

July 1999

IMF Staff Country Report No. 99/55

Vietnam: Selected Issues

This Selected Issues report on Vietnam was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with this member country. As such, the views expressed in this document are those of the staff team and do not necessarily reflect the views of the Government of Vietnam or the Executive Board of the IMF.

Copies of this report are available to the public from
International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
Telex (RCA): 248331 IMF UR
E-mail: publications@imf.org
Internet: <http://www.imf.org>
Price: \$15.00 a copy

**International Monetary Fund
Washington, D.C.**

INTERNATIONAL MONETARY FUND

VIETNAM

Selected Issues

Prepared by Dubravko Mihaljek, Peter Winglee, Etibar Jafarov (all APD),
Il Houg Lee (PDR), and Jong-Won Yoon and Timo Väilä (FAD)

Approved by the Asia and Pacific Department

May 7, 1999

	Page
I. Introduction	4
II. Recent Performance of the Vietnamese Economy	5
A. Sources of Output Growth	5
B. Trends in Foreign Direct Investment	10
III. Banking Reform	23
A. Economic Setting	23
B. Nature and Scope of Problems	27
C. Reforms Since 1998	34
D. Approach to Banking Reform	38
IV. State-Owned Enterprises: Performance and Reform	42
A. Recent Performance of State Enterprises	42
B. Recent Developments in Enterprise Reforms	45
C. Reform Agenda	50
IV.1 Comparison on Main Aspects of Enterprise Reforms in China and Vietnam	56
V. Trade Policy Developments and the Need for Reform	59
A. Introduction	59
B. Overview of the Current System	59
C. Costs of Protection	63
D. Key Issues for Trade Liberalization	67

Text Tables

II.1	Gross Domestic Product and Components at Constant Prices, 1992-1998	6
II.2	Contribution to Real GDP Growth by Sector, 1994-98	9
II.3	Simulation of FDI Loan Repayment Obligations, 1998-2005	12
II.4	Foreign Direct Investment by Country of Origin, 1988-98	13
II.5	Cumulative Commitments and Disbursements of FDI, 1994-98	15
II.6	FDI by Form of Investment, 1991-98	16
II.7	Turnover by Enterprise Established Through FDI, 1991-98	18
II.8	Exports by Enterprises Established Through FDI, 1991-98	19
II.9	Contribution of FDI to Domestic Economy, 1998	20
II.10	Foreign Investment Incentives in Selected Asian Countries, April 1997	21
II.11	Prices of Land, Electricity, and Water for Industrial and Export Processing Zones in Selected Asian Countries, April 1997	22
III.1	Composition and Growth of Credit, 1994-98	26
III.2	Open Foreign Currency Positions of Commercial Banks, 1994, 1994-98	30
III.3	Foreign Currency Lending of Commercial Banks, 1994-98	30
III.4	Bank Soundness Indicators, 1994-98	31
III.5	Capital Adequacy of State-Owned Commercial Banks, 1998	33
IV.1	Summary of Financial Conditions of SOE, 1997	54
IV.2	Key Financial Ratios of State Enterprises, 1997	55

Boxes

II.1	FDI Data Issues	11
II.3	Outstanding FDI Commitments, 1994-98	14
III.1	Summary of Restructuring Plan for the Joint-Stock Banks	35
IV.1	State Enterprise Reform and "Isolation List" in Bulgaria since 1996	52
V.1	Protection and Key Industrial Sectors	65
V.2	Costs of Protection in the Agriculture Sector	66
V.3	Approaches to Phasing out Quantitative Restrictions	69

Figures

II.1	Real GDP, Exports, and Foreign Direct Investment, 1992-9	5
II.2	Actual and Potential GDP Growth, 1990-2000	8
II.3	Outstanding FDI Commitments, 1994-98	14
III.1	Growth of Credit and Inflation, 1996-99	24
III.2	Credit and Output, 1995-98	25
III.3	Required and Excess Reserves, 1995-99	25
III.4	Real Interest Rates, 1993-99	25
III.5	Foreign Currency Loan-to-Deposit Ratios, 1994-98	29

IV.1	Characteristics of SOE Profitability	44
IV.2	Characteristics of SOE Profitability Central government enterprises	44
V.1	Distribution of Tariff Rates, 1998-99	62
V.2	Trade Policies in ASEAN Countries, 1985-1999	68

I. INTRODUCTION

1. The performance of the Vietnamese economy has deteriorated sharply since mid-1997, reflecting domestic structural weaknesses compounded by the impact of the regional crisis. As explained in Chapter II, growth in 1992-97 was impressive, driven by reforms initiated in the late 1980s, along with large inflows of foreign direct investment (FDI) from the Asian region. However, because an increasing share of FDI was directed at import-substituting and nontradeable industries, when FDI inflows plateaued in 1997, stresses in the banking and state-owned enterprise (SOE) sectors and shortages of foreign exchange emerged. Since the authorities have responded to these difficulties by maintaining a prudent budgetary stance, the main policy challenge will be to speed up structural reforms, especially in the banking, SOE, and trade areas, the subject of the other chapters in this paper.

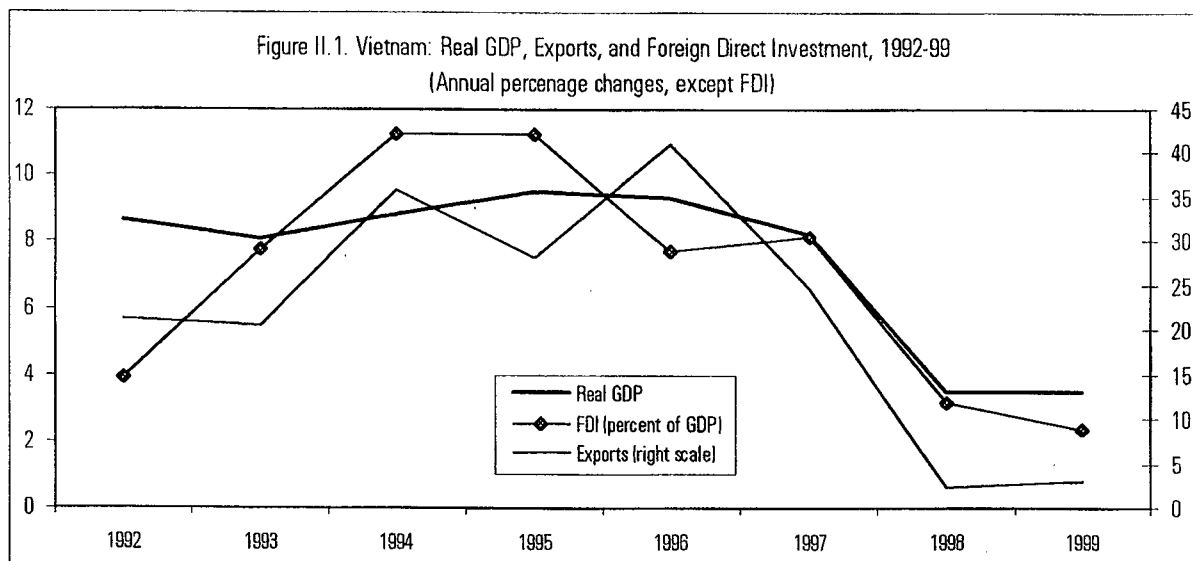
2. Chapter III reviews recent monetary and banking developments, and provides an assessment of the main problems in the banking sector. In the late 1990s Vietnam's banking sector has come under mounting pressure from the slowdown in growth and the weakening financial position of SOEs. In addition, problems have emerged from the banks' large foreign exchange exposure, accumulation of nonperforming loans, weak capital base, and low profitability. In response, the authorities have taken a number of measures to facilitate the necessary restructuring of the banking sector, and have started to develop a comprehensive strategy for banking reform. The chapter concludes with an outline of an approach to banking reform that builds on these initiatives.

3. The acceleration of SOE reform is essential to ensure that the banking system reforms are sustained and that the losses of SOEs do not threaten macroeconomic stability. Chapter IV gives an overview of recent SOE financial performance, noting that under the favorable conditions of 1997 and relaxed profitability criteria, only 40 percent of SOEs were profitable and many were highly indebted. The chapter also summarizes recent reform efforts, especially the recent improvements to the equitization program. Although these initiatives have laid the foundation for further reforms in several areas, they need to be sharply accelerated and more closely linked to strong financial criteria to ensure an improvement in enterprise performance. Complementary policies to promote private sector development are also needed to provide alternative job creation for displaced workers and to create an environment where equitized enterprises can thrive.

4. A greater outward orientation of the Vietnamese economy is necessary for sustained improvements in enterprise efficiency and in the availability of foreign exchange. Chapter V shows that the high levels of protection in the 1990s and FDI inflows have contributed to the start up of very inefficient import substituting industries. Although there have been some initiatives to open up the trade system, the coverage of quotas and licensing to shelter certain sectors from the regional downturn has been increased. Just as other countries have responded to the current crisis by accelerating trade liberalization, Vietnam should also decisively embark on such an approach, with the highest priority given to the early removal of nontariff barriers.

II. RECENT PERFORMANCE OF THE VIETNAMESE ECONOMY¹

1. Vietnam achieved an impressive record of GDP growth in the mid-1990s, averaging 9 percent per year during 1992–97 (Table II.1). The output growth was closely associated with the surge in foreign direct investment (FDI) inflows and exports (Figure II.1). However, growth began to slow sharply in 1998 as the Asian crisis started affecting the Vietnamese economy and exposed the underlying structural weaknesses, especially in the state-owned enterprise (SOE) and banking sectors. Despite efforts by the government to reorient development toward agriculture and rural areas, and support provided to the SOE sector through bank credit, the overall growth rate has decelerated sharply—based on staff estimates, real GDP rose just 3½ percent in 1998 and now projected for 1999. This chapter looks at the main sources of economic growth in Vietnam in recent years in order to explain the observed growth pattern. Section A focuses on the role of domestic demand and changes in the structure of output during this period, while Section B looks at the structure of FDI and its impact on the economy.



A. Sources of Output Growth

2. During the high-growth period of 1992–96, the main impetus to growth came from private consumption and FDI inflows, which on average contributed over 13 percentage points annually to the real growth rate of GDP (see tabulation below). The external sector, by contrast, made a large negative contribution to growth in this period. This suggests that the mid-1990s were a period of domestic demand-led growth, notwithstanding the strong expansion in Vietnam's foreign trade. Large FDI inflows and imports of goods and services were essentially fueling a boom in consumption and domestic investment—growing by

¹This chapter was prepared by Dubravko Mihaljek, Il Houn Lee, and Etibar Jafarov.

Table II.1. Vietnam: Gross Domestic Product and Components at Constant Prices, 1992-98
(In billions of dong, at 1992 prices)

	1992	1993	1994	1995	1996	1997	Staff est. 1998
Consumption	88,227	107,674	119,045	130,106	145,830	155,974	165,549
Private	81,856	98,192	107,193	117,083	131,118	140,102	148,709
Public	6,371	9,482	11,852	13,023	14,711	15,872	16,841
Investment	19,498	30,729	38,122	45,963	50,577	60,074	46,724
Public	6,450	8,398	7,038	7,976	10,279	11,860	12,811
FDI	4,326	10,239	19,619	23,358	19,193	25,293	11,240
Other private	8,722	12,092	11,465	14,629	21,106	22,921	22,673
Change in inventories and statistical discrepancy	0	-7,920	-7,292	-4,141	-8,329	-25,270	-17,592
Domestic demand	107,725	130,483	149,874	171,928	188,078	190,779	194,682
Net exports of goods and services	2,808	-11,011	-19,842	-29,491	-32,337	-22,267	-20,272
Exports	35,765	40,680	57,415	72,353	96,563	127,419	155,126
Goods	27,668	32,244	42,623	50,004	71,117	102,228	124,388
Services	8,097	8,436	14,792	22,349	25,446	25,191	30,737
Imports	-32,957	-51,691	-77,257	-101,844	-128,900	-149,686	-175,397
Goods	-28,339	-44,107	-62,650	-80,970	-102,881	-118,291	-138,298
Services	-4,618	-7,584	-14,606	-20,874	-26,019	-31,395	-37,100
Real GDP	110,535	119,472	130,032	142,437	155,741	168,512	174,410
	(Annual percentage changes)						
Consumption	16.9	22.0	10.6	9.3	12.1	7.0	6.1
Private	7.6	20.0	9.2	9.2	12.0	6.9	6.1
Public	49.9	48.8	25.0	9.9	13.0	7.9	6.1
Investment	27.8	57.6	24.1	20.6	10.0	18.8	-22.2
Public	...	30.2	-16.2	13.3	28.9	15.4	8.0
FDI	...	136.7	91.6	19.1	-17.8	31.8	-55.6
Domestic demand	18.8	21.1	14.9	14.7	9.4	1.4	2.0
Exports	28.4	13.7	41.1	26.0	33.5	32.0	21.7
Goods	23.1	16.5	32.2	17.3	42.2	43.7	21.7
Imports	42.4	56.8	49.5	31.8	26.6	16.1	17.2
Goods	39.6	55.6	42.0	29.2	27.1	15.0	16.9
Real GDP	8.6	8.1	8.8	9.5	9.3	8.2	3.5
	(Contribution to GDP growth, percentage points)						
Private consumption	8.8	14.8	7.5	7.6	9.9	5.8	5.1
Investment	6.4	10.2	6.2	6.0	3.2	6.1	-7.9
FDI	...	5.3	7.9	2.9	-2.9	3.9	-8.3
Domestic demand	12.8	20.6	16.2	17.0	11.3	1.7	2.3
Net exports of goods and services	-4.7	-12.5	-7.4	-7.4	-2.0	6.5	1.2
	(Annual percentage changes)						
Deflators							
Consumption 1/	18.2	8.4	9.4	17.0	5.8	3.2	7.7
Investment 2/	-0.3	3.5	-5.7	10.2	-3.1	-7.9	-1.4
Domestic demand	20.0	13.6	11.9	17.1	5.0	7.6	8.4
Exports of goods 3/	-3.5	-1.5	5.9	10.1	-1.0	-7.7	-4.4
Imports of goods 3/	-5.2	0.4	3.2	10.1	-1.4	-7.7	-3.9
Exports and imports of services 4/	...	-2.6	15.4	5.8	-1.3	0.1	-4.2
GDP deflator	32.6	14.3	14.5	19.5	6.1	6.6	8.5
Real per capita consumption	...	17.2	6.9	7.1	9.9	5.0	4.2

Sources: Data provided by the Vietnamese authorities, and staff estimates.

1/ Consumer price index.

3/ Manufacturing unit value (MUV) index.

4/ World Economic Outlook (WEO) component-based goods trade deflators (average of the export unit value for manufactures, the petroleum price, and the commodity price, weighted by the 1987-89 composition of trade of Vietnam.

5/ Derived from partner country CPI (in U.S. dollars) and dong depreciation.

12½ percent and 23 percent per year, respectively (Table II.1)—that ultimately could not be sustained by Vietnam’s exports and productivity growth. The adjustment that began in 1997 was thus inevitable, and was compounded—rather than caused in a fundamental sense—by the Asian crisis.

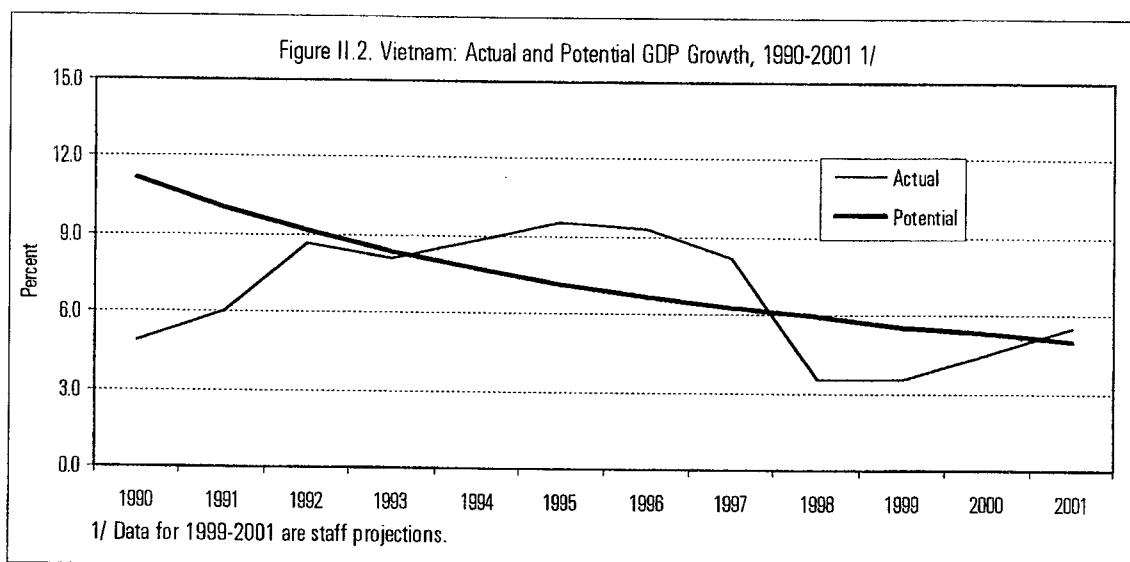
	Contribution to real GDP growth		
	1992–97	1997	1998
	(In percentage points)		
Domestic demand	13.4	1.7	2.3
Of which: Private consumption	9.1	5.8	5.1
Foreign direct investment	3.4	3.9	-8.3
Net exports of goods and services	-4.6	6.5	1.2
Real GDP (percent per year)	8.8	8.2	3.5

3. The pattern of actual and potential GDP growth over the past decade further confirms this conclusion. After the initial round of market-oriented reforms in the early 1990s, real output expanded rapidly, and by 1993 the large output gap left over from the central planning period was closed (Figure II.2). During 1993–97, however, real GDP was growing about 2 percentage points per year faster than potential GDP. Exports were growing rapidly in this period (29 percent per year on average), but were outpaced by the growth in imports (42 percent per year). Output per worker also increased rapidly, but mainly reflecting capital intensive investment in the SOE sector (Appendix Table 15). While inflation remained subdued due to a stable exchange rate and cautious fiscal and monetary policies, there were many signs of a build-up in excess demand pressures as the economy’s capacity to absorb large FDI inflows—especially in the state enterprise sector—was limited. Following the onset of the Asian crisis, real GDP growth dipped below potential, estimated by the staff at about 5½–6 percent (Figure II.2).² Assuming continued macroeconomic adjustment and a gradual recovery in exports and private investment, the output gap—currently estimated at ½–1 percent of GDP—would be closed by 2001.

4. Limited data on the expenditure breakdown of GDP do not allow a more detailed analysis of the sources of growth on the aggregate demand side. The production side data provide, however, several additional insights.

- Sectors that made the largest contribution to growth during 1992–98 were manufacturing (accounting for 27 percent of total growth in value added), wholesale and retail trade (15 percent), and agriculture (13 percent) (Table II.2).

²Potential GDP was roughly approximated by applying the Hodrick-Prescott filter to annual GDP data in constant 1994 prices over the period 1988–98. The estimated current growth rate of potential GDP is sensitive to the endpoints of the data series, and is hence given as a range.



- Within manufacturing, import-substituting industries—metallurgy, machinery, chemical, and materials industries—contributed on average 40 percent of total growth in manufacturing value added (Appendix Table 8).
- Industries producing nontradable goods and services—utilities, construction, wholesale and retail trade, real estate, and public services (not counting the large domestic component of transportation services) on average accounted for 48 percent of growth in GDP during 1991–98 (Table II.2).
- Although the state sector (including government administration) accounted for a solid 42 percent of GDP in recent years, its contribution to real GDP growth fell sharply, from 51 percent in 1996, to 24 percent in 1998 (see tabulation).³ By contrast, the contribution of the nonstate sector (mainly agriculture) increased rapidly in 1998—despite the impact of the Asian crisis—and accounted for 61 percent of over-all growth in 1998.

	Contribution to Real GDP Growth		
	1996	1997	1998
	(Percentage points)		
GDP	9.3	8.8	10.3
State	4.7	4.1	2.4
Nonstate	3.2	3.1	6.3
Foreign invested	1.4	1.6	1.6
	(Percent of total)		
State	50.8	47.0	23.8
Nonstate	34.6	34.9	61.2
Foreign invested	14.7	18.2	15.1
	Share in GDP (percent)		
State	42.8	43.1	41.3
Nonstate	49.5	48.3	49.5
Foreign invested	7.7	8.5	9.2

³The share of state management in GDP is stable at about 10½ percent of GDP.

Table II.2. Vietnam: Contribution to Real GDP Growth by Sector, 1994-98
(In percent of total contribution)

	1992	1993	1994	1995	1996	1997	1998	Average 1992-98
Agriculture, Fishery and Forestry	27.0	12.4	10.9	13.8	12.4	13.3	11.3	13.9
Agriculture	24.6	12.1	10.0	10.7	10.9	13.0	9.8	13.0
Forestry	1.0	-0.6	0.1	0.8	0.3	0.0	0.0	0.2
Fishery	1.4	0.8	0.9	2.3	1.2	0.3	1.5	1.2
Industry	42.2	41.4	42.0	41.2	46.3	48.5	57.4	44.3
Mining and Quarrying	...	...	...	7.2	7.7	8.9	13.1	9.2
Manufacturing	34.1	28.2	-54.4	21.2	22.5	25.3	28.7	27.2
Electricity, Gas and Water Supply	...	...	...	3.1	3.3	3.4	3.9	3.4
Construction	8.1	13.1	13.8	9.7	12.9	11.0	11.7	10.6
Services	30.8	46.2	47.1	45.0	41.3	38.2	31.3	41.8
Wholesale and Retail Trade	13.7	12.9	16.5	20.0	17.9	14.7	11.9	15.2
Hotels and Restaurants	11.1	17.0	...	3.6	3.8	3.0	1.7	9.0
Transport, Storage and Communication	3.4	3.4	3.1	4.1	3.2	4.3	2.7	3.6
Financial Intermediation	2.0	3.3	4.4	2.9	2.5	1.1	1.5	2.7
Real Estate	...	...	...	3.5	3.3	4.2	3.3	3.6
Public Administration, Defense and Compulsory Social Security	0.6	9.7	...	3.4	2.7	1.7	1.8	4.1
Education and Training	...	...	...	2.8	3.1	3.1	4.1	3.2
Health and Social Work	...	...	...	1.5	1.2	0.7	1.1	1.1
Other	...	...	...	3.2	3.8	5.4	3.2	3.9
Gross Domestic Product	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Sources: General Statistics Office and staff estimates.

• The main source of growth in industry in recent years were foreign-invested enterprises: their share in industrial production increased to nearly one-third, and they accounted for more than half of the increase in industrial output in 1998 (see tabulation). However, much of the increase in output of foreign-invested enterprises was concentrated in import-substituting industries (discussed below).

5. In summary, the structure of output growth in the mid-1990s has been relatively unfavorable: growth has been to a large extent generated by import-substituting and nontradable industries. Furthermore, the state sector remains very large despite its declining contribution to growth.

Contribution to Industrial Sector Growth			
	1996	1997	1998
(Percentage points)			
Industry	14.2	13.2	12.7
State	6.0	5.3	5.8
Nonstate	2.8	2.3	1.6
Foreign invested	5.4	5.6	7.3
(Percent of total)			
State	41.9	40.4	30.2
Nonstate	19.8	17.3	12.3
Foreign invested	38.2	42.4	57.5
Share in GDP (percent)			
State	49.3	48.2	46.2
Nonstate	24.0	23.2	22.0
Foreign invested	26.7	28.5	31.8

B. Trends in Foreign Direct Investment

6. Vietnam has benefitted from large inflows of foreign direct investment (FDI) in recent years, averaging over 9 percent of GDP per year between 1993 and 1997. These inflows were attracted by several factors, notably relatively rich natural resources (including oil, gas, and coal), large agricultural potential, good geographic location, and the relatively large domestic market (close to 80 million people). The Asian crisis, however, dealt a severe blow to foreign investment in Vietnam, both because the bulk of FDI originated in Asian countries hit by the crisis, and because it revealed the weaknesses in Vietnam's investment environment, which were masked by the high growth in the mid-1990s. Given the relative size of FDI inflows and their structure—much of FDI was channeled to heavy industry and real estate—the recent developments raise a number of issues, including the capacity of Vietnamese enterprises to repay large FDI-related loans falling due in the next few years and to compete with enterprises from neighboring countries that are implementing deep structural reforms.

7. Against this background, this section analyzes the structure of FDI inflows in the 1990s and their impact on the Vietnamese economy, and compares the investment environment in Vietnam with some of its key competitors—China, Thailand, and the Philippines. As the lack of accurate data is a major analytical constraint in this area (see Box II.1), many conclusions are tentative. Nonetheless, the available data raise concerns about the impact of FDI on the Vietnamese economy. A picture that clearly emerges is that instead of using FDI to develop a solid export base in low-cost, labor-intensive industries—which was the approach followed, for example in China since the early 1980s—FDI in Vietnam has been channeled to high-cost, capital- and import-intensive industries in which Vietnam has no comparative advantage. Moreover, most FDI projects were implemented through joint-ventures with state-owned enterprises, which are considerably less flexible than the private sector.

Box II.1. Vietnam: FDI Data Issues

FDI data in Vietnam are compiled primarily by the Ministry of Planning and Investment (MPI) from a quarterly survey of enterprises that covers actual FDI commitments, disbursements as well as revenue, turnover, exports, tax obligations, and the number of employees associated with FDI projects. In addition, biannual audit reports of FDI activity are prepared by independent auditors who report to the MPI. Due to resource constraints, however, MPI is unable to verify the accuracy of the data reported by enterprises through on-site inspections or cross-checks with other data banks (e.g., commercial bank data). Because enterprises receive tax incentives for FDI-related activities, the MPI data are likely to be biased upward.

The State Bank of Vietnam (SBV) monitors only the loan component of FDI inflows through registration of loans by enterprises. Except for projects specifically targeted at the domestic market, FDI-financed projects are subject to a foreign exchange balancing requirement, under which foreign exchange outlays have to be financed from foreign exchange earnings generated by the project. As a result, many foreign-invested enterprises did not separately register their FDI-related loans in the past, so the SBV data on FDI inflows are biased downward.

On the basis of discussions with the staff from the MPI, the SBV, and the Ministry of Finance, the staff have adjusted the MPI data based on information on the loan component of FDI provided by the SBV. Specifically, total net outstanding FDI-related loans reported by the MPI were adjusted to US\$4.1 billion, compared with US\$6.2 billion reported by the MPI, and US\$3.5 billion reported by the SBV.

Different FDI data have vastly different implications on the historical balance of payments (in terms of large errors and omissions), but even more so on the medium-term balance of payments outlook, as large repayments of FDI-related loans will start falling due in the next few years. A simple simulation shows that, based on the MPI data, projected repayments of FDI-related loans could be up to US\$640 million a year higher during 2001–04 than the projected repayments based on the staff estimates (Table II.3).

Structure of FDI inflows

8. The following are some salient features of recent FDI inflows into Vietnam.
 - Total FDI commitments in the period 1988–98 (including domestic capital contribution) were estimated at about US\$33 billion, and total disbursements at US\$10 billion (32 percent of commitments), of which the bulk was foreign equity contribution (57 percent) (Table II.4).
 - Two-thirds of FDI inflows originated in the Asian region, most of it coming from Taiwan POC (13½ percent of total disbursements during 1988–98), Japan (12 percent), and Singapore, Hong Kong SAR, and Korea (Table II.4). The large concentration of investors in

Table II.3. Vietnam: Simulation of FDI Loan Repayment Obligations, 1998-2005
(In millions of U.S. dollars)

	1998	1999	2000	2001	2002	2003	2004	2005
Staff estimates 1/								
FDI disbursements (cumulative)	9,705	9,240	8,555	7,661	6,775	6,137	5,729	5,589
Equity	5,589	5,589	5,589	5,589	5,589	5,589	5,589	5,589
Loan	4,116	3,651	2,966	2,072	1,186	548	140	0
Repayments	842	1,089	1,275	1,436	1,374	1,081	820	535
Divident on equity	383	391	391	391	391	391	391	391
Interest on loan	237	233	199	151	98	52	21	4
Principles	222	465	686	894	885	638	408	140
MPI data								
FDI disbursements (cumulative)	12,573	12,031	11,240	10,073	8,688	7,560	6,703	6,310
Equity	6,310	6,310	6,310	6,310	6,310	6,310	6,310	6,310
Loan	6,263	5,721	4,930	3,763	2,378	1,250	393	0
Repayments	1,081	1,343	1,553	1,869	2,011	1,679	1,348	846
Divident on equity	429	442	442	442	442	442	442	442
Interest on loan	338	360	320	261	184	109	49	12
Principles	314	541	791	1,167	1,385	1,128	857	393
Difference in repayments	-239	-254	-277	-433	-637	-597	-529	-311
Cumulative	-239	-492	-770	-1,203	-1,839	-2,436	-2,965	-3,276
Assumptions:								
Profit (percent)	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0
Interest rate (percent per year)	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0

1/ Based on various versions of MPI data, SBV data, and discussions with staff from MPI, SBV, and MOF.

Table II.4. Vietnam: Foreign Direct Investment by Country of Origin, 1988-98 1/
(In millions of U.S. dollars)

	Commitment	Disbursement	Equity disbursement	Foreign loans	Undisbursed commitments
Singapore	5,857	998	564	434	4,859
Taiwan POC	4,028	1,375	913	462	2,653
Japan	3,266	1,197	683	514	2,069
Korea	2,903	941	491	450	1,962
British Virgin Islands	2,772	352	241	110	2,420
Hong Kong SAR	2,671	982	583	400	1,689
France	1,489	328	190	138	1,161
Malaysia	1,182	763	308	455	418
USA	1,059	270	171	99	789
Thailand	994	334	164	170	659
Australia	873	398	286	112	474
UK	693	586	260	327	107
Switzerland	653	303	127	176	350
Other	4,102	1,436	863	573	2,666
Total	32,542	10,265	5,843	4,422	22,277

(In percent of total)

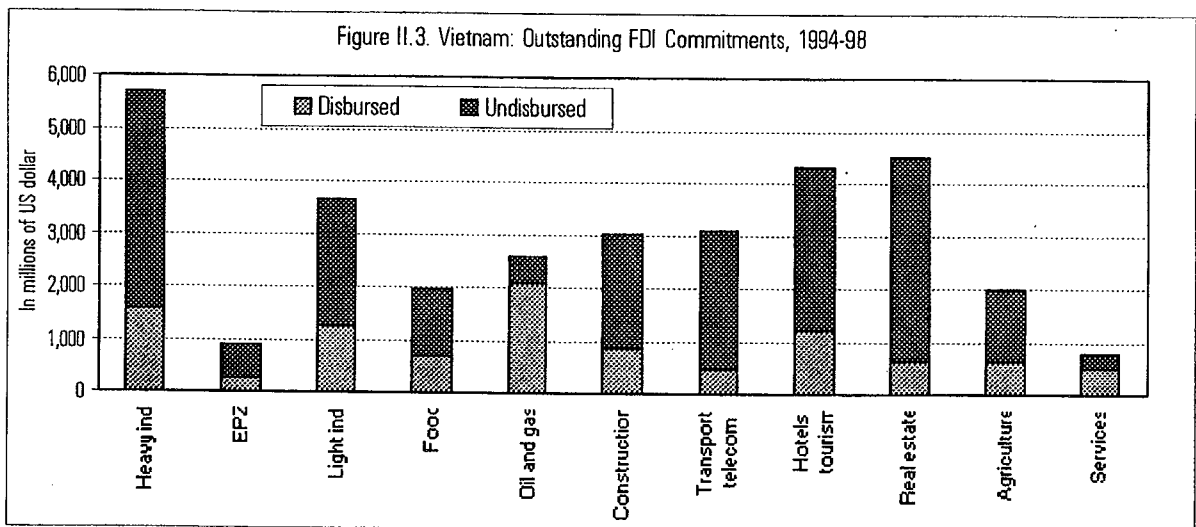
Singapore	18.0	9.7	9.6	8.2	9.8
Taiwan POC	12.4	13.4	15.6	15.7	10.4
Japan	10.0	11.7	11.7	12.2	11.6
Korea	8.9	9.2	8.4	8.4	10.2
British Virgin Islands	8.5	3.4	4.1	4.1	2.5
Hong Kong SAR	8.2	9.6	10.0	9.2	9.0
France	4.6	3.2	3.2	3.4	3.1
Malaysia	3.6	7.4	5.3	5.2	10.3
USA	3.3	2.6	2.9	2.8	2.2
Thailand	3.1	3.3	2.8	2.8	3.9
Australia	2.7	3.9	4.9	4.7	2.5
UK	2.1	5.7	4.4	5.4	7.4
Switzerland	2.0	3.0	2.2	2.0	4.0
Other	12.6	14.0	14.8	15.6	12.9
Total	100.0	100.0	100.0	100.0	100.0

Source: Ministry of Planning and Investment (MPI), State Bank of Vietnam (SBV); and staff estimates.

1/ MPI data, adjusted on the basis of SBV data and staff estimates and discussions with the authorities.

the Asian region partly explains why FDI inflows fell so sharply following the onset of the Asian crisis in 1997—preliminary data indicate that new FDI commitments fell by almost a half in 1997, and were further substantially reduced—by two-thirds—in 1998. Outside of Asia, the main investors came from United Kingdom (5¾ percent of total disbursements during 1988–98), Australia (4 percent), and France, Switzerland, and British Virgin Islands.

- FDI disbursements are concentrated in the industrial sector (34 percent of total disbursements during 1994–98), oil and gas (28 percent), and real estate (17 percent) (Table II.5). Within industry, FDI was disbursed mostly to heavy industries (15 percent of total disbursements during 1994–98), and light manufacturing and food industries. Heavy industry, hotels, and other real estate (office property and apartments) also were the sectors with the largest uncommitted disbursements (Figure II.3). Actual disbursements were the highest in the oil and gas sector (80 percent of commitments).



- The bulk of FDI disbursements took place between 1993 and 1997, peaking at 11.3 percent of GDP in 1995. Large investments in oil and gas, food, and services started as early as 1993, but tapered off by 1998 (Statistical Appendix Table 31). Only FDI in construction continued strongly in 1998.
- Two-thirds of total FDI commitments during 1991–98 were made in joint ventures with state-owned enterprises (SOEs), and only 2 percent in joint ventures with the private sector (Table II.6). Investments in fully foreign-owned enterprises accounted for 22 percent of total commitments, while investments in the form of BCC (a business contract between a foreign investor and domestic partner that does not involve setting up a legal entity in Vietnam) and BOT (build, operate, and transfer) contracts accounted for 12 percent of total commitments. In terms of disbursements, however, joint ventures with SOEs accounted for a smaller share of the total (54 percent), while disbursements in the form of BCC contracts were much higher (24 percent), suggesting that many investors faced administrative hurdles and had to change their approach after initially committing investments to joint ventures with SOEs.

Table II.5. Vietnam: Cumulative Commitments and Disbursements of FDI, 1994-98 1/

(In millions of U.S. dollars)

	1994		1995		1996		1997		1998		Average 1994-98	
	Com.	Disb.	Com.	Disb.	Com.	Disb.	Com.	Disb.	Com.	Disb.	Com.	Disb.
Industry	4,142	934	6,609	1,671	9,344	2,514	11,002	3,484	12,187	3,814	...	...
Heavy industries	1,464	417	2,943	713	4,226	1,044	5,211	1,466	5,683	1,568	...	...
Economic processing zones	366	15	612	55	612	177	830	252	892	277	...	...
Light industries	1,305	214	1,815	446	2,677	770	2,995	1,135	3,642	1,258	...	...
Food	1,007	288	1,239	459	1,829	523	1,966	631	1,970	711	...	...
Oil and gas	1,213	1,133	1,213	1,715	1,265	2,016	1,316	2,018	2,588	2,068	...	...
Construction	919	89	1,605	202	2,235	475	2,946	627	3,013	877	...	...
Transportation and communications	799	124	1,238	283	1,926	364	2,710	441	3,108	456	...	...
Real estate	3,903	474	6,601	907	9,901	1,273	10,239	1,696	8,841	1,808	...	...
Hotels and tourism	2,701	354	3,511	607	3,446	827	3,558	1,124	4,320	1,197	...	...
Office property and apartments	1,202	120	3,090	299	6,456	446	6,681	572	4,520	612	...	...
Agriculture, forestry and fisheries	573	95	891	216	1,004	292	1,593	576	2,014	617	...	...
Services	375	193	489	308	673	331	997	498	792	500	...	...
Total	11,924	3,042	18,646	5,302	26,348	7,265	30,804	9,339	32,542	10,140	...	...
(In percent of total)												
Industry	34.7	30.7	35.4	31.5	35.5	34.6	35.7	37.3	37.4	37.6	35.8	34.4
Heavy industries	12.3	13.7	15.8	13.4	16.0	14.4	16.9	15.7	17.5	15.5	15.7	14.5
Economic processing zones	3.1	0.5	3.3	1.0	2.3	2.4	2.7	2.7	2.7	2.7	2.8	1.9
Light industries	10.9	7.0	9.7	8.4	10.2	10.6	9.7	12.1	11.2	12.4	10.4	10.1
Food	8.4	9.5	6.6	8.6	6.9	7.2	6.4	6.8	6.1	7.0	6.9	7.8
Oil and gas	10.2	37.2	6.5	32.3	4.8	27.8	4.3	21.6	8.0	20.4	6.7	27.9
Construction	7.7	2.9	8.6	3.8	8.5	6.5	9.6	6.7	9.3	8.6	8.7	5.7
Transportation and communications	6.7	4.1	6.6	5.3	7.3	5.0	8.8	4.7	9.6	4.5	7.8	4.7
Real estate	32.7	15.6	35.4	17.1	37.6	17.5	33.2	18.2	27.2	17.8	33.2	17.2
Hotels and tourism	22.7	11.6	18.8	11.5	13.1	11.4	11.6	12.0	13.3	11.8	15.9	11.7
Office property and apartments	10.1	3.9	16.6	5.6	24.5	6.1	21.7	6.1	13.9	6.0	17.3	5.6
Agriculture, forestry and fisheries	4.8	3.1	4.8	4.1	3.8	4.0	5.2	6.2	6.2	6.1	5.0	4.7
Services	3.1	6.3	2.6	5.8	2.6	4.6	3.2	5.3	2.4	4.9	2.8	5.4
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	...	...

Source: Ministry of Planning and Investment (MPI), State Bank of Vietnam (SBV); and staff estimates.

1/ MPI data, adjusted on the basis of SBV data and staff estimates and discussions with the authorities.

Table II.6. Vietnam: FDI by Form of Investment, 1991-98 1/
(In millions of U.S. dollars)

	1991	1992	1993	1994	1995	1996	1997	1998	Total 1991-98	Average 1991-98 (Percent)
Commitments										
100 percent foreign-owned	264	426	1,022	823	1,683	1,151	1,199	439	7,005	21.5
Joint ventures	1,444	1,292	2,397	2,714	4,642	5,907	2,235	996	21,627	66.5
With SOEs	1,423	1,276	2,359	2,631	4,515	5,787	2,118	908	21,018	64.6
With private sector	21	16	38	84	127	120	117	87	609	1.9
BCC	674	575	167	127	365	90	795	304	3,096	9.5
BOT	0	0	0	0	32	554	227	0	814	2.5
Total	2,381	2,293	3,585	3,664	6,722	7,702	4,456	1,738	32,542	100.0
Disbursements										
100 percent foreign-owned	3	80	186	263	413	554	689	84	2,271	22.4
Joint ventures	104	145	435	837	1,169	1,146	1,337	278	5,449	53.7
With SOEs	100	140	423	812	1,145	1,122	1,288	270	5,301	52.3
With private sector	3	5	12	24	24	24	49	8	149	1.5
BCC	61	92	302	537	674	263	47	435	2,410	23.8
BOT	0	0	0	0	4	0	2	3	9	0.1
Total	168	316	922	1,636	2,260	1,963	2,074	800	10,140	100.0
Foreign equity										
100 percent foreign-owned	4	85	142	166	214	250	358	75	1,294	23.1
Joint ventures	79	130	350	556	727	475	628	135	3,080	55.0
With SOEs	76	127	342	546	712	464	594	125	2,985	53.3
With private sector	3	3	8	11	16	10	34	10	95	1.7
BCC	75	79	205	311	342	166	14	25	1,217	21.7
BOT	0	0	0	0	4	0	2	5	11	0.2
Total	158	294	697	1,033	1,287	891	1,002	240	5,601	100.0
Foreign loans										
100 percent foreign-owned	0	4	47	95	208	263	333	35	977	21.5
Joint ventures	8	20	95	273	431	626	706	170	2,369	52.2
With SOEs	8	19	91	259	423	614	690	168	2,315	51.0
With private sector	0	1	4	14	8	12	16	2	54	1.2
BCC	2	14	97	226	350	32	32	355	1,194	26.3
BOT	0	0	0	0	0	0	0	0	-2	0.0
Total	10	38	238	594	989	921	1,072	560	4,538	100.0
Memorandum items										
	(Percent of total disbursements)									
Share of foreign loans										
100 percent foreign-owned	0.9	4.4	25.2	36.3	50.4	47.5	48.4	41.2	43.0	...
Joint ventures	7.7	13.7	21.8	32.6	36.8	54.7	52.8	61.1	43.5	...
With SOEs	7.8	13.2	21.5	31.8	36.9	54.8	53.6	62.2	43.7	...
With private sector	5.8	27.8	34.1	57.7	33.6	50.4	32.4	23.8	36.4	...
BCC	2.9	15.6	32.1	42.1	51.9	12.1	68.6	81.7	49.5	...
BOT	...	...	...	...	...	...	...	...	-21.3	...
Total	5.8	11.9	25.9	36.3	43.8	46.9	51.7	70.0	44.8	...

Source: Ministry of Planning and Investment (MPI), State Bank of Vietnam (SBV); and staff estimates.

1/ MPI data, adjusted on the basis of SBV data and staff estimates and discussions with the authorities.

- The equity share accounted on average for 57 percent of FDI disbursements, well above the required legal capital share of 30 percent. The average equity contribution by Vietnamese partners is estimated at about 20 percent, mainly in the form of land.
- The loan component of FDI inflows rose sharply in recent years, reaching 70 percent of total disbursements in 1997, compared with 6 percent in 1992 (Table II.6). FDI inflows to banking and finance, for example, consisted entirely of borrowing. The loan component of FDI also was high in the food industry (over 80 percent), real estate, and construction. As noted above, this trend suggests that large repayments on FDI-related loans will fall due in the next few years, when the external environment will likely remain considerably less favorable than in the mid-1990s, when investment decisions were originally made.

Contribution to the Vietnamese economy

9. Total turnover by enterprises established through FDI expanded rapidly from 2 percent of GDP in 1991 to 14¼ percent of GDP in 1997, but declined by 1 percent of GDP in 1998 (Table II.7).⁴ Transportation and telecommunications accounted for the largest share of turnover (on average, 26 percent of the total), followed by heavy and light industries, agriculture and forestry, hotels and tourism, and construction. These data indicate that much of FDI has been channeled to import-substituting industries (heavy industry, light industries producing consumer goods) or nontradables (construction, large segments of transportation and telecommunications, office property and apartments).

10. Another indication of the import-substitution bias of FDI inflows is the relatively small share of exports by enterprises established through FDI: on average, these enterprises accounted for only 8½ percent of total exports during 1991–98 (Table II.8). And while merchandise exports generated by FDI-related projects are estimated to have increased steadily to about US\$1.5 billion (16 percent of total exports) in 1998, these exports represented on average less than a third of total turnover of foreign-invested enterprises. Moreover, almost 90 percent of exports by enterprises established through FDI came from just two sectors—oil and gas and food industry. While Vietnam has a comparative advantage in these industries, the export potential of industries such as textiles and garments, footwear, and the vast agricultural sector has hardly been tapped through FDI.

11. The import content of FDI projects is very large: total imports by foreign-invested enterprises amounted to US\$2.7 billion in 1998 (26 percent of total imports), and were almost 80 percent higher than total exports generated by these projects (Table II.9). It is of particular concern that import-substituting and nontradable industries—heavy industry, construction, real estate, and transportation and telecommunications—accounted for 57 percent of total imports by enterprises established through FDI, and less than 1 percent of their total exports in 1998.

⁴Staff estimates based on MPI data as of end-October 1998.

Table II.7. Vietnam: Turnover by Enterprises Established Through FDI, 1991-98 1/
(In millions of U.S. dollars)

	1991	1992	1993	1994	1995	1996	1997	1998	Average 1991-98
Heavy industries	7	28	65	167	414	683	1,232	1,526	...
Petroleum and gas	0	0	0	0	0	100	1	0	...
Light industries	7	19	73	180	380	582	734	787	...
Food industry	1	3	63	162	362	442	434	317	...
Agriculture and forestry	8	11	29	86	141	165	313	278	...
Fisheries	55	19	11	11	19	23	20	12	...
Construction	0	0	3	14	69	43	152	181	...
IP/EPZ infrastructure 2/	0	0	0	5	6	7	17	12	...
Hotels and tourism	10	17	31	80	169	89	182	47	...
Office property and apartments	0	3	4	22	25	40	37	24	...
Services	0	6	8	28	23	12	12	15	...
Transportation and communications	63	115	191	250	399	445	361	54	...
Banking and finance	0	0	0	0	26	41	92	43	...
Culture, health, and education	0	2	6	18	25	27	40	48	...
Total	151	224	485	1,025	2,057	2,699	3,628	3,343	...
(In percent of total)									
Heavy industries	4.7	12.4	13.4	16.3	20.1	25.3	33.9	45.6	21.5
Petroleum and gas	0.0	0.0	0.0	0.0	0.0	3.7	0.0	0.0	0.5
Light industries	4.8	8.5	15.0	17.6	18.5	21.6	20.2	23.5	16.2
Food industry	0.7	1.3	13.1	15.8	17.6	16.4	12.0	9.5	10.8
Agriculture and forestry	5.0	5.1	6.0	8.4	6.9	6.1	8.6	8.3	6.8
Fisheries	36.3	8.6	2.3	1.1	0.9	0.8	0.5	0.3	6.4
Construction	0.0	0.1	0.6	1.4	3.3	1.6	4.2	5.4	2.1
IP/EPZ infrastructure 2/	0.0	0.0	0.0	0.5	0.3	0.3	0.5	0.4	0.2
Hotels and tourism	6.8	7.6	6.4	7.8	8.2	3.3	5.0	1.4	5.8
Office property and apartments	0.0	1.5	0.8	2.2	1.2	1.5	1.0	0.7	1.1
Services	0.0	2.6	1.6	2.7	1.1	0.5	0.3	0.4	1.2
Transportation and communications	41.4	51.2	39.4	24.4	19.4	16.5	10.0	1.6	25.5
Banking and finance	0.0	0.0	0.0	0.0	1.3	1.5	2.5	1.3	0.8
Culture, health, and education	0.3	1.0	1.3	1.8	1.2	1.0	1.1	1.4	1.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	...
Memorandum item									
Turnover as percent of GDP	1.9	2.3	3.8	6.9	10.2	11.5	14.2	13.3	8.0

Source: Ministry of Planning and Investment (MPI), State Bank of Vietnam (SBV); and staff estimates.

1/ MPI data, adjusted on the basis of SBV data and staff estimates and discussions with the authorities.

2/ Industrial promotion (IP) and export processing zones (EPZ).

Table II.8. Vietnam: Exports by Enterprises Established Through FDI, 1991-98 1/
(In millions of U.S. dollars)

	1991	1992	1993	1994	1995	1996	1997	1998	Average 1991-98
Heavy industries	0	0	0	0	0	0	0	0	...
Petroleum and gas	0	0	58	8	29	154	441	653	...
Light industries	0	0	0	0	0	0	15	11	...
Food industry	2	6	145	146	260	446	539	686	...
Agriculture and forestry	0	0	32	10	23	52	67	60	...
Fisheries	0	0	3	1	1	2	3	5	...
Construction	0	0	15	1	2	8	4	7	...
IP/EPZ infrastructure 2/	0	0	0	0	0	100	1	0	...
Hotels and tourism	0	0	58	48	59	102	86	68	...
Office property and apartments	0	0	3	3	0	2	3	6	...
New cities	0	0	1	0	0	0	12	5	...
Services	0	0	14	12	14	15	18	9	...
Transportation and communications	0	0	0	0	0	0	0	0	...
Banking and finance	0	0	27	9	10	9	16	15	...
Culture, health, and education	0	0	1	0	1	3	19	6	...
Total	2	6	356	238	397	893	1,225	1,531	...
(In percent of total)									
Heavy industries	0	0	0	0	0	0	0	0	0
Petroleum and gas	0	0	16	3	7	17	36	43	15
Light industries	0	0	0	0	0	0	1	1	0
Food industry	100	100	41	61	65	50	44	45	63
Agriculture and forestry	0	0	9	4	6	6	5	4	4
Fisheries	0	0	1	1	0	0	0	0	0
Construction	0	0	4	0	0	1	0	0	1
IP/EPZ infrastructure 2/	0	0	0	0	0	11	0	0	1
Hotels and tourism	0	0	16	20	15	11	7	4	9
Office property and apartments	0	0	1	1	0	0	0	0	0
New cities	0	0	0	0	0	0	1	0	0
Services	0	0	4	5	4	2	1	1	2
Transportation and communications	0	0	0	0	0	0	0	0	0
Banking and finance	0	0	8	4	2	1	1	1	2
Culture, health, and education	0	0	0	0	0	0	2	0	0
Total	100	100	100	100	100	100	100	100	...
Memorandum item									
Exports by FDI enterprises									
As percent of total exports	0.1	0.2	11.9	5.9	7.6	12.2	13.4	16.3	8.5
As percent of turnover									
by foreign-invested enterprises	1.1	2.7	73.4	23.2	19.3	33.1	33.8	45.8	29.0

Source: Ministry of Planning and Investment (MPI), State Bank of Vietnam (SBV); and staff estimates.

1/ MPI data, adjusted on the basis of SBV data and staff estimates and discussions with the authorities.

2/ Industrial promotion (IP) and export processing zones (EPZ).

Table II.9. Vietnam: Contribution of FDI to Domestic Economy, 1998 1 /

	No. of Projects	No. of Workers	Turnover In US\$ mil.	Import Value In US\$ mil.	Export Value In US\$ mil.
Heavy industries	519	40,539	1,526	639	0
Petroleum and gas	38	803	0	0	653
Light industries	574	148,755	787	542	11
Food industry	127	12,956	317	194	686
Agriculture and forestry	325	34,366	278	152	60
Fisheries	90	5,952	12	10	5
Construction	237	9,664	181	592	7
IP/EPZ infrastructure 2/	14	499	12	51	0
Hotels and tourism	187	17,534	47	175	68
Office property and apartments	143	3,576	24	114	6
New cities	3	32	0	0	5
Services	108	2,200	15	11	9
Transportation and communications	125	8,799	54	222	0
Banking and finance	32	1,237	43	14	15
Culture, health, and education	84	4,083	48	15	6
Total	2,606	290,995	3,343	2,732	1,531
	Percent of total				
Heavy industries	19.9	13.9	45.6	23.4	0.0
Petroleum and gas	1.5	0.3	0.0	0.0	42.7
Light industries	22.0	51.1	23.5	19.8	0.7
Food industry	4.9	4.5	9.5	7.1	44.8
Agriculture and forestry	12.5	11.8	8.3	5.6	3.9
Fisheries	3.5	2.0	0.3	0.4	0.3
Construction	9.1	3.3	5.4	21.7	0.4
IP/EPZ infrastructure 2/	0.5	0.2	0.4	1.9	0.0
Hotels and tourism	7.2	6.0	1.4	6.4	4.4
Office property and apartments	5.5	1.2	0.7	4.2	0.4
New cities	0.1	0.0	0.0	0.0	0.3
Services	4.1	0.8	0.4	0.4	0.6
Transportation and communications	4.8	3.0	1.6	8.1	0.0
Banking and finance	1.2	0.4	1.3	0.5	1.0
Culture, health, and education	3.2	1.4	1.4	0.6	0.4
Total	100.0	100.0	100.0	100.0	100.0

Source: Ministry of Planning and Investment (MPI), State Bank of Vietnam (SBV); and staff estimates.

1/ MPI data, adjusted on the basis of SBV data and staff estimates and discussions with the authorities.

2/ Industrial promotion (IP) and export processing zones (EPZ).

12. Finally, the impact of FDI on employment is small—the 2,600 FDI projects in operation as of end-October 1998 employed 291,000 workers (Table II.9), only 4 percent of total urban employment of 7.1 million. The average FDI project employed just 112 workers.

The regulatory framework

13. A frequent complaint by foreign investors has been the relatively high cost of doing business in Vietnam, both in terms of time needed to set up and operate foreign-invested projects, and relative to business costs in other Asian countries. As shown in the tables below, Vietnam does not fall behind its competitors in terms of incentives for attracting foreign investments.⁵ In terms of the cost of land, electricity and water, however, it does not score well. Another shortcoming of the investment environment in Vietnam is that regulations favor projects (on a positive list) that are export-oriented and import substituting. Businesses outside this positive list are required to balance their foreign exchange outlays and earnings, effectively preventing them from selling their products domestically if raw materials are imported. Furthermore, domestic producers (especially the SOEs) are protected through extensive trade restrictions (see Chapter V).

Table II.10. Foreign Investment Incentives in Selected Asian Countries, April 1997 1/

	Vietnam 2/	China	Thailand	Philippines
Profit tax	10 % 15 %	15 % 20 %	20 % 25 %	20 % 25 %
Tax holidays	2-4 years	2 years	3-8 years	6-10 years
Import duty exemption	Equipment Raw materials Kits Commodities	Equipment Raw materials Kits Commodities	Equipment Raw materials for construction	All kinds of raw materials

Source: World Bank staff estimates.

1/ Applicable to industrial and export processing zones.

2/ Government Decree of January 23, 1998 extended profit tax exemptions for certain projects to four years, and widened import duty exemptions to capital goods and raw materials not produced locally.

⁵The Foreign Investment Law of November 12, 1996 and the implementing regulations (Decree 12-CP of February 18, 1997) established tax incentives for foreign investors and decentralized the authority for issuing investment licenses (except for some investments in oil and gas, telecommunications, and construction sectors). A separate regulation (Decree 36-CP of April 24, 1997) governs the granting of tax incentives in industrial zones, export processing zones, and high-tech zones.

Table II.11. Prices of Land, Electricity, and Water for Industrial and Export Processing Zones in Selected Asian Countries, April 1997

Country	Land US\$/sq. m	Electricity US\$/KWh	Water US\$/cub. m
China	0.06-3.2 (per year)	0.015-0.037	0.02-0.06
Thailand	39.5-66.7 (for project life)	0.10	0.36
Malaysia	6.3-22.2 (for project life)	0.62	0.35-0.46
Indonesia	45.0-61.7 (for project life)	0.05	0.42
Philippine	0.20-0.24 (per month)	0.037-0.073	n.a.
Vietnam	65-150 (for 50 years) (1.3-3.0 per year)	0.08	0.45

Source: World Bank staff estimates.

III. BANKING REFORM¹

1. After a period of rapid expansion in the mid-1990s, Vietnam's banking sector has come under mounting pressure from the slowdown in growth and the deteriorating financial condition of the state enterprise sector in the past two years. In response, the authorities have taken a number of measures, including with the assistance from the World Bank and the Fund, to facilitate the necessary restructuring, and have started developing a comprehensive strategy for banking reform. This chapter first provides a background on recent monetary and banking developments, and discusses the nature of the problems facing the Vietnamese banks—which is relatively well understood—and the scope of the problems—which has yet to be fully assessed. The chapter then reviews the authorities' reform initiatives since 1998, and concludes with an outline of an approach to banking reform that builds on these initiatives.

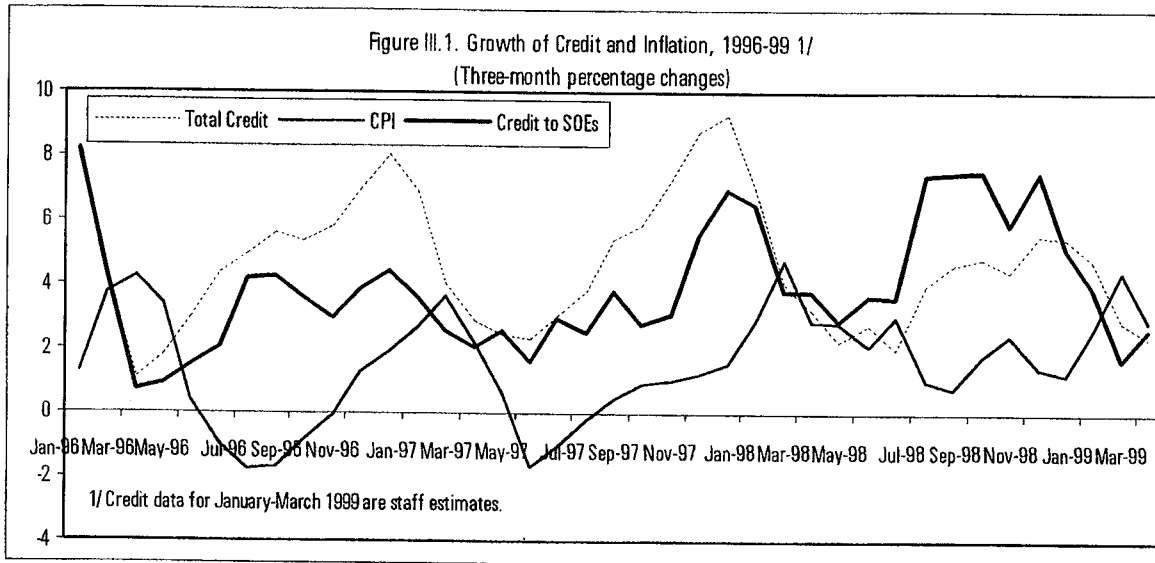
A. Economic Setting

2. Monetary and banking developments in 1998 reflected the difficult tasks facing the policy makers—containing inflation, maintaining currency stability, salvaging the joint-stock banks (JSBs), and cushioning the economy—especially the state enterprise sector—hit hard by the regional crisis that sharply slowed the growth in output, exports, and foreign direct investment inflows. Given the small number of monetary instruments available, conflicting policy objectives, and a deteriorating macroeconomic outlook, measures undertaken were not always coherent. In particular, credit policy was too accommodative, with considerable expansion in credit to the SOEs in the second half of the year pushing up inflation and potentially aggravating the financial condition of banks and enterprises.

3. Despite considerable slowdown in real GDP growth in 1998 (estimated at 3½ percent by the staff), growth of **broad money** reached 24 percent at end-1998, almost the same as in 1997, when GDP grew much faster (8¼ percent) (Appendix Table 21). Rapid expansion in **credit to state-owned enterprises** was a major contributing factor, accounting for 40 percent of broad money growth during 1998. Credit to SOEs began to accelerate noticeably in the third quarter, reaching 22 percent at end-1998, compared with an average of 15 percent in 1995–97. This expansion came at the expense of credit to nonstate-owned enterprises, which rose by just 2 percent in real terms and accounted for only a third of the increase in total credit during 1998, compared with two-thirds in 1995–97. The other major contributing factor was the increase in **net foreign assets**, resulting from an inflow of foreign currencies into the banking system (partly related to higher private transfers from abroad), and a reduction in foreign liabilities (discussed below). Reflecting slower income growth and expectations of exchange rate depreciation, the growth of dong **deposits** decelerated sharply in 1998 (to 22 percent from 38 percent a year ago), while the growth of foreign currency deposits remained strong (36 percent), even after accounting for exchange rate valuation effects (Appendix Table 22).

¹This chapter was prepared by Dubravko Mihaljek.

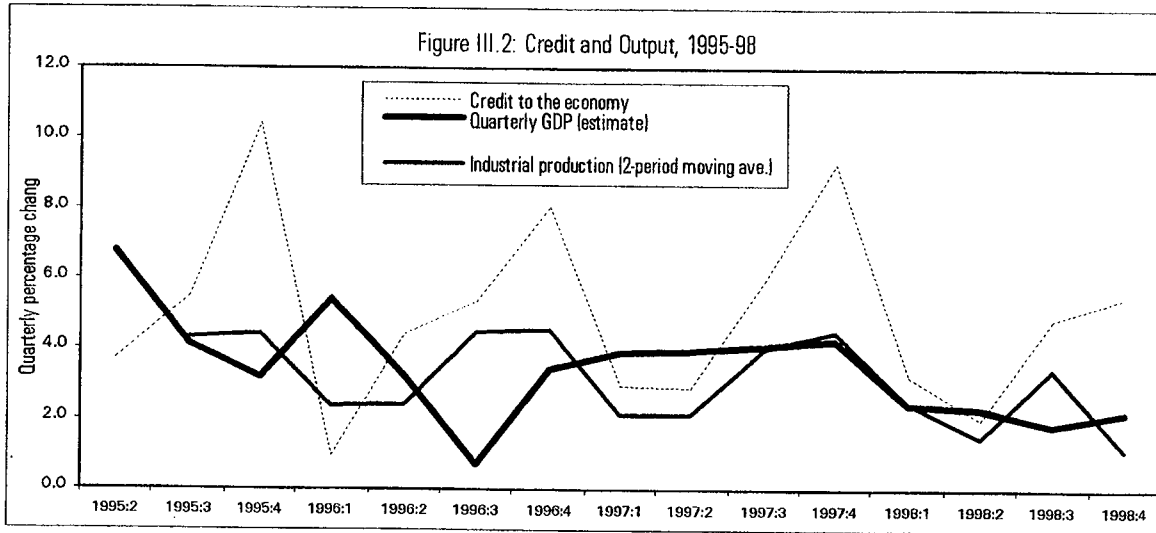
4. Rapid monetary expansion had two main macroeconomic effects in 1998. First, **credit growth and inflation** were highly correlated: changes in credit growth has tended to lead to changes in inflation within 1–2 months (Figure III.1). Faster credit growth in the second half of 1998 thus continued to push up inflation in early 1999.



5. Second, **credit growth and industrial production** were also highly correlated in 1998 (Figure III.2). However, due to the slowdown in domestic consumption, sales of SOEs have stagnated, and much of the growth in credit effectively financed the accumulation of inventories (estimated by the staff to have contributed 4½ percentage points to the real growth rate of GDP). More importantly, credit expansion failed to stimulate the GDP growth, as output in agriculture and services decelerated sharply in the second half of 1998.

6. To expand credit to the SOEs, commercial banks reduced their excess reserves (Figure III.3) and increased their borrowing from the SBV in the third quarter of 1998 (Appendix Table 23). (When excess reserves were getting depleted, the SBV reduced in February 1999 the reserve requirement to 7 percent from 10 percent of short-term deposits.) Much of the increase in SOE credit was in the form of **directed lending** and medium and long-term loans (Table III.1).² This suggests that the state-owned commercial banks (SOCBs) were encouraged to lend to the SOEs for infrastructure and similar projects in order to help the SOEs sustain production and employment in a difficult period.

²Directed lending includes construction and investment loans under state plan, and onlending of foreign grants. In addition, many loans not classified as directed are believed to be made on the basis of perceived national need rather than on strictly commercial principles.



7. On the demand side, the expansion in credit was boosted by the decline in **interest rates** on dong loans. In particular, with rising inflation, nominal interest rates relatively unchanged and a depreciating exchange rate, real interest rates on dong loans fell by over 5 percentage points to 5½ percent between January and December 1998, while the real cost of borrowing in dollars remained above 17 percent through September 1998 (Appendix Table 24); as the exchange rate has effectively been fixed since September 1998, the real interest rate on foreign currency loans dipped to negative levels in early 1999 (Figure III.4). The shift from dollar to dong loans has worked to the benefit of SOCBs, while the nonstate-owned banks (including foreign bank branches, which are the main suppliers of foreign currency loans in key urban centers), reduced their foreign currency lending in 1999 (Table III.1)

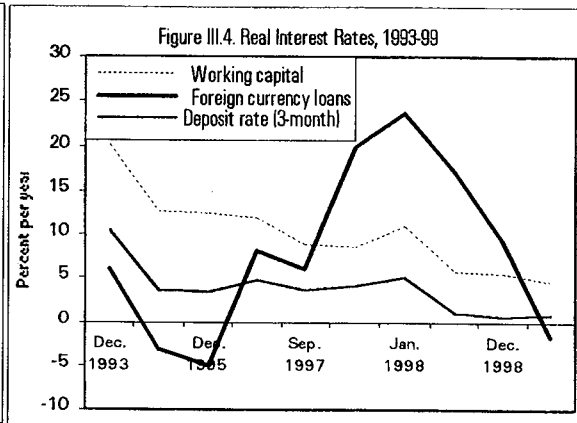
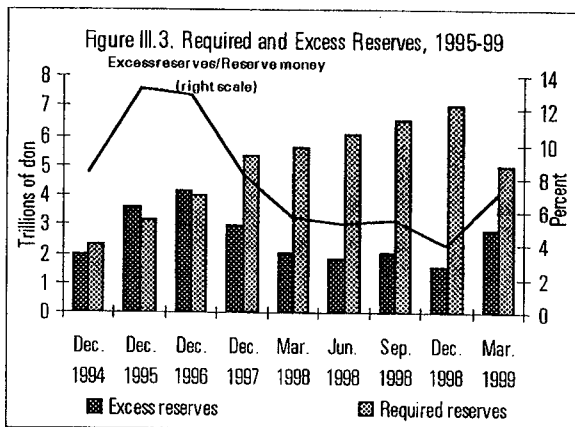


Table III.1. Vietnam: Composition and Growth of Credit, 1994-98 1/, 2/

	1994	1995	1996	1997	1998 Mar.	1998 Jun.	1998 Sep.	1998 Dec.
ALL DEPOSIT MONEY BANKS								
Credit to the economy (in billions of dong) 2/	33,345	42,276	50,744	62,201	64,267	65,673	68,877	72,596
Dong lending	20,472	25,926	32,180	42,801	45,269	47,058	49,174	54,284
Working capital loans	15,857	20,238	25,017	30,293	31,214	31,215	31,358	34,035
Medium and long term loans	2,016	3,503	4,626	9,199	10,353	11,744	13,295	15,265
Construction and investment loans under state plan	2,210	1,714	2,168	2,871	3,249	3,640	4,079	4,547
Other instruments	389	471	369	438	454	459	442	437
Foreign currency loans	12,873	16,350	18,564	19,400	18,998	18,615	19,703	18,312
Composition of credit (percent of total)								
Dong lending	61.4	61.3	63.4	68.8	70.4	71.7	71.4	74.8
Working capital loans	47.6	47.9	49.3	48.7	48.6	47.5	45.5	46.9
Medium and long term loans	6.0	8.3	9.1	14.8	16.1	17.9	19.3	21.0
Directed loans 3/	6.6	4.1	4.3	4.6	5.1	5.5	5.9	6.3
Other	1.2	1.1	0.7	0.7	0.7	0.7	0.6	0.6
Foreign currency loans	38.6	38.7	36.6	31.2	29.6	28.3	28.6	25.2
Growth of lending (annual percentage changes)								
Total credit to the economy	...	26.8	20.0	22.6	23.1	22.5	21.0	16.7
Dong lending	...	26.6	24.1	33.0	33.7	33.9	28.8	26.8
Working capital loans	...	27.6	23.6	21.1	21.6	19.3	11.5	12.4
Medium and long term loans	...	73.8	32.1	98.9	84.2	90.3	89.0	65.9
Directed loans 3/	...	-22.4	26.5	32.4	49.3	48.1	57.9	58.4
Foreign currency loans	...	27.0	13.5	4.5	3.5	0.8	5.2	-5.6
STATE-OWNED BANKS								
Composition of credit (percent of total)								
Total credit by state-owned banks	82.8	79.6	75.5	77.2	78.1	79.7	80.5	81.4
Dong lending	66.2	67.6	70.6	76.8	78.1	77.8	77.2	79.8
Working capital loans	50.2	51.4	53.4	53.1	52.8	50.6	48.1	48.8
Medium and long term loans	7.2	10.3	11.2	17.3	18.7	20.4	22.1	23.7
Directed loans 3/	8.0	5.1	5.7	5.9	6.2	6.4	6.7	7.1
Other	0.8	0.9	0.4	0.4	0.4	0.4	0.3	0.2
Foreign currency loans	33.8	32.4	29.4	23.2	21.9	22.2	22.8	20.2
Growth of credit (annual percentage change)								
Total	...	21.9	13.9	25.4	27.9	26.9	26.8	23.0
Dong lending	...	24.4	19.0	36.3	37.0	34.2	30.6	27.8
Working capital loans	...	24.6	18.5	24.7	25.6	20.6	13.1	12.9
Medium and long term loans	...	74.5	23.4	93.9	80.9	88.5	91.6	68.7
Directed loans 3/	...	-22.4	26.5	31.7	42.4	37.1	44.5	47.1
Foreign currency loans	...	16.9	3.3	-0.9	3.4	6.7	15.2	7.1
NONSTATE-OWNED BANKS								
Composition of credit (percent of total)								
Total credit by nonstate-owned banks	17.2	20.4	24.5	22.8	21.9	20.3	19.5	18.6
Dong lending	38.2	36.9	41.2	41.9	43.1	47.5	47.6	53.0
Working capital loans	36.2	35.4	37.6	35.1	35.0	37.4	37.2	41.1
Medium and long term loans	2.0	1.6	3.6	6.8	8.1	10.2	10.4	11.9
Directed loans 3/	1.4	1.1	0.8	0.8	0.9	0.9	0.9	0.9
Foreign currency loans	61.8	63.1	58.8	58.1	56.9	52.5	52.4	47.0
Growth of credit (annual percentage change)								
Total	...	50.5	44.0	14.0	8.4	7.7	1.8	-4.6
Dong lending	...	45.4	60.9	15.7	15.4	32.1	17.4	20.8
Working capital loans	...	46.9	53.2	6.4	4.0	14.0	5.8	11.8
Medium and long term loans	...	17.5	236.9	112.2	119.8	217.9	94.1	67.6
Directed loans 3/	...	15.7	9.4	11.4	6.2	0.6	7.8	7.7
Foreign currency loans	...	53.6	34.1	12.8	3.6	-7.7	-9.1	-22.9

Source: Data provided by the State Bank of Vietnam.

1/ Derived from the monetary survey data for four state-owned commercial banks and 24 nonstate-owned banks.

2/ Includes credit to state-owned enterprises, cooperatives, shareholding and limited liability companies, joint venture enterprises, and the private sector.

3/ Includes construction and investment loans under state plan, and loans by foreign grant and investment agent funds.

B. Nature and Scope of Problems

8. At the end of 1998, Vietnam's banking system consisted of four state-owned commercial banks (accounting for 82 percent of total bank assets), 51 joint-stock banks, whose shareholders include state-owned enterprises and private entities (accounting for 10 percent of total assets), and 23 branches of foreign banks and four joint-venture banks (together accounting for 8 percent of total assets).³ Total bank assets were equivalent to 38 percent of GDP at end-1998, total loans to 22 percent, and total deposits for 20 percent, indicating a relatively low degree of monetization of Vietnam's economy.

9. As in other transition economies, the problems affecting Vietnam's banking system originate in incomplete reforms of the financial sector and the SOEs. The SOCBs still account for 80 percent of loans and deposits and their lending remains subject to official intervention. Accounting practices make credit evaluation problematic; the banking supervisory framework is weak; and supervisors have difficulties in enforcing the existing prudential rules. This has especially affected the performance of the joint-stock banks, which have accumulated large nonperforming loans and short foreign currency positions due to imprudent lending and weak regulatory standards, and many are undercapitalized and suffer from serious governance problems. Banks, in turn, have been hampered in their efforts to improve accountability and transparency by the lack of appropriate accounting standards for businesses. As a result, banks find it difficult to evaluate the feasibility of projects they are asked to finance, and the value of collateral their customers have to offer.⁴ This state of affairs has left the banking system weak and vulnerable, and the regional economic crisis has further strained its fragile condition.

10. Many problems can further be traced to the poor performance of state enterprises, which are the main customers of the banks, especially the SOCBs. In particular, financial discipline remains weak, and although the SOEs no longer receive direct budgetary subsidies and real interest rates have been kept at positive levels, state enterprises receive extensive fiscal, trade, and credit privileges.⁵ A thorough reform of the SOE sector should therefore be a key complement of a longer-term strategy for rehabilitation of the financial system.

³The four state-owned commercial banks are: Vietcombank (the major foreign trade bank), Bank for Agriculture and Rural Development, Industrial and Commercial Bank, and Bank for Investment and Development; at the end of 1998, the former two banks accounted for about 22 percent of total banking sector assets each, and the latter two for about 19 percent each.

⁴This problem is especially acute for small and medium-size firms, which frequently keep very rudimentary accounts, and affects severely the joint-stock banks, which are their main lenders.

⁵The SOEs are typically allowed to roll over loans for half the length of the original maturity, or for 3–6 months. After renewing the loan once or twice, banks usually classify the loan as past due.

11. While weaknesses in accounting practices and in banking supervision make it difficult to adequately assess the true state of the banking system at the moment, the available data indicate a steady deterioration in banks' balance sheets since the mid-1990s, partly related to the loss of impetus in the reform process. The data further indicate that the most vulnerable segment of the banking sector today are the joint-stock banks (JSBs). Although their presence in most areas is small, JSBs account for more than 25 percent of banking sector assets in Ho Chi Minh City, which accounts for a quarter of Vietnam's GDP, 40 percent of foreign direct investment inflows, and over half of exports.⁶ The main problems in terms of potential risks for macroeconomic stability are contained in the following paragraphs.

Foreign exchange exposure

12. A major source of risk that emerged in the banking sector in the past two years was the default on a number of deferred letters of credit (L/Cs) by some joint-stock banks, triggering an immediate reaction from the international banking community. The ruling of the Supreme Court in July 1998 failed to enforce payment of the L/C obligations, further eroding international confidence in the Vietnamese banking system. However, over the second half of 1998, the backlog of late L/C payments was reduced by some US\$350 million to about US\$200 million at the end of 1998.⁷ The clearance of the L/Cs was reflected in the improvement in banks' foreign exchange position in 1998: the SOCBs increased their net long foreign currency position (to 160 percent of their capital), while the nonstate-owned banks, which traditionally have maintained short foreign currency positions, for the first time achieved net long positions in the second half of 1998 (Table III.2).⁸

13. Roughly 30 percent of total bank credit is extended in foreign currencies (over 50 percent in the case of nonstate-owned banks), of which over 70 percent to the SOEs (Table III.3).⁹ The exposure to exchange risk is especially large for the JSBs, which make foreign currency loans far in excess of their foreign currency deposits (Figure 5). While the SOCBs

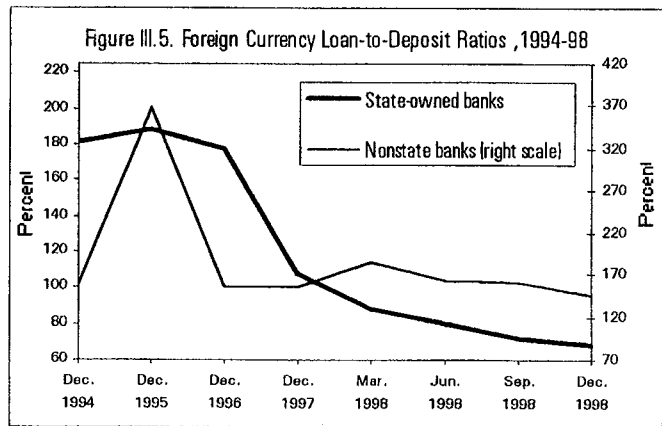
⁶Together with foreign bank branches in Ho Chi Minh City, JSBs account for 60 percent of total lending in the city.

⁷Most of these L/Cs were owed by the JSBs after their customers—who purchased goods from foreign suppliers on 12–18-month L/Cs—failed to repay the local banks. Not infrequently, the goods were delivered, sold, and the funds used to speculate in real estate, with the hope that a quick profit could be made before the L/Cs became due.

⁸An additional source of foreign exchange risk is guarantees offered by Vietnamese banks to their domestic customers; no data on the amount of guarantees are available, however.

⁹About one-third of foreign currency loans to state-owned enterprises consisted of on-lending of funds borrowed by the government abroad.

reduced their high foreign currency leverage during 1998, their indirect exposure remains very high, as the SOEs often have used foreign currency loans for domestic operations. Another concern is the continued rise in *overdue foreign currency loans* (Table III.3), a trend which could foreshadow a wave of bankruptcies, especially in the private sector, and mounting difficulties in the nonstate-owned banks that are the main lenders to the private sector.



Nonperforming loans

14. Rapid deposit growth in the banking sector in the mid-1990s has masked a significant increase in nonperforming loans. *Overdue loans* (officially classified nonperforming loans) amounted to 12½ percent of total loans (7¼ percent of total assets) at end-September 1998, compared with less than 8 percent of loans (5 percent of total assets) at end-1995 (Appendix Table 25). However, overdue loans are under-reported in official statistics on account of vague definitions and current prudential and accounting regulations, which minimize loss provisioning and allow repeated roll-over of loans. Thus, despite the high proportion of overdues, *loan loss provisions* (which are not risk-weighted) remained less than 1 percent of total loans during most of 1998, clearly not reflecting the underlying risk of loan losses (Table III.4).

- Among the SOCBs, the share of overdues in total loans varied in 1998 from 2½–5 percent for the two stronger banks, to 19–23 percent for the two weaker banks. Based on recent audits using international standards, however, NPLs at SOCBs were estimated at 30–35 percent of their total loans at end-1997 (on a weighted average basis), with a range from 17–25 percent for the two stronger banks, to 40–45 percent for the two weaker banks.

- NPLs of the nonstate-owned banks soared during 1997, largely reflecting problems with the letters of credit, and these banks have since surpassed the SOCBs in terms of the share of overdues, which stood at 17½ percent at end-September 1998. Individual banks were, however, in considerably worse shape, as illustrated by the fact that two such banks were closed by May 1998. Recently, the authorities estimated the size of NPLs at the joint-stock banks at 30–40 percent.

15. The *maturity mismatch* in the composition of assets and liabilities is another serious problem affecting banks' liquidity. Virtually all bank deposits are of less than one-year maturity, while about 20 percent of all loans have a maturity of more than one year. This maturity mismatch is in large part caused by the ceiling on lending rates, which squeezes

Table III.2. Vietnam: Open Foreign Currency Positions of Commercial Banks, 1994-98 1/

	1994 Dec.	1995 Dec.	1996 Dec.	1997 Dec.	1998 Mar.	1998 Jun.	1998 Sep.	1998 Dec.
Net aggregate long (>0) or short (<0) foreign currency position 2/								
In millions of U.S. dollars	134	144	115	217	338	460	545	753
State-owned banks	157	182	211	270	419	451	528	717
Nonstate-owned banks	-22	-39	-96	-53	-82	9	17	37
As percent of aggregate foreign assets and liabilities	11.3	9.7	6.1	12.2	18.5	25.7	31.7	38.8
State-owned banks	13.2	12.3	11.2	15.2	23.0	25.2	30.7	36.9
Nonstate-owned banks	-1.9	-2.6	-5.1	-3.0	-4.5	0.5	1.0	1.9
Net short-term long (>0) or short (<0) foreign currency position 3/								
In millions of U.S. dollars	148	280	332	385	487	629	680	785
State-owned banks	252	390	451	452	575	607	643	751
Nonstate-owned banks	-104	-110	-119	-67	-89	22	37	35
As percent of aggregate foreign assets and liabilities	12.5	18.9	17.5	21.6	26.7	35.1	39.5	40.5
State-owned banks	21.3	26.3	23.8	25.4	31.5	33.9	37.3	38.7
Nonstate-owned banks	-8.8	-7.4	-6.3	-3.8	-4.9	1.2	2.1	1.8

Sources: Data provided by the State Bank of Vietnam, and staff estimates.

1/ Derived from the monetary survey data for four state-owned commercial banks and 24 nonstate-owned banks.

2/ Foreign assets, less foreign liabilities.

3/ Deposits with foreign banks, less foreign currency deposits of nonresidents and short-term foreign currency borrowing.

Table III.3. Vietnam: Foreign Currency Lending of Commercial Banks, 1994-98 1/

	1994 Dec.	1995 Dec.	1996 Dec.	1997 Dec.	1998 Mar.	1998 Jun.	1998 Sep.	1998 Dec.
Share of foreign currency loans in total loans (percent)								
State-owned banks	38.6	38.7	36.6	31.2	29.6	28.3	28.6	25.2
Nonstate-owned banks	33.8	32.4	29.4	23.2	21.9	22.2	22.8	20.2
	61.8	63.1	58.8	58.1	56.9	52.5	52.4	47.0
Foreign currency loans by sector (percent)								
State-owned enterprises	81.3	76.3	75.8	68.8	69.1	70.8	71.0	72.2
Cooperatives	0.2	0.2	0.3	0.1	0.2	0.2	0.2	0.1
Joint stock companies	7.7	9.8	7.4	12.1	12.1	12.2	11.7	10.8
Joint ventures	4.7	11.4	14.5	17.1	16.2	14.7	14.4	15.0
Private sector	6.2	2.2	2.0	1.9	2.4	2.2	2.7	1.9
Growth of foreign currency lending								
By bank (12-month percentage change)	...	27.0	13.5	4.5	3.5	0.8	5.2	-5.6
State-owned banks	...	16.9	3.3	-0.9	3.4	6.7	15.2	7.1
Nonstate-owned banks	...	53.6	34.1	12.8	3.6	-7.7	-9.1	-22.9
By sector (12-month percentage change)	...	19.3	12.8	-5.2	-4.3	-2.5	4.4	-0.9
State-owned enterprises	...	26.7	23.7	-39.1	-27.2	-12.5	-8.8	-14.1
Cooperatives	...	62.7	-14.0	69.1	56.4	39.4	29.2	-15.1
Joint stock companies	...	210.1	44.0	23.2	13.9	-5.9	-9.7	-17.3
Joint ventures	...	-54.4	2.8	1.1	7.2	5.0	44.0	-9.3
Private sector	...	...	...	...	...	...	...	...
Share of overdues in foreign currency loans (percent)								
By bank	7.2	4.8	5.6	15.9	16.9	18.4	18.5	16.3
State-owned banks	9.5	6.6	7.2	16.3	17.5	17.9	18.0	15.4
Nonstate-owned banks	1.2	1.2	3.1	15.4	16.0	19.3	19.5	17.9
By sector	8.3	5.5	6.0	10.9	11.5	12.5	12.9	10.7
State-owned enterprises	20.0	18.4	23.4	48.9	53.0	51.8	58.1	52.8
Cooperatives	4.1	4.6	10.3	64.1	67.2	71.1	72.6	70.7
Shareholding and limited liability companies	0.0	0.2	0.5	0.9	1.2	1.9	2.7	2.4
Joint ventures	1.0	2.8	6.5	22.6	19.3	23.0	14.0	22.4
Private sector	...	...	...	...	...	...	...	...

Source: Data provided by the State Bank of Vietnam, and staff estimates.

1/ Derived from the monetary survey data for four state-owned commercial banks and 24 nonstate-owned banks.

Table III.4. Vietnam: Bank Soundness Indicators, 1994-98 1/

(In percent; end of year)

	Capital/Total Assets								Capital/Total Loans 2/							
	1994	1995	1996	1997	Mar. 1998	Jun. 1998	Sep. 1998	Dec. 2/ 1998	1994	1995	1996	1997	Mar. 1998	Jun. 1998	Sep. 1998	Dec. 2/ 1998
Deposit money banks	6.0	7.7	7.2	7.9	7.8	7.6	7.4	9.1	9.4	12.5	12.3	13.2	12.9	13.1	12.6	15.9
State-owned commercial banks	5.5	4.8	5.0	5.5	5.3	5.0	4.8	7.2	9.2	8.4	8.6	9.3	8.9	8.6	8.3	12.9
Nonstate-owned banks	7.7	25.1	14.6	16.5	17.3	18.1	18.6	17.5	10.1	28.5	23.8	26.3	27.2	29.4	30.7	29.3
	Loans/Deposits 4/								Loans/Total Assets 3/							
	1994	1995	1996	1997	Mar. 1998	Jun. 1998	Sep. 1998	Dec. 1998	1994	1995	1996	1997	Mar. 1998	Jun. 1998	Sep. 1998	Dec. 2/ 1998
Deposit money banks	146.3	127.9	122.4	110.5	109.5	101.5	100.4	...	63.2	61.4	58.9	59.9	60.5	57.7	58.3	56.9
State-owned commercial banks	148.1	136.6	125.5	108.6	105.1	99.8	97.0	...	59.9	57.0	58.1	59.1	59.7	58.4	57.8	56.3
Nonstate-owned banks	140.9	102.6	113.8	117.5	128.2	122.9	117.6	...	76.3	88.3	61.5	62.8	63.6	61.5	60.5	59.6
	Profits/Total Assets								Profits/Loans							
	1994	1995	1996	1997	Mar. 1998	Jun. 1998	Sep. 1998	Dec. 2/ 1998	1994	1995	1996	1997	Mar. 1998	Jun. 1998	Sep. 1998	Dec. 2/ 1998
Deposit money banks	0.10	0.30	0.73	0.77	1.29	1.16	0.92	0.47	0.17	0.48	1.24	1.28	2.13	2.00	1.57	0.83
State-owned commercial banks	0.20	0.39	0.85	0.75	1.19	1.10	0.85	0.42	0.33	0.68	1.47	1.26	1.98	1.88	1.48	0.75
Nonstate-owned banks	-0.27	-0.25	0.32	0.83	1.69	1.40	1.19	0.71	-0.36	-0.29	0.52	1.32	2.66	2.28	1.96	1.18
	Loan Loss Provisions/Total Loans								Loan Loss Provisions/Overdue Loans							
	1994	1995	1996	1997	Mar. 1998	Jun. 1998	Sep. 1998	Dec. 2/ 1998	1994	1995	1996	1997	Mar. 1998	Jun. 1998	Sep. 1998	Dec. 1998
Deposit money banks	0.2	0.2	0.3	0.4	0.4	0.4	0.4	1.4	2.2	3.0	2.7	3.0	3.0	3.0	2.9	...
State-owned commercial banks	0.2	0.2	0.2	0.3	0.3	0.3	0.3	1.5	1.9	2.7	2.3	2.3	2.3	2.3	2.2	...
Nongovernment banks	0.1	0.2	0.3	0.7	0.7	0.8	0.8	0.8	7.4	6.1	6.2	4.9	5.3	4.8	4.5	...

Source: Data provided by the State Bank of Vietnam.

1/ Based on the monetary survey of four state-owned commercial banks and 24 nonstate-owned banks.

2/ Reflects recapitalization of SOCBs in October 1998 through conversion of frozen loans from the State Bank of Vietnam.

3/ Excluding loans to government.

4/ Excluding government deposits.

interest rate margins and constrains the issuing of longer-term liabilities to match the longer-term assets. In addition, the *maturity structure of overdue loans* is extremely unfavorable, with well over half of nonperforming loans overdue by more than 180 days.

Capital adequacy

16. The *capital base* of Vietnamese banks is very weak. Prior to recapitalization in October 1998, Vietnam's highest capitalized SOCB had a ratio of capital to total assets of 5¾ percent (Table III.4). Nonstate-owned banks had a stronger capital base, with an average capital-asset ratio of 18½ percent, and an average capital-loan ratio of about 30 percent.¹⁰ However, the State Bank's assessment of the joint-stock banks in Ho Chi Minh City in 1998 revealed that many banks were severely undercapitalized and that much of the capital consisted of borrowed funds.

17. In October 1998, the State Bank recapitalized the four state-owned commercial banks by converting into capital the D 2.4 trillion of SBV loans to these banks, which were for the most part "frozen" since the split of the monobank in 1990.¹¹ As a result of this operation, capital adequacy of the four state-owned commercial banks improved and presently exceeds minimum legal capital requirements established by the State Bank in October 1998. According to staff estimates, adjusted capital/asset ratios are much lower, and an additional D 6.4 trillion (1.9 percent of GDP) would be needed to recapitalize the four SOCBs up to the desirable capital/asset ratios (Table III.5).¹² While the clearance of frozen debt in principle represents a welcome step,¹³ its timing is inauspicious, as it might create the expectation on the part of the SOCBs that they would be bailed out by the State Bank each time the economy and their own performance deteriorates.

¹⁰Minimum capital requirements are specified in dong (in U.S. dollars for joint venture and foreign banks), and include loan loss reserves ("reserve capital") as part of capital.

¹¹The SBV originally made these loans to the SOCBs for onlending to the SOEs. As the SOEs never repaid the loans, the SOCBs' liability to the SBV was "frozen" (the loans were nonetheless listed as credit from the SBV in the monetary accounts). The loans in question were reclassified as claims on government to recognize the latter's ultimate responsibility for recapitalization.

¹²In calculating capital deficiency, capital was adjusted by excluding existing loan loss provisions and an imputed loss equivalent to 50 percent of overdue loans, while assets were adjusted by excluding 50 percent of overdue loans as nonperforming assets. The assumption behind desirable levels of capital adequacy (10 percent of risk-adjusted assets) is that capital adequacy ratios should exceed minimum standards established under Basle principles, and should be highest for Vietcombank (i.e., 12 percent), because it is exposed to greater risk as Vietnam's major international trading bank.

¹³Under previous procedures, the Ministry of Finance, the State Bank, and local governments had to certify that such loans could not be collected. The Ministry of Finance would then cover the loss in the form of capital injections.

Table III.5. Vietnam: Capital Adequacy of State-Owned Commercial Banks, 1998

	Sep. 1998 Recapitalization		Oct. 1998		Min. legal capital 3/	Desirable capital 4/	Capital deficiency 5/
	amount 1/		Actual	Adjusted 2/			
(In trillions of dong)							
Capital	4.6	2.4	6.9	3.6	5.5	9.8	6.2
(In percent of total assets at end-October 1998)							
Capital/Assets	4.8	2.5	7.2	3.8	5.6	10.3	6.5

Sources: Data provided by the State Bank of Vietnam; and staff estimates.

1/ As per SBV Decisions on Conversion of Loans into Capital for state-owned commercial banks, October 1998.
 2/ Capital is adjusted by excluding existing loan loss provisions, and an imputed loss equivalent to 50 percent of overdue loans. Assets are adjusted by excluding 50 percent of overdue loans as of end-September 1998 as nonperforming assets.

3/ As per Decree of the Government on the Legal Capital for Credit Institutions, October 3, 1998.

4/ Based on the assumption that capital adequacy ratios should exceed minimum standards established under Basle principles.

5/ Difference between desirable and adjusted capital/asset ratios.

Profitability and operational issues

18. The Vietnamese banks' *profitability* is very low. Two of the four state-owned banks have been reporting zero profits in the past four years. The largest SOCB, which received relatively favorable reviews in international audits conducted since 1994, reported small losses in 1994-95, but its performance improved steadily, and in the first nine months of 1998 its gross return on assets averaged a respectable 0.84 percent. Nonstate-owned banks had an average gross return on assets of 1.4 percent, and a gross return on loans of over 2 percent, in the first nine months of 1998. However, many joint-stock banks faced losses.

19. Governance problems and management weaknesses in Vietnamese banks are widespread. In the present environment, it is difficult for SOCB managers to actively pursue the basic tasks of bankers in market economies (processing information about customers and investment opportunities, assessing risks through contingency-based credit appraisal, spreading risk through asset diversification, managing liquidity through active loan collection and continuous transformation of assets). This state of affairs partly reflects the undeveloped state of financial markets and inadequate legal, accounting, and regulatory framework, but it also resulted from the lack of competition in the banking industry and the predominant structure of ownership, which provides little incentives for bank managers and employees to improve their performance.

20. *Weaknesses in banking supervision and prudential regulations* contributed to the problems. In particular, the SBV's licensing criteria were not strong enough to prevent the mushrooming of weak institutions; loan classification is based primarily on the time past due rather than the loans' credit risk; the loan loss provisions until recently limited the amount of total provisions for bad loans; collateral valuation issues have not been properly addressed;

and current inspection procedures focus on statutory compliance with guidelines issued by the State Bank, rather than an assessment of capital adequacy in line with the banks' risk profiles.

C. Reforms Since 1998

21. Recognizing that the nature and scope of problems in the Vietnamese banking sector called for a comprehensive approach to banking reform, the authorities started in May 1998 to address the problems of the joint-stock banks, and have recently begun developing a strategy to restructure the large SOCBs. On a parallel track, efforts have been underway to strengthen bank legislation and upgrade the enabling environment for banking reform. A Bank Restructuring Committee, headed by a Deputy Governor of the State Bank of Vietnam, was established in early 1998 to oversee reform, particularly of the systemic risk emerging in weak joint-stock banks in Ho Chi Minh City.

Joint-stock banks

22. In mid-1998, the SBV assessed the scope of distress in 18 joint-stock banks in Ho Chi Minh City. Based on triggers that included measures of insolvency, illiquidity, and losses relative to capital, the State Bank intervened in eight banks under two different regimes: a "special control regime," under which teams from the SBV took over all key aspects of bank operations (deposits taking, however, continued); and a "special supervision regime," under which prudential oversight was strengthened in order to correct shortcomings in operations, although the existing management continued to run day-to-day operations of the banks. Two joint-stock banks that were placed under the special control regime have since been closed.

23. In early 1999, the authorities prepared a plan to reorganize all 51 joint-stock banks in Vietnam (Box III.1). Bank-by-bank restructuring plans have also been developed, allowing for the closure/merger of up to eight banks. The plan emphasizes operational reforms, debt workouts, and recapitalization (including through an increase in the foreign ownership limit up to 50 percent of bank capital). Public funds would be used sparingly for recapitalization, and under appropriate conditions for other restructuring operations. Separately, plans for a limited deposit protection scheme aimed at small depositors were prepared. In the next stage of this process, the authorities plan to develop, with assistance from the World Bank, guidelines for establishing a transparent resolution mechanism for handling troubled banks.

24. The authorities are also planning to establish an asset management company (AMC) to facilitate corporate debt restructuring and help the banks reduce the burden of nonperforming loans. The AMC would be funded mostly by the government, and would buy and sell bank loans secured by the collateral that the banks could not liquidate because of the nature of assets, lack of documents, or origin of the loans. Although auction mechanisms were piloted to sell foreclosed collateral, substantial further work is needed on collateral liquidation. A key prerequisite in this area is to improve the enabling legal environment and the functioning of the real estate markets and the court system.

Box III.1. Summary of the Restructuring Plan for the Joint-Stock Banks

In early 1999, the State Bank of Vietnam submitted to the government a plan for strengthening and reorganizing the joint-stock commercial banking system. The main elements of this plan are as follows.

Coverage

- 31 urban joint-stock banks (JSBs) (of which 18 bank in Ho Chi Minh City), and 20 rural JSBs.

Objectives

Establish banks that operate safely, provide services of good quality, have adequate capital and size, and are competitive. The SBV also recognizes the need to reduce the number of weak joint-stock banks, and improve their management and operations.

Classification

- *Group 1*—Banks with normal operations that need further improvement to become more competitive (8 urban JSBs and 12 rural JSBs);
- *Group 2*—Banks facing some weaknesses in activities or inadequate legal capital (7 urban JSBs and 3 rural JSBs). These banks are considered to be viable, but need to strengthen their operations more substantially than the JSBs in group 1, and during this period the scope of their activities must be limited;
- *Group 3*—Weak banks with high risk of insolvency and low legal capital that need to be thoroughly restructured (12 urban JSBs and 3 rural JSBs);
- *Group 4*—Banks that are insolvent and are subject to license withdrawal (3 urban JSBs and 1 rural JSBs). Two urban JSBs have already been closed.

Implementation strategy

- *Bank strengthening* (Groups 1 and 2) would include: amending the banks' charters; recapitalizing banks to conform with minimum capital requirements (the SBV proposed to raise foreign ownership in some banks to 30–50 percent); replacing management and reorganizing the work of executive, management, and supervision boards; improving the skills of staff, especially in credit operations; and improving the quality of deposit taking, credit, and guarantee operations with a view to promoting safe and sound bank practices, reducing nonperforming loans, and raising profitability;
- *Restructuring* would focus on banks in groups 3 and 4. These banks would not be allowed to carry out external payments or expand the scope of activities during the restructuring process, and if their operations did not sufficiently improve, would be subject to license withdrawal. Restructuring methods would include:
 - Mergers (which should be voluntary and would receive government support under certain conditions), and acquisitions;
 - Temporary capital injections by SOCBs and appointment of new management to restructure the operations of a JSB. The additional SOCB shares would be sold once the JSBs are restructured;
 - Placing a JSB under receivership of a strong SOCB or a JSB, to which deposits would be transferred. The receiving bank would be provided with the state funds on a temporary basis to recover debt and liquidate the assets of the bank received. Eventually, the bank's license would be withdrawn and bankruptcy proceedings initiated.
 - Placing JSBs under SBV's special control or supervision regime and revoking the bank's license.

Timetable

The plan would be implemented in two phases:

- In 1999, all JSBs would prepare restructuring plans for approval by the SBV. Banks in Group 3 would be placed under SBV's special control, and an initial round of mergers and closures would be carried out.
- In 2000, banks in Groups 1 and 2 would strengthen their operations, and the remaining banks in Groups 3 and 4 would be merged or closed.

State-owned commercial banks

25. Efforts to restructure the SOCBs are still at the early stage: international standard audits of four large banks were completed in early 1999; their frozen loans (inherited from the monobank system) were cleared in the October 1998 recapitalization exercise described above; and a general strategy for the sector, including assessments of the four large banks, was outlined in early 1999. Major weaknesses of SOCBs identified in these assessments included high risk profile of the banks' asset portfolios, low profitability, heavy reliance on lending activities and a low quality of other banking services, costly operations with a large number of staff (estimated at about 40,000 at end-1998, or about 2 percent of the total state sector employment), and inadequate internal controls and information management systems.

26. Based on these assessments, the SBV developed in early 1999 an overall restructuring plan that aims at improving the competitiveness and soundness of SOCBs, strengthening their internal operations and management, and integrating them with the international financial system. Under current thinking, the plan would include structural and operational measures, as well as debt workouts. On the structural side, the emphasis is on separating commercial and policy lending (discussed below). Operational reforms would provide for:

- Autonomy in the formulation of business plans and the distribution of revenues;
- Reorganization of management boards and boards of directors;
- Establishment of independent committees for internal control and supervision;
- Strategy for streamlining management operations and operational staff, including through staff retrenchment, which would be under the purview of individual SOCBs;
- Improvements in management information systems and accounting standards, which would be upgraded to comply with international accounting standards; and
- Improvements in management development and staff training.

27. The plan also considers various options for dealing with nonperforming loans and their macroeconomic impact, but does not make any firm recommendations in this area. As a significant step, the plan sees as necessary the selection of one SOCB for equitization on a pilot basis after the year 2000. The sales of shares would be open to strong foreign banks (under the allowable cap), so as to increase capital and gain management experience. The government is expected to approve the overall restructuring plan in the first half of 1999; subsequently the SBV would develop, with World Bank assistance, business plans for each of the SOCBs.

Policy banks

28. As part of the SOCB restructuring plan, the authorities intend to separate "policy" or directed lending from purely commercial operations. In the first, transitional stage, policy lending would continue through existing SOCBs, but would be clearly separated in the accounts of the banks. In the second stage, "policy banks" would be established as separate institutions, to be funded from the state budget, and with the precise scope of operations defined by the government. The first such bank to be established will likely be Bank for the Poor, currently an affiliate of Bank for Agriculture and Rural Development making loans to

poor farmers. In the future, if conditions permit, the authorities will consider establishing an export-import bank and an investment development bank to provide concessional loans for the promotion of exports and infrastructure construction. The remaining activities of the SOCBs would be consolidated and organized on a fully commercial basis.

Prudential regulations, bank supervision, and legal environment

29. The new Law on the State Bank of Vietnam, passed in December 1997, consolidated the existing central banking regulations and clarified authority for monetary policy. The law authorizes the National Assembly to approve monetary policy (rather than the State Bank), and assigns policy coordination to a new Monetary Policy Advisory Council.

30. The Law on Credit Institutions, passed in the same session, requires banks to adopt improved business practices. Pursuant to the two laws, the State Bank began to promulgate during 1998, with MAE and World Bank assistance, 24 new government decrees on monetary policy, foreign exchange issues, prudential regulation and supervision of credit institutions, and other key topics. Although the new prudential regulations still fall short of international standards, improvements have been made in a number of areas:

- The loan classification scheme began to reflect credit risk assessment, although it remains primarily based on the time past due of the loan;
- Banks will be allowed to establish loan loss provisions of 20–100 percent of the total value of loans classified in four different loan risk groups (previously, banks had to observe a limit on the aggregate size of loss provisions for tax purposes equal to 2 percent of total loans);
- The minimum ratio of capital to risk-weighted assets was set at 10 percent for all banks (previously, 5 percent on a nonrisk-weighted bases); the definition of a bank's capital was strengthened; and conversion of off-balance sheet items to on-balance sheet items was addressed;
- Banks will also have to observe various prudential ratios to ensure the safety of their operations, including the ratio of medium and long-term loans to short-term liabilities, and the ratio of liquid assets to short-term liabilities. The SBV was also authorized to establish limits on exposure to interest rate risk and liquidity risk;
- A draft CAMEL framework for assessing a bank's overall financial condition has been developed, covering the ratings for capital, asset quality, management, earnings, and liquidity.

31. The authorities are continuing their efforts to improve and streamline these regulations, and have also agreed to develop risk-based prudential regulations. On this basis, the SBV intends to strengthen, through a risk-based approach, its supervisory capacity in on-site inspections, off-site surveillance, and accounting and auditing. These improvements should in time enable bank supervision in Vietnam to move closer to the Basle Committee's Core Principles for Effective Banking Supervision.

32. The authorities have recognized that progress in bank restructuring also will require significant improvements in enabling legal and regulatory environment. In this area, the authorities have undertaken to strengthen the rules on bank licensing, bankruptcy (which now covers enterprises and banks under the same regime), collateral valuation and foreclosure, and the transfer of land-use rights. The need to implement international accounting standards to ensure true and accurate information on the financial condition of banks and bank borrowers has been recognized. To further this work, a new chart of accounts has been implemented by the State Bank and commercial banks as of January 1999.

D. Approach to Banking Reform

33. In recent decades, many countries have experienced banking problems requiring a major and often expensive overhaul of their banking systems (see Sheng (1996) and Sundararajan and Baliño (1991)). As in Vietnam, these problems typically had domestic causes—weak banking supervision and corporate governance, outside interference in lending decisions, inadequate capital, poorly developed financial sector infrastructure—and were exacerbated by external shocks, cyclical downturns, and domestic structural weaknesses. Countries have taken different approaches to resolving their banking crises, with differing degrees of success. Useful and fairly uniform lessons emerged, however, when countries were ranked by the success of their reform efforts, and by comparing the use of the available strategies, policies, and tools for reform (see Dziobek and Pazarbasioglu (1997)).

34. Against the background of these experiences, the authorities' reform objectives—to develop a safe, sound, and competitive banking sector that will help protect macroeconomic stability, instill financial discipline, and facilitate Vietnam's international economic integration—are highly appropriate. The prompt action to contain the problems of the JSBs, and the intention to rely on market-based instruments to develop a restructuring program also are pertinent.¹⁴ Another welcome element is the emphasis on a comprehensive approach—encompassing the JSBs, the SOCBs, and the regulatory framework—as well as the intention to coordinate banking and SOE reforms. There are, however, some additional approaches from successful experiences that are relevant for Vietnam, and could become part of a more detailed strategy of banking reform. The key approaches can be summarized as follows.

- **Diagnosis** of the nature and extent of banking problems is an important component of successful reform programs. It would thus be important to supplement preliminary assessments of the JSBs and the SOCBs with more in-depth analyses of their loan portfolios and operating practices, with a view to preparing detailed business plans for individual banks.
- **Firm exit policies** are an integral part of best practices. In order to maintain public confidence in the banking system in Vietnam, it would thus be necessary to develop an

¹⁴Country experiences show that a particularly costly alternative in terms of long-term growth is the recourse to nonmarket instruments of bank restructuring—interest and exchange controls, strengthening of state banking and directed lending to priority sectors, limiting competition, and restricting the scope of banking activities.

effective resolution mechanism for rehabilitating weak but viable joint-stock banks, and for closing the insolvent ones. Such a mechanism typically includes transparent triggers for intervention by bank supervisors; procedures on the timing and nature of actions to be taken; criteria for liquidity support and transfer of deposits to safe banks; criteria for acceptance of rehabilitation plans; and conditions for closure, merger, or rehabilitation.

● **Operational restructuring** is seen as a necessary condition for banks to improve their flow behavior and return to profitability and sustained solvency. Key elements of successful operational restructuring typically include:

- *Replacing management*, which is usually seen as one of the most important immediate steps to restore confidence, given that management deficiencies often are a major contributing cause of the banks' problems. In practice, successful banks typically used incentive measures such as closely monitored, performance-related management contracts, which define the responsibilities and the structure of incentives facing directors;
- *Formulating business plans* that focus on core products and competencies, and aim at cutting operational costs by selling off branches, reducing the number of staff, ceasing unprofitable activities, and disposing of unproductive assets (e.g., real estate investments);
- *Improving internal procedures* for credit assessment, collateral valuation, risk management and pricing, monitoring the condition of borrowers, ensuring payment of interest and principal, and active loan recovery. While the SOCBs in Vietnam already have in place such procedures, they mainly use them mechanically, in order to comply with various statutory rules, rather than as part of their own internal procedures;
- *Strengthening governance structures* by enforcing internal controls and audit, improving systems of accounting and asset valuation, and creating internal incentive structures to align the interests of managers and staff with those of the owners. For example, managers and staff should be given strong incentives to disclose the true financial condition of their banks to banking supervisors and the public;
- *Twinning arrangements*, whereby reputable foreign banks are hired to lead the operational restructuring of weak domestic banks, and prepare them for equity participation by strategic foreign partners in 2–3 years. Several state-owned banks in the Eastern European transition countries moved very quickly with reform once such twinning arrangements with foreign banks were put in place. Twinning arrangements could be particularly useful in Vietnam, given the binding nature of the human resource constraint.

● In tandem with operational reforms, banks would typically begin **restructuring nonperforming loans**, i.e., dealing with their “stock” problem.

- The priority is usually to arrest further accumulation of bad assets by *restricting certain lending operations* (for example, new lending to the heavily indebted enterprises and lending without collateral) and any injections of capital and other public resources into the state-owned banks;
 - In cases of successful bank restructuring, a portion of nonperforming loans typically was removed from the banks' balance sheets and transferred to a separate *loan recovery agency*;
 - At the same time, *loan workout* (foreclosure or asset sales) was initiated to recover some of the costs of bank restructuring and send signals to delinquent borrowers. Especially important in this area are clear legal rules on bankruptcy, land-use rights and property ownership, collateral valuation and foreclosure, as well as the use of internationally accepted standards in accounting, loan classification, and loan loss provisioning. Loan workouts can be done in a central organization, usually operated by the state, or in special loan collection units, usually established in larger banks. Such units manage and work out recoverable but overdue loans, and make realistic loan-by-loan assessments of the banks' loan portfolios. One advantage of the bank-based loan workout is that it preserves the bank-client relations—one of the most valuable assets in banking—and makes it easier to rehabilitate these relations once the problem loans are repaid. Banks also develop valuable asset resolution skills and assume the responsibility for solving the problem of nonperforming assets;
 - The potential *size of the bad loan problem and the cost of its resolution* need to be carefully and repeatedly assessed, and different financing options examined, so that this operation does not threaten macroeconomic stability.
- **Recapitalization** is typically the last step in the restructuring process. Once the balance sheets have been cleaned up and operations substantially improved, state-owned banks can be successfully recapitalized, and their commercial operations prepared for partial or full privatization.
 - **Private equity participation** in state-owned banks worked well in many countries. More generally, experience from a wide range of countries indicates fairly unambiguously that the goal of developing a sound and efficient banking sector historically could not be accomplished within predominantly state-owned banking systems (see Roulier (1997)). In particular, private ownership that seeks commercial profit lends itself more easily to good governance than does state ownership. From a regulatory perspective, private ownership also offers a separate potential source of capital without tapping fiscal resources. By contrast, state ownership contains significant risks, including:
 - Resources are being wasted trying to recapitalize and restructure banks rather than opening the banks to private equity participation;
 - Conflicts of interest for the state as owner, regulator, depositor, borrower, monetary authority, tax authority, and employer (including to insolvent and unviable bank borrowers) are virtually impossible to avoid;

- Skill sets and compensation schemes in state-owned banks do not provide incentives to maximize the return on invested funds;
- In terms of the **market structure of banking industry**, international experience suggests that competitive and efficient banking systems are characterized by a relatively small number of banks, none of which has dominant market power, supported by a firm financial regulatory framework. The overall number of commercial banks and market power of individual banks thus are typically reduced as a result of bank restructuring, while prudential regulations, banking supervision, and the accounting, regulatory, and legal standards are upgraded to comply with the current international practice.
- Finally, establishing a **level playing field between different types of banking institutions** has fostered competition and standardization of banking services, and has helped achieve efficient market outcomes in areas that were traditionally dominated by the state-owned commercial banks. In particular, many countries established a level playing field for foreign banks in the areas of capital requirements, collateral rules, banking supervision, access to the secondary market, and the lender of last resort facilities.

35. While the government's reform agenda to be accomplished remains large, the progress made in bank restructuring since 1998 is encouraging. Another encouraging sign is that commercial banks themselves are beginning to adjust to a more difficult operating environment. Credit approval procedures are being reinforced more firmly, and closer loan monitoring has become common. Efforts are also being made to address the maturity mismatch between banks' assets and liabilities by issuing bonds and offering long-term deposits. Local banks have broadened their loan portfolios to include private, small and medium-size firms, and small market traders, while foreign banks have expanded their customer base and lending in local currency.

References

- Dziobek, Claudia, and Ceyla Pazarbasioglu (1997), "Lessons and Elements of Best Practice," in William E. Alexander et al., *Systemic Bank Restructuring and Macroeconomic Policy* (Washington: International Monetary Fund).
- Roulier, Richard P. (1997), "Governance Issues and Banking System Soundness," in Charles Enoch and John H. Green, *Banking Soundness and Monetary Policy* (Washington: International Monetary Fund).
- Sheng, Andrew (1996), *Bank Restructuring: Lessons from the 1980s* (Washington: World Bank).
- Sundararajan, V., and J.T. Baliño (1991), *Banking Crises: Cases and Issues* (Washington: International Monetary Fund).

IV. STATE-OWNED ENTERPRISES: PERFORMANCE AND REFORM¹

1. The tentative approach to structural reform and the recent severe external shocks have substantially increased the threat of state-owned enterprises to Vietnam's macroeconomic stability and potential for sustainable growth. The inability of state-owned enterprises to address long standing problems to declining demand, despite the tightening of administrative controls, has led to widening of the quasi-fiscal deficit. This underscores the need to speed up state-owned enterprise reform and expose enterprises to greater competition. The next section reviews the recent financial performance of SOEs and the following section reviews recent reform efforts, especially equitization. The final section proposes a reform agenda with complementary actions on private sector development and the social safety net. The appendix compares China and Vietnam's reforms to SOEs and illustrates that in many aspects Vietnam's reforms have lagged China's reforms.

A. Recent Performance of State Enterprises

2. Despite their long standing problems, SOEs continue to play a leading role in the economy. The SOE sector accounts for about 30 percent of GDP, 20 percent of total investment, 15 percent of nonagricultural employment, and about one half of outstanding domestic bank credit, with dominant shares in the production of oil, cement, chemicals, and steel. The SOE sector is highly concentrated, with the 200 largest SOEs accounting for 60 percent of state capital and 40 percent of total debt (Table IV.1).

Profitability

3. In order to better assess the enterprises, the Ministry of Finance has developed a reporting system to classify enterprises by financial performance. Based on the reports of 5,429 enterprises (out of a total of about 5,800), SOEs were classified into profitable, temporarily loss-making and permanent loss-makers. Profitable enterprises were classified as enterprises that not only reported profits in each of the last three years, but also paid to its workers at least the average salary of the sector, paid its debts, taxes, and social and health contributions in full and avoided arrears, and made appropriate provision for depreciation. Conversely, permanent loss-making enterprises were defined as those without a stable market for their products, were making losses for more than two years, and whose accumulated losses and bad debts amounted to more than 75 percent of the state capital in the enterprise.

4. It should be noted that the above financial criteria are relatively weak and have enabled many more enterprises to be counted as profitable, than, say, requiring a minimum return on capital. Also, because these criteria were set out in general terms and required consideration of several variables, the provincial level governments interpreted these criteria for classification according to their specific situation. Thus, these figures and the classification of

¹This chapter was prepared by Jong-Won Yoon, Peter Winglee, and Timo Väilä.

enterprises have to be treated with considerable caution, pending the development of more rigorous criteria.

5. The results of this exercise, based on data for 1997, indicated that 40 percent of the enterprises were profit-makers; 44 percent were temporary loss-makers, and 16 percent of the group were permanent loss-makers. The corresponding shares of labor force in the three categories were 58 percent, 33 percent, and 9 percent (Table IV.2). Central government administered enterprises seemed to perform slightly better than locally administered ones.

6. Some key characteristics of profitable and unprofitable enterprises are depicted in (Figures IV.1 and IV.2). The profitable enterprises have considerably less debt relative to both assets and equity than the unprofitable ones, and have negligible bad loans. Permanent loss-makers have 30 percent of their short-term loans overdue. The ratio of bank debt to fixed assets was below 50 percent for profitable enterprises, but around 90 percent for permanent loss-makers. While profitable enterprises were more labor-intensive than unprofitable ones, they were markedly more export-oriented as exports accounted for more than a third of their sales, while temporary and permanent loss-makers exported 10 and 2.5 percent of their output, respectively. Labor productivity in profitable enterprises was 64 percent higher than in unprofitable enterprises, with both temporary and permanent loss-makers recording approximately the same level of labor productivity.

7. Unprofitable enterprises (temporary or permanent loss-makers) were geographically concentrated in three provinces. Roughly a third of all unprofitable enterprises, accounting for 40 percent of the sample's workforce, were located in the provinces of Hanoi, Ho Chi Minh City, and Haiphong. Notably, the unprofitable enterprises in these three provinces accounted for nearly half of all debt in the sample.

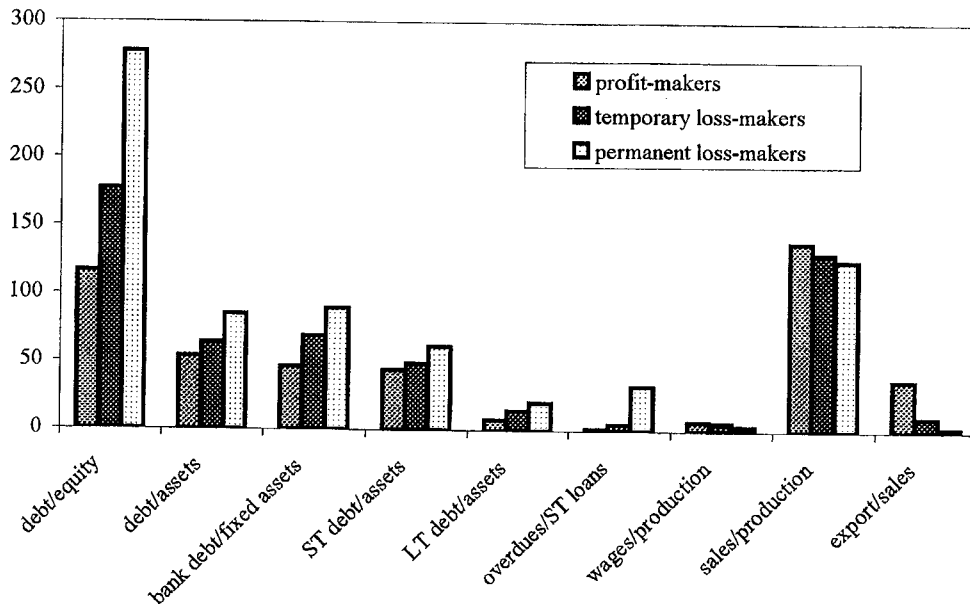
8. Based on the available data, it appears that larger enterprises perform better than smaller ones. About 90 percent of the 200 largest enterprises showed positive pretax profit, compared with 75 percent for the whole sample. However, the better performance by larger enterprises may be due to their monopolistic position as well as preferential treatment in business operation, including financing and import protection.

Indebtedness

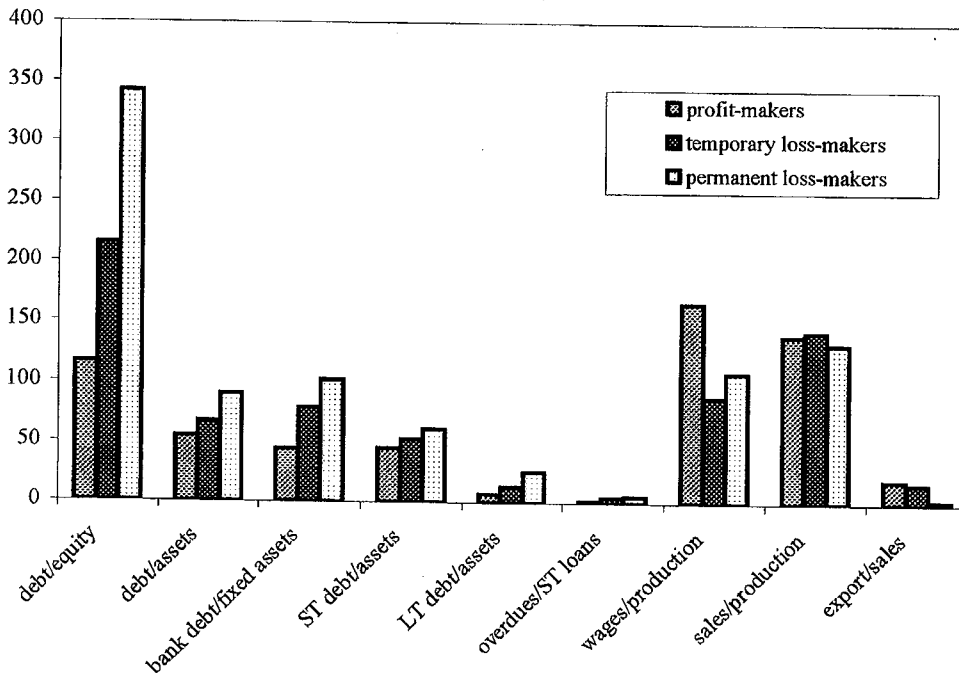
9. As shown in Table IV.1, the indebtedness of the state enterprises at end 1997 was very high. On the average, the state enterprises are shown to have larger debt than equity. The average debt-asset ratio for a sample of 1,044 large enterprises is 0.61, and for about two-thirds of the sample ratio is higher than 0.5.² Generally, the larger enterprises have lower debt-

²Since the debt to asset ratio was calculated as debt/(debt+equity), an enterprise with a debt asset ratio above 0.5 has more debt than equity.

**Figure IV.1. Vietnam: Characteristics of SOE Profitability
(In percent)**



**Figure IV.2. Vietnam: Characteristics of SOE Profitability
Central government enterprises
(In percent)**



asset ratios, for example, 48 percent for the 100 largest SOEs had debt-asset ratios under 0.5, compared with 66 percent in the whole sample.

10. The indebtedness of the sample enterprise was fairly concentrated: the 50 most indebted enterprises accounted for more than 60 percent of the total debt of the group of 1,044 enterprises. These 50 most indebted enterprises were from several sectors, including food, power, textiles, transportation, cement, construction, steel, trading, petrochemicals, and coal. Food and power-related enterprises each had the most indebtedness, with each accounting for about 24 percent of the group's total debt, followed by textiles (13 percent). The debt stocks of approximately half of the 50 exceeded their annual gross sales; particularly high debt-turnover ratios were recorded in food and construction sectors, and only 8 of the 50 enterprises had debt stocks less than their fixed assets.

11. During 1997, 13 of the 50 most indebted enterprises increased their total outstanding debt by 50 percent or more. In almost every case, the main source of indebtedness was the domestic banking system, and only two of the 13 enterprises accumulated more debt from outside the banking system.

Developments in 1998

12. The situation in the state enterprise sector appears to have deteriorated markedly since end-1997 in terms of both performance and indebtedness, although enterprise related data are not available to Fund staff. Domestic and foreign demand have fallen sharply, as indicated by the sharp decline in the growth of real GDP growth, exports, and foreign direct investment. Anecdotal reports also suggest that stocks of key commodities such as steel and cement increased sharply. The continued production in the absence of demand was financed through accelerated lending through the banking system; credit to SOEs grew by 22 percent in 1998, compared with 11 percent for other sectors.

B. Recent Developments in Enterprise Reforms

13. Enterprise reforms during the 1990s progressed extremely slowly. After mergers and a rationalization of the enterprise sector in the late 1980s and early 1990s,³ the SOE reform program tapered off. The process of equitization (the conversion of SOEs into joint stock companies) was launched in mid-1992, but by end 1997 only 17 enterprises were equitized. This slow pace reflected the weakened pressure for reforms, especially with large inflows of foreign direct investment; concerns of workers and management about their jobs; concerns of local governments over losing revenue sources; and the lack of a well articulated framework for equitization and valuation.

³The number of SOEs was dramatically reduced from 12,000 to 6,000 in 1989-92 through mergers and some closures.

Developments in 1998 and early 1999

14. In early 1998, as a result of a review of the SOE reform program, especially equitization, and recognition of the need to advance the reform process in response to the regional crisis, several initiatives were taken:

- Decree 20 (April 1998) was issued that set out the main policies to guide the restructuring of enterprises to accelerate modernization and integration into the international economy. In particular, it set out the framework for classifying in terms of plans for ownership diversification, and stipulated that chronic loss-making enterprises should be divested or liquidated.
- A decree clarifying and simplifying the equitization process was issued (Decree 44, June 1998) (see below).
- Equitization targets were announced for 150 enterprises by end 1998, 400 by end 1999, and 1000 by end 2000.
- The National Enterprise Reform Committee (NERC) was set up in June 1998 under the chairmanship of the Deputy Prime Minister responsible for the SOE sector, as a national level organization to tackle SOE reforms.
- A program of complete divestiture of small enterprises (with capital less than VND 1 billion, \$70,000), either by tender, or complete sale to employees, was announced but the regulations have not yet been issued. Approximately 1,500 enterprises may fall into this category.
- The further refinement of economic and financial criteria used by the Ministry of Finance to classify SOEs (the aggregate data from this exercise was used in Section A above).
- A review of the large general corporations (large groups of SOEs in the same sector) was conducted in early 1999. Although it noted many deficiencies with the performance of general corporations, and especially the low productivity, high costs, and tendency to monopoly, it called for the maintaining and strengthening of the general corporations and the development of plans to form conglomerates on a pilot basis.

15. Despite these initiatives, actual reforms continued to move slowly, and the deterioration in the financial position of the SOEs in 1998 was mainly addressed by more bank credit and tighter trade controls. The financial criteria used to classify enterprises were relatively weak and gave an optimistic picture of enterprise profitability. Also, the financial criteria were not fully incorporated into the framework for making enterprise specific reform decisions and local governments were able to make extensive use of other considerations in

developing their reform proposals. The approach, especially by general corporations, of trying to improve profitability by restricting domestic and foreign competition, has not produced improvements in enterprise efficiency.

Equitization arrangements

16. As described in Decree 44 (June 1998), which provides the latest framework for equitization, the process aims at mobilizing capital from domestic and foreign sources to develop and improve the competitiveness of enterprises, and change the structure of SOEs. The essential features of this framework are described in the following paragraphs.

17. All SOEs may be equitized, except for the following:

- Enterprises not eligible for equitization comprise enterprises producing explosives, radioactive, or toxic chemicals, printing money, and operating the main components of communication networks.
- The state will continue to hold dominant shares in “strategic” enterprises, comprising: public service enterprises with capital in excess of VND10 billion (about \$0.7 million); enterprises in large-scale mineral and petroleum exploitation; and production of fertilizers, petrochemicals, tobacco, alcohol, and pharmaceutical products; aircraft repair; large-scale electricity production, transmission, and distribution; post and telecommunication services; rail, sea and air transport; printing and publication; and investment banks and banks for the poor;

18. All legal entities, citizens (resident and nonresident) and foreign residents may purchase shares, subject to the following limitations:

- Employees may purchase a maximum of 10 shares (all shares have a face value of VND 100,000) each for year of employment at a discount of 30 percent, subject to an overall cap of 20–30 percent of such shares in the total capital. Poor employees may pay for their shares by installment.
- In equitized enterprises with controlling or special state shares, no legal entity can hold more than 10 percent, and an individual, not more than 5 percent of the shares.
- In equitized enterprises where there are state held shares (but not a controlling interest), legal entities may hold up to 20 percent, and individuals up to 10 percent. The limits on shareholding may be adjusted by the approval of the supervising agency.
- In enterprises without state shares, there are no limits on the size of shareholdings, but under the Law on Companies there must be at least seven shareholders.

- Foreign shareholdings will be subject to forthcoming regulations, and the overall limit of 30 percent.⁴

19. Other main features of the framework for equitization in Decree 44 include the following:

- Equitized enterprises continue to receive preferential tax and trade policy treatment as well as bank credit on the same preferential terms as SOEs.
- The process of equitizing an enterprise is designed and implemented by a committee comprising the management of the enterprise, and the local party secretary and chairman of the trade union.
- Equitized enterprises are not permitted to involuntarily lay-off workers during the 12 months after equitization. However, voluntary separation packages can be offered at the consent of the labor union, and early retirements are frequent. Involuntary separations are permitted after 12 months.
- Proceeds from the sale of state shares (net of equitization costs) have to be used for retraining employees, redundancy allowances; or providing additional capital to certain priority enterprises. Currently, some VND 60 billion (about \$4.3 million) in equitization receipts have been accumulated, pending the establishment of an extrabudgetary fund.

Recent experience of equitization

20. Under the revised guidelines, about 130 enterprises were equitized between end 1997 and March 1999. This included a few relatively large enterprises (valued at about \$1 million), and four have sold some shares to foreign investors.

21. Despite the improvements to the equitization process, many limitations remain:

- Supervising ministries, and especially general corporations remain reluctant to submit enterprises, especially valuable and profit-making ones, to the equitization process because of a loss of influence. Managers are also reluctant to have their performance subjected to the scrutiny of outside shareholders. Thus the key parties in the process have little incentive to promote equitization.

⁴A higher percentage would require the formulation of a joint-venture. Share purchases by foreign investors will be limited to certain sectors, including garments, agriculture and aquaculture, consumption goods, road transport, and hotels and related services.

- The improvement in corporate governance from equitization has not been particularly large. The dominance of the current management in the equitization process limits the potential for management reform. In some cases, equitization plans have resulted in insider control being formalized and assets transferred to managers and workers at well below market costs.
- The caps on shareholdings prevent the emergence of strategic shareholders limiting the potential for domestic and foreign shareholders to contribute management and technical expertise, and capital.
- The residual state shareholding, even in cases where a dominant state share is not envisaged, and the retention of SOE preferential treatment after equitization, blurs the distinction between equitized and nonequitized enterprises.
- The valuation and equitization procedures remain cumbersome and slow.

Economic impact of equitization

22. The economic impact of the equitization process has remained small, both because of the slow pace of equitization and because of the privileges that enterprises and their employees continue to enjoy after equitization. From the macroeconomic viewpoint, the small number of equitized enterprises, and their relatively small size means that their impact on factor markets as well as fiscal and quasi-fiscal policies have been very small.

23. The microeconomic benefits, notably improvements in productivity and technical efficiency, are customarily associated with equitization, but empirical evidence remains mixed. A 1994 study conducted by the Japanese Overseas Economic Co-operation Fund examining the earlier reforms concluded that enterprise-specific factors (managerial autonomy, sector, size, degree of competition) were more important than the ownership structure in explaining enterprise performance. A more recent study by the World Bank covering 14 out of the 17 enterprises that had been equitized by early 1998 found that equitized firms showed revenue and profit growth and those equitized in earlier years showed remarkable growth. However, the good performance was found to be largely attributable to very favorable initial conditions. Indeed, initial profitability, small indebtedness, and the absence of redundant workers were cited as key to the firms' passage through the equitization process.

24. Although equitization could contribute to the development of financial markets by providing equities that could be traded in the stock exchange, this has not happened. The legal base for stock exchanges in Hanoi and Ho Chi Minh City have been established, but very few companies are expected to be eligible for listing. This partly reflects the lack of reliable (audited) financial accounts of enterprises, as well as minimum size requirements that rule out the bulk of equitized enterprises.

C. Reform agenda

The need for reform

25. Both in relation to the magnitude of SOE problems and the speed of reform in other countries, the pace of enterprise reform in Vietnam has been very slow. Chapter III on banking reform has noted the direct relationship between their problems and those of SOEs. Section A of this chapter reported the high percentage of loss making and highly indebted SOEs, even before they were fully hit by the impact of the Asian Crisis. Other transition economies, when faced with such problems have embarked on more aggressive reforms. Most of these countries have made extensive use of privatization to improve the performance of enterprises, and a recent study points to the importance of ownership changes, complemented by reforms to promote private sector development, as the key to improving the efficiency of the enterprise sector.⁵

26. In China, which like Vietnam is making the transition to a market economy while maintaining its political system, the pace of SOE reform has been somewhat faster than Vietnam. Although some limited reforms to Chinese SOEs were made during the 1980s, reforms did not begin in earnest until the early 1990s, but thereafter the pace increased steadily. The relative size of the SOE sector in China has shrunk to much lower levels, and major progress has been made in the corporatization the largest enterprises, about half of which have many multiple shareholders and most of these are listed on stock exchanges. Major progress has also been made in divesting the smaller enterprises. Most recently, the constitution has been amended to give the private sector equal status to the state sector. A more detailed comparison is given in the Appendix.

Key reform policies

27. As the mounting need of SOEs for quasi-fiscal support is a major threat to macroeconomic stability and the banking system, strong action needs to be taken to address the financially-troubled enterprises:

- The first priority is to identify the most troubled large enterprises and take corrective actions to improve their operations using the full range of policy options, including restructuring, divestiture or the diversification of ownership, or liquidation of unviable enterprises (see Box IV.1 on the Bulgarian experience). In particular, steps will have to be taken to ensure that the liquidation process is made effective.

⁵Oleh Havrylyshyn and Donal McGettigan (1999) *Privatization in Transition Countries: A Sampling of the Literature*, WP/99/6.

- Enhanced, continuous monitoring of the performance and indebtedness of the largest enterprises needs to be rapidly instituted so as to allow a quick response to emerging difficulties.
- More generally, a comprehensive action plan is needed for the entire state enterprise sector, including the classification of all state enterprises according to financial criteria and policy options designed appropriately, especially restructuring, full/partial divestiture, or liquidation.

28. Further improvements in the equitization program can contribute to this reform. Reducing the role of enterprise management in the design and implementation of the equitization process, especially for larger enterprises, will reduce the insider domination. Removal or at least increasing the caps on equity stakes to a majority level will enable the development of strategic shareholdings. Reducing the size of the state share after equitization will also help equitized enterprises free themselves of state influence. Dedicating the equitization fund to assistance for redundant workers rather than state investment will also enable reform to be sped up.

29. In addition, programs for the rationalization of general corporations in order to promote efficiency and competition should be developed. Pilot projects for this restructuring are being developed, and the general corporations should be required to submit a significant number of enterprises for equitization and other forms of ownership diversification. The divestiture of the smallest enterprises should proceed as rapidly as possible.

Complementary reforms

30. There is now an increasing awareness that in order for SOE reform to be fully effective, positive steps have to be taken to promote the private sector. Key measures in this regard include facilitating the entry of business into a full range of sectors. Business registration and licensing are particularly burdensome. Currently, the dominant state-owned enterprises as well as the relatively few equitized enterprises enjoy significant privileges, including preferential access to credit, tax concessions, and trade policy privileges. To level the playing field, the budget constraints of state-owned and equitized enterprises will have to be hardened and competition, including from imports, promoted.

Social aspects

31. The restructuring of state-owned enterprises will unavoidably entail lay-offs. Estimates about excess labor in state-owned enterprises suggest this is at least 25 percent of their total labor force. An acceleration of the state enterprise reform process will have to be accompanied by a strengthening of the social safety net. Although Decree 176 contains provisions for income support, training, and subsidized credits for those laid off in the restructuring process, laid-off workers typically fall outside the formal social security. For example, medical insurance is dependent on employment, and an unemployed person must

meet strict criteria for exemptions from or reductions of hospitalization and other fees. Furthermore, those having contributed to the pension system for less than 20 years receive a lump sum payment upon separation, and only those having contributed for more than 20 years retain their eligibility for old-age pension upon retirement. Better designed social safety nets need to be established for retrenched workers, including improved severance payments, training and micro-credits, to facilitate labor mobility in enterprise reform.

Box IV.1. State Enterprise Reform and "Isolation List" in Bulgaria since 1996

Following deep-rooted problems in the state enterprise and banking sectors, Bulgaria embarked on a structural reform program in the context of the 1996 Stand-by Arrangement and World Bank's Structural Adjustment Loan (SAL). Soft budget constraints and weak corporate governance in both state enterprise and banking sectors had led to quasi-fiscal deficits corresponding to 4-5 percent of GDP. Widespread losses among state enterprises led to problems in the banking sector, with almost 75 percent of the banking system's credit to the economy considered to be nonperforming. These structural problems, together with large external debt service obligations, triggered confidence crises in the banking sector and in the currency, which were to be arrested by the 1996 economic program. The financial problems in the banking and state enterprise sectors was addressed under the SAL.

The main mechanisms to achieve financial discipline were liquidation or isolation from the banking system of the largest loss-making state-owned enterprises. The closure of 64 enterprises, whose losses were equivalent to 1.5 percent of GDP in 1995, was effected prior to the approval of the arrangements. Moreover, banks were prohibited from lending to any borrower with payments more than three months overdue and to any enterprise on the "isolation list". The isolation list consisted of some 70 loss-making state-owned enterprises, which accounted for losses corresponding to 2.8 percent of GDP in 1995. Conditional on them implementing cost-cutting and downsizing measures as well as a financial recovery program, these enterprises received a temporary moratorium on their debt service to domestic banks so as to demonstrate their ability to operate in a cash-flow regime without accumulating arrears.

At the end of the isolation period, which was not to exceed one year, the enterprises on the isolation list were to be either privatized or liquidated. However, it was recognized that a large number of enterprises on the isolation list would never be liquidated as they provided essential services, including electricity, heating, and transportation. Although these enterprises were allowed to receive limited subsidies from the state budget and privatization proceeds, they had to adopt strong cost-cutting measures and adjust administered prices to match their cash expenditures with their cash revenues.

The isolation program is expected to stretch until mid-1999, when also the remaining 15 "non-essential" enterprises on the original isolation list will have been liquidated or privatized. Restructuring of the "essential" enterprises, including utilities and monopolies, needs to be strengthened further before financial viability is achieved. Their access to bank credit continues to be limited, and they still receive budgetary subsidies to cover their losses.

References

- Havrylyshyn, Oleh and Donal McGettigan (1999) *Privatization in Transition Countries: A Sampling of the Literature*, WP/99/6.
- International Monetary Fund, *People's Republic of China—Selected Issues* (SM/98/184, July 15, 1998)
- National Committee for Enterprise Management Reform (1998). *Guideline Instruments on Equitization in Vietnam* (Hanoi Statistics Publishing House).
- OECD: *State-Owned Enterprise Reform in East Asian Transitional Economies* (China and Vietnam). OECD Research Papers. No. 24, September 1998 (Tokyo: OECF).

Table IV.1. Summary of Financial Conditions of SOEs, 1997 1/

	Largest 100 2/	Largest 200 2/	Large 1,044	Total
(In billions of dong)				
1. Asset, capital and turnover				
Total state capital	40,492	44,332	50,130	73,075
(Average)	405	222	49	13
Total fixed assets (FA)	62,548	67,354	78,194	...
(Average)	625	337	76	...
Total turnover (TR)	56,523	77,644	116,363	267,523
(Average)	571	392	115	49
Total taxes and contributions to the budget	14,094	15,651	18,409	23,919
(Average)	141	78	18	4
2. Debt				
Total debt	29,369	40,237	64,511	101,439
(Average)	294	201	62	19
Total bank loans	13,544	18,286	30,573	...
(Average)	167	118	38	...
3. Profit/loss				
Total profit before tax (EBT)	3,725	4,942	5,658	8,177
(Average)	38	25	7	2
(Number of SOEs with positive profit)	89	180	773	2,196
4. Selected financial indicators				
Debt-asset ratio (DER) 3/	0.47	0.52	0.61	0.58
(Number of SOEs with DER>1/2)	48	111	690	...
Gross pretax margin (GMAR=EBT/TR)	6.1%	7.5%	2.5%	3.1%
(Number of SOEs with GMAR>10%)	23	40	73	...
(Number of SOEs with 0<GMAR<10%)	66	140	700	...
Fixed assets turnover ratio (TR/FA)	7.07	7.71	7.72	...

Source: Data provided by the authorities, and staff calculations.

1/ The data are from two sets. The first three columns are derived from the report on 1,044 large subsidiaries of general corporations with independent accounting systems. The last column is derived from the aggregated data set of all available 5,429 SOEs. Note that some of the variables have been derived from the source data with inconsistent classifications, and the comparisons need to be interpreted with caution.

2/ Sorted according to the size of the state capital.

3/ The DER is the total debt divided by total assets (proxied by debt plus equity). DERs above 1/2 indicate that debts are greater than equity.

Table IV.2. Key Financial Ratios of State Enterprises, 1997 ^{1/}
(In percent)

	Number of SOEs	Debt/ Equity	Debt/ Assets	Short-ter Debt/ Assets	Long-term Debt/ Assets	Overdues/ Short-ter Loans	Bad Debt/ Receivable	Salary/ Production Value	Average Number of Workers	Labor Productivity (mill. dong)	Sales/ Productio Value	Export/ Sales	Actual Profit tax/ Profit
I. Total	5,429	138.8	58.9	46.5	10.2	5.9	4.9	6.0	293	124	135.6	28.7	32.6
Profit-making enterprises	2,196	116.7	53.9	44.1	7.4	1.4	1.1	6.6	423	148	138.4	36.8	31.7
Temporary loss-making enterprise	2,393	176.6	64.1	48.4	14.3	4.8	6.9	5.8	222	90	130.1	10.0	49.0
Loss-making enterprises	840	278.0	84.9	61.4	20.4	32.6	26.4	3.1	158	89	125.1	2.5	20.9
II. Central Enterprises	1,593	139.3	59.5	47.8	9.5	2.6	3.3	6.7	554	140	139.3	17.8	29.8
Profit-making enterprises	739	116.2	54.8	45.3	7.1	1.5	0.8	7.4	783	166	139.1	19.1	29.9
Temporary loss-making enterprise	659	214.7	67.3	52.8	13.5	4.1	5.8	6.4	367	88	142.2	16.3	28.4
Loss-making enterprises	195	342.0	89.9	61.2	25.7	5.3	22.7	2.2	315	108	132.2	2.7	19.9
III. Local Enterprises	3,836	138.0	58.0	44.3	11.3	11.1	8.0	5.3	185	104	129.3	48.4	41.4
Profit-making enterprises	1,457	117.9	51.8	41.1	8.0	1.2	1.9	6.1	240	120	136.6	77.8	38.0
Temporary loss-making enterprise	1,734	148.7	61.1	44.2	15.0	5.6	8.0	5.3	167	91	120.4	4.0	65.8
Loss-making enterprises	645	227.9	79.7	61.6	14.9	63.2	30.1	4.3	111	73	116.0	2.1	23.9

Source: Data provided by the authorities

^{1/} Financial ratios are based on the data from 5,429 enterprises which were compiled and classified by the provincial branches of the Ministry of Finance.

Comparison on Main Aspects of Enterprise Reforms in China and Vietnam	
China	Vietnam
<p>1. Overview of the SOE sector</p> <p>View of the state sector China undertook market-oriented reforms in order to stimulate economic growth rather than transform its economic system, and has taken a pragmatic approach in SOE reforms. The constitution has just been amended to give an equal role to the private sector.</p> <p>Size of SOEs There are about 250,000 SOEs employing 11 percent of workforce. The SOE sector accounts for one-fourth of GDP, and the share of industrial output of SOEs has fallen from 55 percent in 1990 to under 25 percent in 1998.</p> <p>Share of large enterprises Large SOEs play a dominant role. The roughly 5,000 large enterprises among 85,000 industrial SOEs with independent accounting systems account for 70 percent of the SOEs assets and two-thirds of the gross output.</p> <p>Areas reserved for the state The SOEs play a dominant role in key sectors: (i) energy and utilities; (ii) military and hardware industries; (iii) infrastructure and capital intensive industries; (iv) essential services, such as grain distribution and finance. This has left a large number of "competitive" sectors where the state's ownership is not considered necessary.</p> <p>2. SOE reform strategy</p> <p>Progress so far Statements by key political leaders since 1997 have clarified macroeconomic and industry level reform strategy, particularly on the large enterprises, and have opened the door for further ownership restructuring of SOEs.</p> <p>Focus of SOE reform The central government's SOE reform agenda has focussed on improving management and governance in large SOEs, under the guiding principle of "seize the big and release the small". Small SOEs, which are the responsibility of local government, have been explicitly encouraged to leave the state sector.</p>	<p>The market mechanism is seen as an instrument to stimulate economic growth, rather than as a goal. The dominance of the state sector is still considered to be crucial. The constitution stipulates that SOEs should have a leading role in the economy.</p> <p>There are about 6,000 SOEs. The SOE share of industrial production has fallen from 78 percent in 1990 to 55 percent in 1997.</p> <p>The SOE sector is highly concentrated. The 200 largest enterprises account for about 60 percent of both state capital and bank credit to SOEs, and 40 percent of total SOE debt.</p> <p>Officially there is a negative list of areas reserved for the state under equitization. However, equitization has proceeded so slowly that this list is far from binding. SOEs in the sector and the local People's Committee can veto the entry of any new business.</p> <p>The authorities' policy goal has remained that an efficient state sector should continue to lead growth, and there has been reluctance to reduce the role of the state in the economy.</p> <p>There has been very little progress in the 1990s. The authorities envision implementing further SOE reform, including diversification of SOE ownership, but they have focussed on small and medium-size enterprises, with the large SOEs mostly untouched.</p>

Comparison on Main Aspects of Enterprise Reforms in China and Vietnam	
China	Vietnam
<p>Macroeconomic adjustment In an effort to reduce the macroeconomic burden, China has undertaken economic reforms for SOEs, including the hardening the budget constraints, exit of uncompetitive resources, removing social burdens, and reducing indebtedness.</p> <p>Budget constraints for SOEs have been progressively hardened. However, directed lending to loss-making SOEs has continued.</p> <p>SOEs have laid-off redundant workers and idled production capacity in response to market pressures. A cumulative total of at least 17 million workers had been laid off by end-1998.</p> <p>The government implemented policies to reduce indebtedness of SOEs, including establishing funds for debt write-down. However, the scope for such write-downs remains constrained by a lack of financing.</p> <p>In order to divest SOEs of their traditional social welfare burdens, nonproductive social services units, such as housing, are being transferred to the government, and pension and unemployment liabilities are being lightened.</p> <p>Enterprise management and organization About 2,600 SOEs, mostly large, had adopted modern corporate forms of governance (corporatization) by end- 1997, being subject to the Company Law. Among corporatized SOEs, about half have adopted multiple-investor status. Other investors were mainly other state entities, including management and workers.</p> <p>For enterprise autonomy, central government restructuring has eliminated the industrial branch ministries, further removing government from day-to-day management of SOEs. However, government control over enterprise management has not been fully removed.</p> <p>Ownership reform For large SOEs, activity was concentrated in stock issuance, both domestically and abroad, and the creation of joint ventures with foreign investors. About 950 enterprises had been listed on the stock exchanges. However, the ownership reform process for large SOEs has been slow.</p>	<p>The current cautious approach to SOE reforms does not support macroeconomic stability. Comprehensive reform plans as well as concrete reform actions need to be taken urgently.</p> <p>The budget subsidies were cut substantially in the early 1990s, but SOEs have received considerable bank financing.</p> <p>Enterprise employment rolls were cut substantially in the early 1990s, but there has been little restructuring since then.</p> <p>Some limited plans have been developed to address the heavy debt burden of SOEs, but implementation has been tied up with bank reform.</p> <p>Industrial SOEs provided few social functions beyond employment and retirement incomes. Retirement incomes have been take over by the government, but employment concerns continue to constrain reforms.</p> <p>Equitization has proceeded very slowly, although there has been a modest pick-up recently.</p> <p>The Vietnamese SOEs have largely achieved autonomy in basic production and marketing decisions. However, financial autonomy and market discipline remain weak.</p> <p>Little has been done for large SOEs beyond the formation of General Corporations. Moreover, the stock exchange in Vietnam has not yet been opened because of a shortage of equities to trade. Also, sale of enterprise shares to foreign investors is limited.</p>

Comparison on Main Aspects of Enterprise Reforms in China and Vietnam	
China	Vietnam
<p>Also, 120 key production SOEs have been given the right to form large holding structures, aiming at achieving economies of scale and playing an instrumental role in the restructuring of other enterprises.</p> <p><i>Small SOEs</i> continue to be moved out of the state sector quickly. By late last year, the fast reforming coastal and southern provinces had already shed most of their small-and medium-sized enterprises.</p> <p>The many small SOEs have been sold to management and workers as shareholding collectives or are being auctioned or offered for public sale.</p> <p>Social aspects Excess labor in SOEs was estimated to be over one-third of SOE labor force, about half of which have already been laid off. For retrenched workers, the government focused on training and reemployment, while providing a basic living allowance.</p> <p>3. Complementary reforms</p> <p>Private sector development (level playing field) While China still advocates a strong role of the state, it continues broad support for market-determined price and production decisions, and is taking steps to improve the business environment for private enterprises. SOEs have lost their former stronghold position in many industrial and service sectors, and competitive pressure from nonstate sources is pervasive.</p> <p>Competition for joint ventures and imports Joint-ventures in China have been effective in creating domestic competition. One key reason is flexibility in choosing a local partner. Many JVs are export-oriented, and some have achieved a relatively high quality level.</p> <p>Even though China has high import protection, the borders are porous and there are many avenues for exemptions. Tariff receipts are 3 percent of imports.</p>	<p>General Corporations have been established for large, strategic SOEs to exploit economies of scale. However, they restricted competition rather than improved their efficiency.</p> <p>About 150 medium-sized SOEs have been equitized since 1992, 130 of them since end 1997, and a total of 1,000 are planned by end-2000.</p> <p>Enterprises of capital of VND1 billion (\$72,000) will be sold as a unit by tender or to employees, if bidding is unsuccessful.</p> <p>Excess labor in SOEs is estimated to be at least 25 percent. Severance payment covers half a month of basic salary per year of service. While there are programs for retrenched workers, including income support, training, and subsidized credit, few have taken them voluntarily.</p> <p>There has been little progress in leveling the playing field with regard to the private sector. Throughout the 1990s, SOEs continued to enjoy various privileges, which have allowed many inefficient state enterprises to survive.</p> <p>In Vietnam, joint ventures must accept the designated local partner, which is often the same SOE for all entrants to that sector. Most JVs have been set up for import substitution behind high protection. Their scale is typically too small to compete on global markets.</p> <p>Although there is a great deal of smuggling in Vietnam, it is less dramatic than China. Moreover, the effective tariff rate in Vietnam is 16 percent.</p>

V. TRADE POLICY DEVELOPMENTS AND THE NEED FOR REFORM¹

A. Introduction

1. Despite a reduction in the number of goods subject to formal quantitative restrictions since 1994, Vietnam's trade system remains highly restrictive. Trade is restrained by high and frequently changed tariffs, many import quotas and bans, and extensive bureaucratic impediments. Protection has been further heightened by the difficulty in obtaining foreign exchange for imports competing with domestic production.
2. Although such protection is intended to promote "strategic" industries, the effect has been to promote inefficient import substitution. Chronic overcapacity, uneconomic production scales, and high costs are common. These problems are not transitory, because the import substituting industries are not competitive and have little prospect of exporting. Such industries impose substantial costs on all sectors of the economy, especially agricultural exports, and contribute little to employment.
3. Given the costs of the current trade system, it is essential that protection is phased out. Key aspects of a trade liberalization strategy that emphasizes the early removal of nontariff barriers (NTBs), with appropriate transitional arrangements and supporting actions to reduce the level of tariff protection, are presented in the final section. However, it will also be important to complement these reforms with the domestic liberalization, especially of business registration, trading rights, and investment regimes, to enable foreign and domestic investors to take full advantage of the new opportunities.

B. Overview of the Current System

4. Vietnam's trade regime results in very high levels of protection over a broad range of products. The combination of pervasive NTBs and relatively high tariffs make Vietnam's trade system one of the most restrictive of Fund members. With the increase in the average tariff in 1999, Vietnam is rated 9 on a scale of 1-10 (with 10 being the most restrictive).² This section outlines the main elements, and changes to Vietnam's trade system in 1998 and early 1999.

Foreign trading rights

5. Restrictions on foreign trading rights are one of the main measures that have distorted trade flows by permitting informal trade controls and allowing certain SOEs to earn large

¹This chapter was prepared by Peter Winglee.

²Based on the Fund's index of trade restrictiveness, described in Robert Sharer et. al., (1998). *Trade Liberalization in IMF-Supported Programs*. World Economic and Financial Surveys, (Washington: International Monetary Fund).

rents. Although the number of enterprises with trading rights gradually increased over the 1990s, these rights were largely confined to large SOEs for products related to the production of the enterprise. Only a few SOEs have general trading rights (to import unrelated products). This limitation was enforced by skill and working capital requirements, and the need for the approval of the local People's Committee (local government) who often have their own trading enterprises.

6. With the issuance of Decree 57, in July 1998, the opening up of the trading rights regime was initiated for domestic enterprises by removing the skill and working capital requirements for registering as a trading enterprise. However, the right to engage in trade was based on an enterprise's business license, which rarely specified the general import/export business. Nevertheless, the number of enterprises registered to trade increased from about 3,000 to about 30,000 as more production enterprises decided to trade in their own products.

7. Several additional steps are needed to fully liberalize trading rights. Regarding domestic enterprises, the link to business registration emphasizes the need to reform this system which has hindered many aspects of private sector development.³ Business registration and changes to the business activities should only involve notification and not approval, and business licences should only be required for activities that require regulation for health, safety or environmental reasons. These changes would enable enterprises to readily enter into the import/export field, which should be broadly defined, and not in terms of specific commodities. Foreign invested enterprises continue to have restricted trading rights as a result of the Foreign Investment Law and its requirement to precisely specify the line of business in the joint-venture contract. Such contracts could be revised, but the domestic partner of the joint-venture is often the main SOE importer for related products.

Quotas and licensing

8. Despite the general policy of regional economic integration, trade controls have been tightened over the past year. This approach reflects the government's view that such trade controls are an effective means of limiting the impact of external shocks by saving foreign exchange and improving business confidence by complying with pressures for additional protection by new producers of import substitutes, including joint ventures. However, reliance on trade controls clearly increases the cost structure of the economy, especially because many import substitutes are key products whose increasing costs have very significant downstream effects.

9. According to Decree 57, ten types of imports are subject to licensing. These are: petroleum and oil, fertilizer, motor cycles, cars of 15 seats or less, steel and iron, cement, sugar, paper, alcohol, and construction glass. All of these goods, except for petroleum,

³Business registration requires approval from the local People's Committee, and is subject to the veto of existing SOEs in the field.

complete with domestic production, and quotas have generally been set at very low levels, typically zero. At the start of 1999, eight additional categories of goods were temporarily added to the list of licensed goods, in order to protect the balance of trade (electric fans, ceramic and granite tiles, ceramic consumer goods, packaged in plastic, liquid caustic soda, bicycle, refined vegetable oil, and some plastics). The latter group of goods all had import substitutes available, and several were in support of newly established production.

10. In addition, consumer goods imports, for which licensing requirements were removed at the start of 1998, continued to be subject to impediments to trade. The requirements of consistency with the business registration and funding only by importers' foreign exchange (which became scarce after the imposition of the foreign exchange surrender requirement) have continued to limit imports. Moreover, in April 1999, the issuing of letters of credit for imports of consumer goods and other materials (such as steel and PVC) was banned.

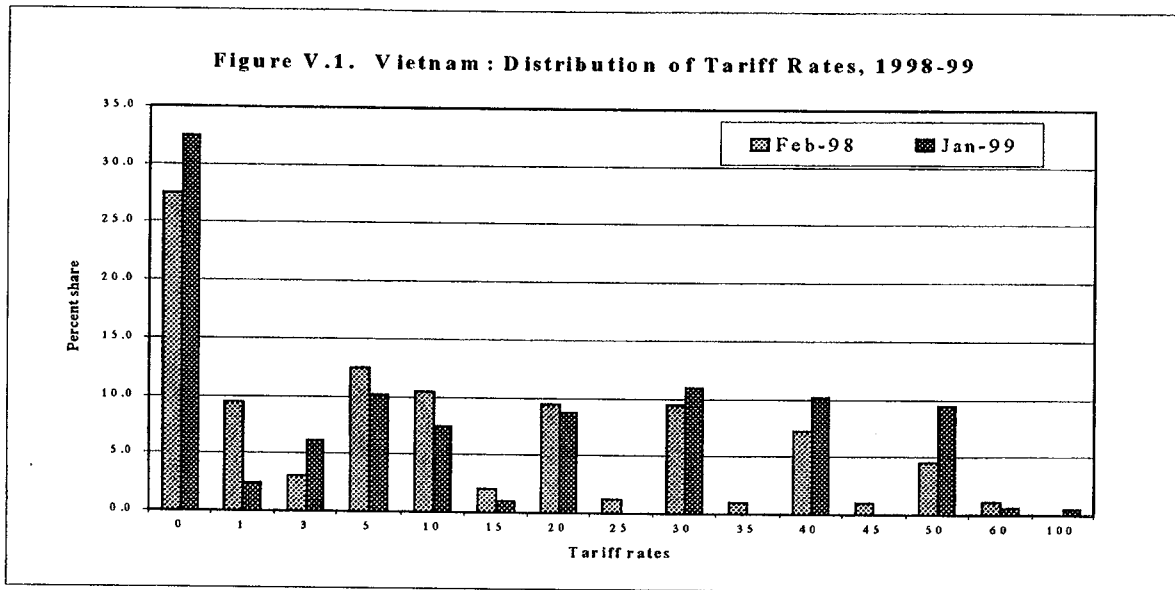
11. Vietnam also continues to have a large range of products subject to the specialized management by individual ministries, including chemical substances, medicines and medical equipment, and recording and broadcasting equipment.

Tariffs and other taxes on imports

12. At the start of 1999, Vietnam introduced a new tariff schedule that reduced the maximum standard tariff rate from 60 percent to 50 percent, except for a few sensitive products,⁴ and the number of rates was reduced from 14 to 10. However, the average tariff increased slightly, from 13.8 percent to 15.5 percent, as the number of items at the 40 and 50 percent rates were increased (Figure V.1). The new tariff schedule also introduced a three column system consisting of an ordinary rate (50 percent above the preferential rate), a preferential (most favored nation and the generally applied) rate, and a special preferential rate applying to goods from countries where there is a special preferential rate negotiated (e.g., under the ASEAN Free Trade Agreement (AFTA)). Since many rates are set at zero, the dispersion of the tariff structure affords very high levels of effective protection.

13. Vietnam maintains some customs surcharges, which are often levied on an ad hoc basis. Surcharges of 2-10 percent are levied on certain iron and steel products, and at times, they have also applied to fertilizers. Often surcharges are used to offset price fluctuations in international markets and avoid losses to SOEs which may have imported such products at higher prices.

⁴ Tariffs for alcoholic beverages and used clothing were set at 100 percent, and those for motor cars and motor cycles remained at 60 percent



14. A special consumption tax is implemented to give additional protection to certain products. Although in principle it is levied on both imports and domestic production, the tax can be waived or reduced for industries experiencing losses. This tax, which is levied at 100 percent for motor cars and 60 percent for beer producers, is currently waived for domestic producers because of their losses.

15. Due in part to the need to have procedures to contain smuggling, the Vietnamese customs procedures are very cumbersome. However, these procedures, including crack-downs on corruption and the use of a stamp system,⁵ have not constrained smuggling, which remains very significant. Moreover, a considerable amount of tax revenue is lost not only at the border, but also on downstream transactions. Minimum prices are used for about 20 types of products and the valuation system remains far from the WTO standard.

Exports

16. The authorities have made some progress in reforming export trade arrangements during 1998 and in early 1999. Some small private sector rice traders were given a small allocation of rice export quotas. Also, 20 percent of garment export quotas to the EU were auctioned for the first time in January 1999. Export taxes were eliminated for all products (notably rice) except crude oil and scrap metal, in stages during 1998.

⁵ Under this system, special tax stamps are offered when the duties are paid to certain types of imports prone to smuggling, especially consumer goods. However, offering stamps to all units in the shipment is time consuming and the stamps are easily forged.

C. Costs of Protection

Inefficiencies of the industrial sector

17. The government has recently stated that its objectives are to maintain social and political stability, develop an efficient industrial sector, promote agriculture and rural development, expand consumer demand, and promote employment.⁶ Trade restrictions and tariffs have been used to support targeted industries, assisted by preferential access to bank credit and tax exemptions. But the impact on the economy of the import substitution policy has been largely negative.

18. Although price liberalization and protection have fostered a rapid growth in industrial GDP, averaging about 14 percent over the past 5 years, there are considerable weaknesses in this performance. This growth has been associated with a sharp increase in the investment to GDP ratio from 18 percent to 26 percent, but despite this substantial capital deepening, the growth in industrial employment has remained under 2 percent, and unemployment has been rising. After five years of rapid growth, the manufacturing sector accounts for only 20 percent of output and 9 percent of employment.

Vietnam: Sectoral Distribution of Output and Employment, 1997

(In percent)

	Output	Employment
Agriculture forestry and fishing	25.2	68.8
Manufacturing	19.8	8.9
Construction and other industry	13.3	3.6
Services	<u>41.7</u>	<u>18.7</u>
Total	100.0	100.0

Source: General Statistical Office (1998), Statistical Yearbook, 1997 (Hanoi, Statistical Publishing Office).

⁶ See statement by the Vietnamese Government at the 1998 Consultative Group Meeting.

19. The protective system and the strong emphasis on import substitution has had a detrimental impact of Vietnam's industrial structure. At the end of the 1980s, the manufacturing sector was small and based on out-of-date equipment. During the 1990s, protection was used to encourage the development of a more modern manufacturing sector. However, the focus on import substitutes has meant that this sector remains very inefficient, despite the more modern equipment, because of the small scale of production. Box V.1 describes some of these developments in the protected sectors.

20. Few enterprises in the protected, industrial sectors have shown a profit. Although many enterprises were financed through direct foreign investment, there is still a significant financial impact on Vietnam. About 40–50 percent of the investment was financed by debt which still needs to be serviced. Moreover, the failure of investors to make a profit impacts on Vietnam's reputation as a destination for investment.

21. The losses suffered by producers in protected industries are not likely to be transitory. In most cases, more joint-ventures have entered the market than could operate efficiently (partly because they were not aware of the other deals being made). In other cases, many SOEs tried to become more efficient by simply purchasing new equipment, but failed because a larger scale of production is needed in many industries and there was no rationalization of producers. Since they are too inefficient to export, many will never be able to build up economies of scale.

Indirect costs on agriculture

22. Protection has also imposed large indirect costs on other sectors, especially agriculture. Only a small part of these costs is visible to downstream users; while most costs are small increments for other sectors, aggregated costs for the economy are substantial.

- The real value of farmers' incomes is reduced when they have to pay higher prices for protected final manufactured products (workers protected sectors get higher wages than in free trade).
- Agricultural (and other) exporters do not benefit from export competitiveness when exchange and trade controls have been used to avoid exchange rate depreciations.
- The rural sector pays more for protected important inputs such as transport equipment and fertilizer and face a limited choice of products. Fertilizer quotas are estimated to directly add about 0.2 percent of GDP to costs (Box V.2).
- Rice farmers receive lower prices for the products under rice export quotas which give distribution rents to quota holders, (mainly SOEs). Although the government rationalizes these quotas using the food security argument, this is misplaced. Rice production significantly exceeds domestic consumption and any shortages that lead to increased domestic prices can be readily offset by imports from neighboring countries, especially Thailand.
- State domination in other agricultural sectors, such as rubber, coffee, and tea, also limits their export potential.

Box. V.1. Protection and Key Industrial Sectors

The following key industries have developed through very high levels of import protection in recent years and remain extremely inefficient:

- **Motor vehicles:** Import bans attracted 14 manufacturers (11 are still operating) to invest about \$600 million with a declared capacity of about 170,000 cars per year. However, only about 5,000 cars were sold in 1998. Production is essentially for assembly, and the local component industry is almost non-existent, but the government is trying to establish one. Even with domestic prices at about three times the duty free price, all manufacturers are losing money.
- **Motor cycles:** Import bans on fully assembled and CKD kits have attracted three large Japanese producers, plus a number of other assembly operations. The market for motor cycles is relatively large, with annual sales of about 350,000 units per year, but there is also sizeable over capacity. High tariffs and bans on some types of kits have been imposed to promote the component industry, adding to costs and reducing quality. Domestic prices are more than twice the international price.
- **Bicycles:** Imports were liberalized in 1998 and made subject only to tariff protection. However, this was not sustained and licensing was reinforced in 1999. Bicycles are manufactured by a few SOEs with old equipment producing outdated styles. Considerable restructuring would be needed to make these producers internationally competitive.
- **Cement and Steel:** The production of steel and cement has expanded recently as new joint-venture production has been added to the existing state-owned enterprises. Some of the latter have also borrowed extensively from state banks to expand their production, but other SOEs continue to use antiquated equipment. With the recent slump in domestic and foreign demand, these industries have been hard hit and import bans are being used to shelter them. Although Asian steel and cement producers are taking strong adjustment measures, adjustment in the Vietnamese enterprises has been comparatively mild. On average the plants are operating at about 40 percent of capacity. The current price of steel and cement in Vietnam is about 60 percent above the f.o.b. import price.
- **Fertilizers:** Import quotas of fertilizer are linked to the state management of this essential commodity, and a credit allocation is also provided. Quotas are allocated exclusively to key SOEs. The domestic production of urea fertilizer is small and antiquated. Recently joint-venture plants producing more advanced types have opened, and import bans were introduced for these products. Generally, the domestic fertilizer price is 20-25 percent above the free trade price, reflecting both the restriction of imports and the reliance on SOEs for distribution.
- **Sugar:** Until 1994, Vietnam did not have a significant sugar sector, which was created as a result of a decision to achieve self sufficiency by 2000. With concessional credit, many new sugar refineries have been built, but these exceeded the growth of the sugar cane sector, and were sometimes located in relatively poor sugar growing areas. Thus, while some refineries have the potential to be internationally competitive, many have little chance of doing so. To protect the sugar sector, quotas have been placed on both refined and raw sugar, raising prices to about 25 percent above the import price. Downstream activities such as the confectionary industry have become uncompetitive.

Box V.2 Vietnam: Costs of Protection in the Agriculture Sector

Recent research has estimated the costs of protection in Vietnam's agriculture sector and the potential benefits of trade liberalization. In particular, it has been shown that the doubling of rice production in the period since 1980 was linked directly to the degree of liberalization of land laws, trade, and input and output markets.¹ Nonetheless, large distortions continue to exist in the rice, sugar, and fertilizer sectors.

- Annual *rice export quotas*, which arise from a concern for food security, lower the domestic price received by farmers and, hence, transfer income from farmers to urban consumers. Recent studies estimate that the removal of the rice quota would increase national income by US\$225 million (1 percent of GDP), and that over 5 million tons of rice could be exported, a significant expansion from the current 3.6 million tons.² Quota elimination would benefit the majority of the rural population, especially the poor, if other restrictions on competition are eliminated that would reduce the returns to middlemen. Increased income would make food more affordable for the rural poor.
- *Sugar policy* has been used as a strategy of rural industrialization and development of regions with lower agricultural potential than the two deltas. The pattern of import restrictions is constantly shifting from tariff, to quota, to import ban, resulting, in some years, in over-supply of sugarcane (e.g., in 1997), and in others in undersupply (e.g., in 1998). Currently, the wholesale price of sugar is about 25 percent higher than the import price, and the effective rate of protection is around 90 percent.³ The latest analysis shows that trade liberalization would make sugar available at a 22 percent cheaper price, increase the real income by US\$92 million (½ percent of GDP), and would maintain domestic production of sugarcane.
- With domestic production providing only 13 percent of total use, *fertilizer imports* have been critical in meeting the needs of Vietnam's agriculture. However, because of a quota system, the domestic price of fertilizers is about 70 percent higher than the price of imports from Indonesia (average during 1990–96), and 40 percent higher than the price of imports from Eastern Europe, costing Vietnam about US\$38 million per year (0.2 percent of GDP) in direct costs. (Goletti (1998)). A more liberalized import system that allows competition would lower prices to farmers, reduce the rents to privileged importers, and result in more prompt delivery.

¹See Che Tuong Nhu, *The Effects of Internal and External Trade Liberalization on Agricultural Growth: A Case Study of Vietnam* (Ph.D. dissertation, Australian National University, Canberra, 1997).

²See International Food Policy Research Institute (IFPRI), *Rice Market Monitoring and Policy Options Study for Vietnam* (Washington: IFPRI, 1996); and F. Goletti and N. Minot, "From Famine to Surplus: The Transformation of the Rice Sector in Vietnam" (Washington: IFPRI, 1997).

³See F. Goletti, "Trade Distortions and Incentives in Agricultural Trade: The Case of Rice, Sugar, Fertilizer, and Livestock-Meat-Feed Subsectors in Vietnam" (Washington: International Food Policy Research Institute, 1998); and Centre for International Economics (CIE), *Vietnam's Trade Policies 1998* (Canberra: CIE, 1998).

Indirect costs on the service sector

23. Protection also creates a large bias against the service sector, which has the greatest potential for supporting employment growth and expansion in other sectors. There are almost 2½ times the number of employees in the service and construction sectors than in manufacturing. The relative contribution of manufacturing can be seen even more starkly in construction where 30,000 workers and 10,000 workers are engaged in cement and steel production, respectively, but 900,000 workers are employed in the formal construction sector. Liberalizing imports of cement, steel, and other building products would reduce the input costs of construction and increase the demand for workers in this sector. Similarly, lowering the cost of transport equipment and construction can help promote tourism by making the provision of international quality facilities and services more competitive. Liberalizing the imports of small buses would also improve the private provision of public transport, especially in the older cities with many small streets. Effectively liberalizing the import of consumer goods would promote the distribution sector.

D. Key Issues for Trade Liberalization

General considerations

24. Although the Vietnamese government has stated that for an efficient industrial sector to develop, protection must be selective, conditional, and temporary,⁷ Vietnam's trade system, as noted above, remains one of the most highly restrictive and interventionist, with considerable costs to the economy. Many countries, including other ASEAN countries have been progressively liberalizing their trade systems (Figure V.2) and Vietnam cannot afford to be left behind.⁸ International experience suggests that adjustment costs are minimized by undertaking reforms in a comprehensive and phased framework. Thus trade reform should be:

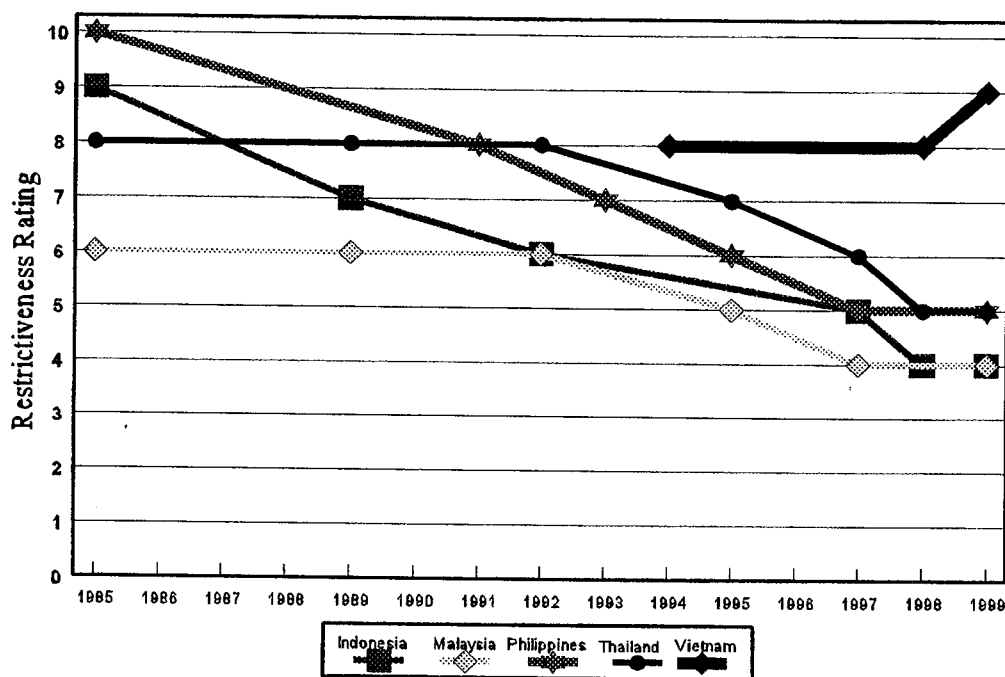
Significant and front loaded, within a well-defined multi-year framework;

- Applied to all sectors without any scope for new increases in protection;
- Based on the rapid elimination of all NTBs, with the genuine and up front liberalization of trading rights and reduction in the tariff protection;
- Not offset by other administrative devices, especially domestic regulations and foreign exchange control;

⁷The Resolution at the Conclusion of the Fourth Plenum of the Central Committee (8th Congress), December 1997.

⁸The indices in Figure V.2 were calculated in accordance with the Fund's index of restrictiveness of trade regime.

Figure V.2. Trade Policies in ASEAN Countries, 1985-1999



Source: IMF staff estimates.

- Complemented by related reforms to promote private sector development, especially liberalization of domestic regulations to reduce the high costs of business; movement towards current account convertibility; and a flexible approach to direct foreign investment.
- Accompanied by a flexible exchange rate policy to restrain excessive import demand without the need for exchange controls;
- Accompanied by well-targeted safety nets for displaced workers, through retraining and the other safety nets, including those planned under SOE reform.

Specific Policies

25. In the process of liberalizing imports, the highest priority should be given to the early removal of NTBs, which could be replaced by transitional tariffs in some cases. This approach

would both reduce the distortion in trade flows, and reduce one of the main sources of bias in favor of SOEs and against the private sector. Such a policy should be implemented in a pre-announced plan to show that a broad range of sectors will have to bear some adjustment, and to reduce the pressure for exemptions to reform.

26. Given the restrictiveness of NTBs, their removal may need to be facilitated by some transitional instruments. Box V.3. lists some examples of transitional instruments used in other countries in the region.

Box V.3. Approaches to Phasing out Quantitative Restrictions

International experience highlights a range of approaches that can be used to phase out quantitative restrictions (QRs):

- One-off elimination of quotas, without replacement by tariffs--as was done for most of Indonesia's NTBs in the first year of the recent Fund arrangement.
 - Removal of import licensing requirements--for instance, by Thailand--on 31 items (some two-thirds of all items subject to such requirements) between 1992 and 1995.
 - Progressive raising of quotas to nonbinding levels.
 - Auctioning of quotas in conjunction with their expansion to obtain revenue, make the allocation process transparent, and to obtain a benchmark for the tariff equivalents of quotas. This approach was used in Australia and New Zealand.
 - Replacement of quotas with tariffs (not necessarily at equivalent levels), as in the Philippines where restrictions were removed on agricultural products.
 - Conversion of quotas to tariff quotas, i.e., through two tariff rates--a lower rate (in-quota rate) applied to specified volume of imports and a higher rate (out-of quota rate) applied to any imports above that volume, then reducing the out-of-quota tariff rates to the in-quota tariff rates. This method was used by Thailand, and the Philippines (as well as many other countries) in the context of the conversion of quotas for agricultural products into tariffs at the beginning of 1995.
-
- On some sensitive and relatively high valued products, such as motor cars and motorcycles, the auction of quotas for the fully assembled product may help to introduce competition and determine equivalent tariffs.

- For products such as steel and cement, where the domestic price is less than double the import price, transitional tariffs should be applied relatively quickly. Even if the tariff protection is marginally less protective than the current import bans, these sectors should start to catch up with the adjustment in other countries.
 - For some other products, such as fertilizers, the import restrictions should be eliminated immediately to end the bias against agriculture, and not replaced with tariffs.
 - There should be a full liberalization of trading rights so that any product not subject to a quantitative restriction (other than those indicated for health, safety, and environmental reasons) should be freely imported with the payment of the appropriate taxes on duties.
 - The goods subject to the specialized management of ministries should be sharply reduced and only applied to those products with a substantial risk for health, safety, and the environment.
27. Other import related liberalization measures should accompany the removal of NTBs:
- Tariffs and the number of tariff rates should continue to be reduced. Although the removal of quantitative restrictions would need to be facilitated in some cases with transitional tariffs, these should be kept to a minimum. At the same time, there is a need for other tariffs to be reduced to promote the shift to a more open economy and reduce the scope for trade diversion under AFTA.⁹
 - Customs procedures should be streamlined to improve the flow of goods in and out of Vietnam, which is essential for developing an outward-oriented economy.
 - WTO consistent procedures for clearance, import valuation, and trade classification should be adopted as soon as possible. Customs fees and port charges should be based on published schedules and limited to the cost of the services.

Complementary Reforms

28. Trade reforms need to be supported by a broad range of complementary policies to maximize their benefits and reduce any adjustment costs. Domestic liberalization and policies to develop the domestic and foreign invested private sector are crucial, as are SOE and banking reforms.

⁹AFTA calls for regional tariffs of 0-5 percent across the board by 2006, except for a small exclusion list and the liberalization of NTBs on such goods.

29. Export expansion is also a key complementary policy and participation in bilateral and multilateral trade agreements are important for this objective. The liberalization under AFTA could be a significant boost to exports. A low wage economy, such as Vietnam, can obtain very large employment gains in a free trade area, if other costs are also reduced by liberalization and administrative reform, and market-based rents and utility prices applied, and if new investment can be attracted. For example, Mexico's export growth rose significantly after joining NAFTA, and Eastern European countries hope to also benefit from eventual inclusion in the European Union. Trade liberalization that would gain access to the US market, especially for garments, would also help to cushion the impact of restructuring in other sectors. WTO membership would also help Vietnam's export prospects and progress at trade liberalization would facilitate Vietnam's membership drive.

30. With liberalization, sectors would be rationalized and need not disappear completely and overnight. In most sectors, the very efficient producers could survive if domestic deregulation enabled them to reduce their costs. Greater flexibility in the market would result in considerably fewer producers in many sectors, e.g., motor vehicles, motorcycles, steel, electronic goods, and cement. Such a rationalization would improve the scale of operation of the surviving domestic firms and help them to be competitive with imports. Also, instead of continuing to develop or assemble finished goods, some enterprises would gradually shift towards globally integrated production, in line with the trend observed in many emerging markets.

References

- Center for International Economics (1998) Vietnam's Trade Policies, 1998 (Canberra: Center for International Economics).
- McCarty, Adam (1999), *Vietnam's Integration with ASEAN: Survey of Nontariff Measures Affecting Trade* (Hanoi: UNDP).
- Sharer, Robert et. al., (1998), *Trade Liberalization in IMF-Supported Programs*. World Economic and Financial Surveys (Washington: International Monetary Fund).