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VIETNAM STRUCTURAL REFORMS:

Sustainable growth means some painful changes

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This note is an attempt to analyze the essential role that structural reforms have played in the recent development of the Vietnamese economy, highlight the reasons for the current economic slowdown, and argue for the need to accelerate an intensive reform program to enable sustainable growth in Vietnam.

Vietnam has traveled on a long and arduous road of development, from an extremely difficult period (1986-89) through a first wave of comprehensive structural reforms with solid achievements (1990-95). Since then, the momentum for reforms and growth has slowed down (Box 1). The positive impacts of the first reform wave have reached the end and outlived their usefulness. These reforms could no longer address a set of newly emerging challenges facing Vietnam on its way toward a fully functioning market economy. Many constraints and bottlenecks in the current structure have been revealed and most of them have not been tackled adequately, timely, and forcefully. The East Asia financial turmoil helped bring these into the open and under closer scrutiny. *These structural disadvantages and constraints reflect the inefficient resource allocation with a bias toward investments in import-substituting industries, and the reliance of the economy on highly protected and inefficient state enterprises -- often monopolies -- within a subsidized, unhealthy, and inefficient financial and banking system.*

Results from a 1997 analysis by the Ministry of Finance (MOF) indicate that 46 percent of the 5,800 State-owned enterprises (SOEs) incurred losses with a disturbing debt/equity ratio of nearly 100 percent; more than half of total corporate debts are probably unrecoverable. Inefficient SOE operations impose a negative impact on the economy's competitiveness through four major channels. *First*, consumers are forced to accept overpriced but low-quality products from inefficient SOEs, while they are restricted in the choices of commodities sold domestically due to import restrictions. *Second*, protected SOEs tend to misallocate and waste scarce resources. *Third*, the monopolistic nature of SOEs in several industries is a formidable entry barrier for other non-state enterprises, thereby preventing the development of a multi-sector economy. *Finally,* with easy and preferential access to credit sources and interest subsidies, SOEs create unavoidable risks in banking operations, threatening not only the banking system's health but also the country's socio-economic stability.

Protection for import-substituting industries such as steel, cement, sugar, etc. leads to an domestic over-supply of these products. Produced at higher costs, these products are more expensive than imported goods, but usually with lower quality, leading to large accumulated inventory, contributing to the current economic slowdown and deflation. Production contraction in some protected industries such as cement, sugar, and steel, etc., requires the granting of additional privileges to these industries, not only in terms of higher trade barriers but also in preferential credits, etc. While the government's temporary bans on import of these goods can keep these industries afloat in the short-term, these restrictions eliminate an opportunity to force loss-making SOEs to restructure themselves and enhance their efficiency. More importantly, this protection mechanism always breeds more needs for additional protection at a higher level while the cost of this inefficiency is transferred unequitably to other economic groups of the society, especially those who live in rural areas.

Import restrictions, especially non-tariff barriers, not only adversely affect domestic investment and production, but they also create distorted and wrong signals to foreign investors. Foreign direct investment (FDI) in recent years has been concentrated on import-substituting industries through joint-ventures with state enterprises. Foreign investors rush in to seek economic rents from investments in highly protected industries, creating oversupply and stockpiled products. The automobile industry is such a case with 11 joint-ventures from 14 registered projects. This situation leads to surpluses and difficulty for domestic production, given the small and saturated automobile market in Vietnam. Some of the foreign investors enjoy substantial economic rents and privileges from protection and take away such rents from poor Vietnam.

Instead of making good use of their privileged access to preferential credit sources, especially through state-owned commercial banks (SOCBs), SOEs' inefficiency and poor performance foster unhealthy operations in the banking sector. SOCBs lend to SOEs without collateral and take away the limited credits needed for other pressing development projects, such as the development of physical and social infrastructure, especially in rural areas. Unrecoverable amount of corporate debts increases as poor enterprises cannot repay their debts easily. If SOEs cannot service their overdue debts, the government as the fund provider of last resort, will need to intervene by injecting additional capital to the banking system, committing large amounts of money from future revenues, thus creating fiscal instability.

Recent measures focus on demand stimulation by easy monetary and fiscal management and boosting investment and purchasing power, including lending rates reduction, larger fiscal deficit target, and proposal to increase civil servants' salary. In addition, the government mobilizes thousands of billion dong from the banking sector and budget to expand "directed lending" to on-going projects that are largely implemented by inefficient SOEs. However, these short-term measures are only able to treat the symptoms of economic ills but do not strategically address deeper and root problems underlying the current economic recession.

Some of the current long-term measures underway are either delayed or untimely, or are not strong enough to revive the growth momentum. For trade reforms, although Vietnam has already committed to AFTA plan, an actual schedule for gradual tariff reduction with annual targets is not available. In the mean time, existing non-tariff barriers are not dismantled, on the contrary they are being reinforced in the short-run. In 1998, due to the accumulated inventory and production slowdown of several import-substituting goods, nine commodities were added to the temporary goods list with restricted import quantity. To date, there is no commitment to a timetable for dismantling non-tariff-barriers.

SOE reforms have been discussed countless times, but to date, there has not been any actual reform timetable plan that specify clearly SOE classification and measures to be undertaken. Although the decree on transfer, sale, lease, and management contract has been promulgated, SOE reforms are still operating within the equitization framework that

proceeds very slowly. There is yet no clear policies to treat large SOEs with losses or poor performance.

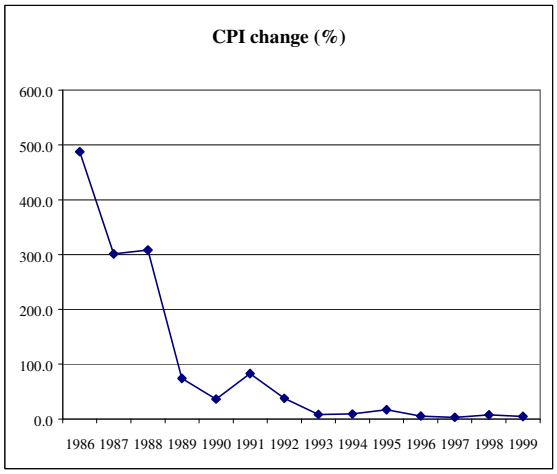
While progress has been made in the promulgation of two banking laws and implementing decrees to strengthen the legal prudential basis, reforms in the banking system lack an action plan with measures and timetables to separate non-commercial lending activities from SOCBs, to restructure joint-stock banks (JSBs) and SOCBs, to build an accounting and supervision framework consistent with international standards.

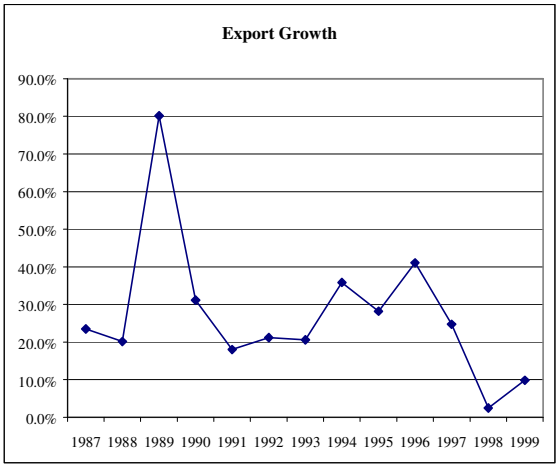
The current economic problems have received just far only superficial treatment which only address symptoms of illness. More effective and intensive structural measures need to be urgently taken to restore healthy growth to the economy. Similar to a medical operation which requires the patient to have the courage to face the pain, a plan for appropriate treatment with his doctor, and preparation of available means for the operation to be successful, the reform program equally needs a strong determination, a clear action plan, an exact timetable with concrete targets, and resources to deal with social issues emerging from and during the transition. The structural program needs to be a inter-sectoral plan concentrating in three closely interrelated areas, namely trade reforms, SOE reforms, and banking sector reform under the strong leadership of the Government (Box 2).

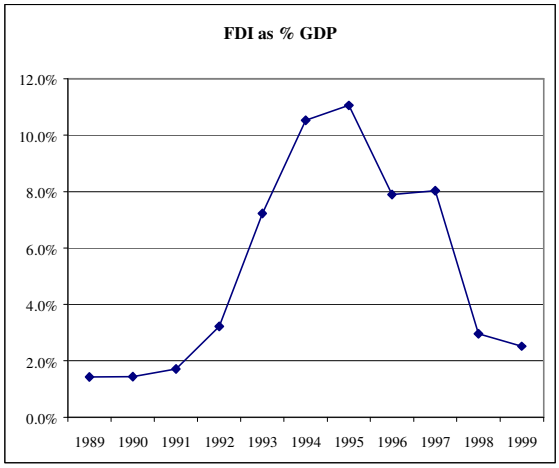
Box 1: Patterns of Economic Development in Vietnam

The economic development process since 1986 can be classified into three periods: 1986-1989; 1990-1995; and 1996-present, covering specific trends and characteristics of policy measures to stabilize the economy and sustain growth.

1986-1989 Period. During this period, the economy was centrally planned and highly inefficient, relying heavily on external assistance. It was characterized by low growth rate, chronic and galloping hyperinflation, inefficient SOE performance, substantial fiscal deficit, and high unemployment rates due to unsound economic management and inappropriate policies. The situation deteriorated further as Soviet assistance ($1 billion per year) disappeared overnight while the American embargo remained in place and there was no alternative assistance sources. The internal and external economic imbalances had a negative impact on macroeconomic stability and the people's living standards.







Box 1: Patterns of Economic Development in Vietnam (Continued)

1990-1995 Period. Facing with such challenges, Vietnam embarked on a Doi moi program toward a market-oriented and open economy with a series of structural reforms emphasizing four important issues. *First*, domestic trade and price liberalization, including the devaluation of the foreign exchange rate and hyperinflation control contributed toward a sound foundation for a market economy where signals for production are market-determined prices, not government administrative interventions. *Second*, freeing land's user-rights in rural areas, and changes in the production system from cooperatives to households, encouraged farmers to improve their productivity and production. *Third*, SOEs were granted autonomy and responsibility in production to encourage more efficiency and better performance while easing the budget burden. *Finally*, foreign trade was encouraged and legal provisions were made to attract foreign direct investment, following the strategy of integrating Vietnam into regional and world economies. As a result, annual average GDP growth rate was 8.1 percent; exports grew at 29.1 percent on average and imports grew even faster at 37 percent; actual FDI disbursements reached the highest record of 11 percent of GDP; inflation was brought down from over 400 percent in 1986 to 5.3 percent in 1993.

1996 to Present. Since 1996, Vietnam has experienced signs of economic slowdown. GDP growth rate slowed from the highest rate of 9.5 percent (1995) to an estimated low rate of 4.7 percent (1999). FDI, as percentage of GDP, fell from the record level of 11 percent in 1995 to 2.5 percent in 1998, and an estimate of 2.2 percent in 1999. Exports growth rate was 28 percent in 1995 but slowed to an estimated 15 percent this year.

The 1997 regional financial crisis had a negative impact on the economy, with decline in two major growth sources, namely exports and FDI. In 1998, exports to Asian countries in financial crisis were nearly halted (at only 2.4 percent) due to their low demand. Net 1998 FDI flows declined drastically by USD1 billion and if this trend continues, Vietnam will lose USD3 billion for three consecutive years, or 10 percent of GDP.

The situation worsens in 1999. Monthly inflation rate has been negative for the last eight months. Farmer income fell due to a series of serious calamities. Substantial imports contraction, due partly to investment declines and partly to current import restrictions, resulted in a substantial plunge in foreign and domestic investments and slowdown in industrial output. While exports have grown again in the past few months as crude oil price improves, the recovery would take quite some time, with no U.S. trade agreement. FDI has declined further to below USD1 billion. The economic recession is reflected in the banking operations. For the first half of 1999, total bank deposit grew 29 percent while total outstanding loans increased by only 6 percent due to a drastic fall in investment. This situation reflects the symptoms of the economic structural illogicality addressed in the main text.

Box 2. Objectives of the Second Wave of Structural Reforms

1. Improve the economy's competitiveness by accelerating state sector reform to enhance SOE efficiency in the same competitive environment and market discipline as with other businesses, Create a favorable environment for the private sector to mobilize more resources for the development of a multi-sector economy;

2. Phase out all trade protective barriers, especially non-tariff barriers, for a competitive environment in the domestic market and strategically integrate Vietnam's economy into the regional and world economies;

3. Restore and maintain people's trust and confidence in the banking system to maximize the mobilization of and effectively allocate domestic resources for economic development by restructuring SOCBs and JSBs and separating policy lending from commercial banks. Develop a healthy banking system within a prudential legal framework based on modern accounting and supervision system consistent with international financial standards;

4. Strengthen economic policy management and implementation by creating a more favorable and market-oriented environment, allowing the market-determined price system to function while minimizing government interventions, and improving policy coordination among government agencies in policy making process.

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