of partnerships with foreign financial institutions would be of great value.

[29] See "Share Cap Rule Irks Foreign Investors" Viet Nam *Investment Review* January 24-30 2000.

[30] "Viet Nam Banks Get Poor Grade in S&P Rating" *Asian Wall Street Journal*, January 25, 2000; "Viet Nam Banks at Highest End of Risk Ranking" AFP report in *Bangkok Post*, January 25, 2000.

establishment of a new policy bank, a deposit insurance system, and an Asset Management Company to consolidate non-performing loans and remove them from the banks' balance sheets, all received qualified approval.

However, S&P also cautioned that "poor disclosure makes it difficult to evaluate the impact of progress" in implementation of reforms. High levels of non-performing loans, poor disclosure, underdeveloped risk management systems, and more general weaknesses in the legal and regulatory framework were particular sources of concern. Due to the poor information made available for its review, S&P was able to reach its conclusions only on the basis of (weak) publicly available information. The overall rating of CCC(pi) reflected its view of continued vulnerability of banks to problems in meeting their financial commitments. In light of all of its concerns, the report concludes that: "the Vietnamese banking system is likely to remain at the highest end of the global industry risk spectrum."

A more recent report by Moody's Investors Services[31] echoed this pessimistic appraisal of the financial sector and of its key role in the (lack of) economic reforms. According to their press release, "The outlook for the Socialist Republic of Viet Nam's B1 rating is negative as a result of Viet Nam's lack of progress in advancing structural reforms aimed at reinvigorating the financial sector, state enterprises and the Republic's external trade regime." It pointed in particular to weaknesses in implementation of ongoing banking sector and SOE reform policies.

Viet Nam's financial system reforms face many challenges over the coming decade. Successfully meeting these challenges will be a key element in the success of Viet Nam's international financial integration and, more importantly, in achieving her long-term socio-economic development goals.

International financial integration and macroeconomic policies

The Asian financial crisis illustrates, among many other things, some of the close links between international financial integration, the exchange rate and domestic monetary and fiscal policies.[32] A fundamental relationship, sometimes referred to as the impossible trinity, is that a country cannot simultaneously enjoy the benefits of international financial integration, the choice of its exchange rate, and control of its own monetary policies. The failure to understand this impossibility was one of the main causes of the financial crisis that struck Thailand in 1997.[33] Having opened up its short-term capital markets in the early 1990s, Thailand monetary authority did not recognize the futility of its efforts to defend an overvalued exchange rate in 1996-1997. Regardless of whether the defense of the baht could have been justified on other grounds (which was also doubtful), the fact is that it was very costly and, in the end, impossible.

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[31] Moody's Investors Services 2000.
[32] The economics of these links were expounded some time ago by Robert Mundell, and it was his elucidation of their fundamental policy implications in the 1960s that was the principal reason his being awarded the Nobel Prize in economics last year.
[33] See Flatters 1998 and Flatters 1999.

As Viet Nam increases its international financial integration, it will have to pay closer attention to the links between its macroeconomic policies and the exchange rate. There is room for serious and healthy discussion about the appropriate degree and type of regulation of short-term speculative capital flows to curb unnecessary macroeconomic instability. However, few policy makers and even fewer economists would argue for financial isolation in order provide greater freedom over monetary and exchange rate policies. International financial integration thus adds a new and important dimension to the conduct of macroeconomic policies.

Regardless of the degree of international financial integration, of course, macroeconomic policy is a key element in the pace and stability of socio-economic development. Prudent macroeconomic policies, especially with respect to inflation, real interest rates and the exchange rate were central to the success of the East and Southeast Asian economies prior to the economic crisis, and in their recovery since then. Stabilization of fiscal deficits and of inflation have also been central to the success of *doi moi* in Viet Nam.

The real exchange rate, which depends on both the country's exchange rate relative its trading partners, and its relative rate of inflation, is a key macroeconomic variable in signaling the competitiveness of a country's industries and facilitating trade according to comparative advantage. Monetary and exchange rate policies that permit the real exchange rate to get very far out of line can have severe consequences for a country's patterns of trade, investment and development.

The extensive use of capital controls robs the exchange rate of its value in transmitting information about relative costs and in preserving macroeconomic balance. The setting of unrealistic exchange rates invites further capital controls to ration shortages of foreign exchange. Foreign exchange rationing distorts investment and production decisions, encourages rent seeking and perpetuates political and bureaucratic allocation mechanisms. These problems are familiar from recent Vietnamese experience.

The exchange rate is too important a macroeconomic tool to be used on an *ad hoc* basis for other purposes.

While Viet Nam has been quite successful in controlling inflation, there are likely to be growing fiscal and monetary pressures arising from debt-financed, low productivity public investments and from the growing financial burdens of the banking sector. As mentioned in earlier sections, these are potential fiscal time bombs that could cause serious disruption to the government's recent reputation for fiscal prudence. The social and economic instabilities arising from such disturbances should not be underestimated.

3. Recommendations for A Strategy

Review and synthesis of principal strategic issues

Viet Nam's dual transformations – from a centrally planned to a market-based socialist economy, and towards greater integration with the global economy – are central to its long-term strategy to achieve *sustainable development with equity.* This is seen as the best means of developing and capitalizing on Viet Nam's many internal strengths.

The Government is also strongly committed to the goal of *stability*. Recent regional and international experience has shown that international financial integration can be risky. This is especially true in the absence of well developed domestic market institutions for the mobilization and allocation of investment resources.

The key to maximizing the opportunities and minimizing risks and instabilities arising from international integration is the development of domestic market institutions and especially a sound, transparent and market-oriented regulatory and legal framework. International financial integration – whether in the form of direct investment, lending and borrowing, or official development assistance – can be dangerous and costly without such well developed domestic market institutions. The risks are greatest with respect to short-term international capital flows.

While all domestic markets are important in shaping the contributions of international financial integration, the financial sector and its relation to capital markets is most critical. The state of the domestic financial sector is also crucial in determining how well Viet Nam will be able to mobilize *domestic* resources to finance her long-term development.

Viet Nam's financial sector and related institutions are still relatively underdeveloped. Preferential treatment of state-owned enterprises (SOEs) is an especially important barrier. A strong, market-oriented financial sector requires a legal infrastructure that clearly defines property rights, provides the basis for entering and enforcing contracts, and establishes procedures and regulations concerning bankruptcy and foreclosure. There must be well-established and transparent standards of accounting and corporate governance.

The problems of Viet Nam's financial sector are becoming increasingly well recognized, and many reforms have been or are in the process of being implemented. However, progress has been slow and uneven. Recent experience in Viet Nam and in other regional economies has exposed the risks of shallow and incomplete financial sector reform. *A major challenge in a new socio-economic development strategy will be to speed up the pace and, more importantly, increase the depth of reform of the financial sector.* This will be important both in its own right, and in its implications for international financial integration.

The pace of financial market reform will have an inevitable impact on the pace of Viet Nam's development financing. The slower the pace of reform, the smaller will be the opportunities and the larger the dangers of mobilizing external and internal resources to finance development.

Finance, international and domestic, is not just about mobilizing funds. At its heart is the gathering and processing of economic information, which is central to the task of allocating resources for development. Viet Nam's strategy for financial development and integration, therefore, will be critical in determining the success of *doi moi*, Viet Nam's unique and so far very successful programme for transforming its economy into a socialist market economy.

A number of strategic issues related to international financial integration have been reviewed. A few recurring and cross cutting themes have been identified as central to Viet Nam's socio-economic development strategy for the next decade.

Most of these themes relate to fundamental weaknesses in institutional mechanisms and capabilities for mobilizing and allocating investment resources.

- The foreign exchange regime is riddled with unnecessary and counter-productive capital controls and rationing mechanisms, especially on current account transactions, which distort trade and investment decisions. These controls are non-transparent, and they change frequently, in an *ad hoc* and unpredictable fashion. They are a serious hindrance to foreign investment in particular and are a threat to prudent macroeconomic management.
- Savings rates are low, making Viet Nam more dependent than necessary on foreign borrowing. Viet Nam will certainly not be able to continue to rely on foreign sources of savings to nearly the same extent as in recent years. Only a small portion of savings flows through the formal financial system, reducing the opportunities for mutually beneficial and economically productive intermediation between savers and investors. Gaps, weaknesses and lack of trust in the banking system, together with a punitive tax regime and weak tax administration are all to blame.
- Lack of availability and unreliability of basic economic data make it difficult to determine the current level or the likely future burdens of Viet Nam's foreign debts. Banks are heavily exposed to foreign liabilities, but details are not publicly available. Due to fundamental weaknesses in the financial system and the investment regime, foreign and domestic loans are often used to finance projects of low and even negative value, further increasing the risk of future domestic and international debt crises.
- Changes in the global investment environment, and disappointment of foreign investors with the pace and effectiveness of Viet Nam's economic reforms will make it increasingly difficult for Viet Nam to attract foreign direct investment. Trade and industrial policy biases in favor of import substitution and SOEs ensure that much of the FDI that does enter Viet Nam is of low economic value to the country.

- ODA has recently overtaken FDI as a source of foreign exchange inflow. Poor incentives created by the investment regime, together with rent seeking and inability or unwillingness to conduct economic analysis of projects reduces the value of ODA inflows. ODA will be effective only if it helps promote the economic reform agenda.
- The banking system is weak and vulnerable to future domestic crises. It is of very little value to the private sector. The rest of the financial system is much less developed than the banks.

Solutions to these problems are critical to Viet Nam's development over the next decade and beyond.

The financial system and international integration: Strategic visions

Successful international financial integration requires, above all, a sound domestic financial system and investment environment. The development of such a financial system and of a transparent, market based investment environment must be at the heart of a reinvigoration and acceleration of *doi moi* over the next decade.

The pace of reform, of course, are sovereign, political decisions, to be made by the people of Viet Nam. It is not the role of this report to speculate on the likely outcomes or to comment on the processes underlying these decisions. But the direction and pace of reform is also a matter of vision. On the basis of the discussion in this report, two alternative visions can be offered.

Vision 1: Speedy and comprehensive resumption of reform

A speedy and comprehensive resumption of the reform process that began in the mid-1980s is Viet Nam's best hope for setting itself on a high and sustainable long-term growth path. It will ensure that public and private investment decisions, whether domestically or internationally financed, are made in the face of incentives that reflect Viet Nam's economic circumstances and interests. It will minimize the risk of short-term or longer-term instabilities. It will offer the best hope for poverty reduction and equitable treatment of vulnerable groups.[34]

Under this vision, Viet Nam would quickly remove many immediate obstacles to development, such as foreign exchange controls on current account transactions for trade in goods and services, and unnecessary limitations on the activities of foreign banks. At the same time, longer-term reforms in the legal and regulatory environment for SOEs, private sector development and the financial system would be pursued as quickly and systematically as possible. This would include vigorous evaluation and improvement in implementation of reform measures already underway.

This strategy will not necessarily mean an immediate resumption of high growth. In fact, Viet Nam should be prepared to adjust to a slightly lower pace of investment and

[34] See World Bank 1999c, especially item 3.

development until the regulatory, institutional and legal framework of its market system is improved. This will help avert potential financial and economic crises in the transition period. However, a clear signal of Viet Nam's renewed commitment to its process of economic reform will be well received in international markets, with subsequent increases in investment in and trade with Viet Nam.

Comprehensive reform is not "shock therapy". As has been learned in many other countries, economic reform involves systemic issues that can only be handled over a period of time. Comprehensive reform processes recognize these constraints. Viet Nam's systemic constraints require more comprehensive reform than in many other places, and so demand even greater commitment to the process of reform.

Economic and systemic reform in these circumstances is also a learning process. While general timetables can be set, and should be adhered to as closely as possible, the completion and fine-tuning of detailed blueprints will be an ongoing process.

Vision 2: Continuation of opportunistic reform

After the initial measures of the late 1980s and early 1990s, Viet Nam's reforms have become much more sporadic. This pattern is familiar from reform experiences in other countries. Political will diminishes as the "easy" reforms are completed and vested interests dig in to preserve privileges created through subsidies and market restrictions. Viet Nam's reforms are becoming more the opportunistic outcome of high level political processes than of a consistent strategy. The process has lost direction.

This might be inevitable; it might be politically necessary or even desirable. But it will not yield a consistent reform programme. It will create uncertainties for potential investors – domestic and foreign. This is not conducive to long-term development.

Sporadic and opportunistic reform will not necessarily mean lower growth in the short run. The government could stimulate growth by requiring banks to fund new SOE investments and public projects – cement and fertilizer plants, oil refineries, uneconomic bridges and highways, etc. This would bring short-term growth, but at the risk of financial crises and the certainty of larger government debts in the not-so-distant future.

In a sporadic and inconsistent reform environment, short-term concerns often override longer-term economic interests, and lead to policies which impede and even reverse the reform process. Capital controls provide an instructive example. Rather than adjusting monetary and exchange rate policies, the government expands and contracts the scope of capital controls in response to short-term foreign exchange concerns. This is not only bad macroeconomics; it also conflicts directly with the agenda of trade and industrial policy reform.

The more likely outcome of opportunistic reform will be a gradual weakening of Viet Nam's international financial integration and a steady deterioration of growth. In the post-crisis world, foreign investors are wary of countries with poor and/or inhospitable

economic policies. Investment funds are much scarcer than before. Viet Nam is competing for direct and portfolio investment against countries that have made major reforms. Direct investors have already signaled their impatience with the poor investment environment and the lack of reforms. Portfolio investors will be extremely cautious about investing in a country with poor accounting and corporate governance practices, lack of financial disclosure and absence of basic financial laws. Donors will also become impatient with lack of commitment to reform.

Opportunistic reform might satisfy some political concerns, and protect important vested interests. But it will result, at best, in steady but low growth. It will be accompanied by a higher risk of short and long-term instability. And it will deprive the country's poorest and most vulnerable groups of the capability to exercise the basic economic choices expected from the development of Viet Nam's socialist market economy under *doi moi*.

Recommendations

Of the two alternative visions suggested, a renewed commitment to *doi moi* is the preferred option. This will require fundamental restructuring of both the investment and financial environments. This involves legal, regulatory and institutional development that cannot be accomplished overnight, and that will require strong and committed leadership at the highest levels. The fundamental reforms that are needed here can be summarized under three main headings.

- Remove as quickly as possible the barriers to the development of the private sector (see also Riedel 2000).
- Accelerate the restructuring of the SOE sector. In particular, eliminate special treatment provided under licensing laws, and preferred access to foreign exchange, credit from the banking system and all other business activities. Create alternative social safety nets to perform the social functions of SOEs and ameliorate any short-term social costs arising from the adjustment to the new regime.
- Accelerate the fundamental reforms in the banking sector, in the development of a legal and regulatory framework, and in the creation of new financial instruments, institutions and markets.

These are the basic reforms required for successful international financial integration. A great deal of the groundwork for these programmes has been prepared already. It is now a question of the government's commitment to move ahead.

At the same time as these reforms are proceeding, a number of more immediate measures can and should be undertaken. The following is an illustrative list of recommendations.

- Remove capital controls and foreign exchange restrictions related to import and export of goods and services. At the same time, study the examples of Chile and

other countries to determine a set of measures for discouraging short-term capital inflows, especially while the financial system remains weak.[35]

- Place increased reliance on overall monetary policy and the exchange rate, rather than selective trade and foreign exchange controls to adjust to imbalances in the overall demand for and availability of foreign exchange.
- Cease the practice of attracting or increasing the profitability of new investment through increased import protection, whether through special import duties, import licensing privileges or any other measures.
- Establish a clear and publicly stated government policy not to guarantee commercial debts, especially those in foreign currencies.
- Improve the government's capabilities to conduct economic analysis of publicly- and ODA-funded investment and infrastructure projects, and impose a requirement that new public investments be subject to such appraisals.
- Increase and consolidate the basis for foreign participation in the banking sector and the emerging stock market and related institutions.

[35] See Ariyoshi *et al* 2000 for a useful review of recent lessons from Chile and other countries.

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