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Viet Nam: a transition tiger?
Ongoing reforms: building the institutions for macroeconomic management

Abstract for chapter 8

By 1991, Viet Nam had made the first important steps to a market economy with a degree of macroeconomic 'shock therapy', but despite initial achievements, the economy still faced difficult structural problems.

This chapter focuses on the ongoing reform agenda where in 1991 the Party re-affirmed its commitment to the *Doi Moi* process and identified macroeconomic stabilisation as a key priority for socio-economic development for the years 1992 to 1995. By 1988-89, the Vietnamese authorities implemented a rigorous policy package in an effort to balance the state budget. This pursuit of fiscal and monetary stability formed the basis for further reforms as Viet Nam had started the reform process with a banking system designed along Soviet lines.

As the Vietnamese economy moved towards a more market-oriented system, it became apparent that existing financial institutions were inadequate. While banking reform was cautious, this slow growth of modern banking avoided the serious risks demonstrated in the performance of other economies in the 1990s.

Keywords:

1996-2000 Five-Year Plan, agriculture, central banking, commercial banking, East Asian crisis, economic growth, fiscal and monetary policy, Fourth Party Plenum, land-use rights, macroeconomics, market economy, National Tax Collection Office, National Treasury System, oil, rice, seafood produce, service sector, Seventh Congress, Sixth Party Plenum, State Bank of Viet Nam, two-tier banking system

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8

ONGOING REFORMS: BUILDING THE INSTITUTIONS FOR MACROECONOMIC MANAGEMENT

THE ONGOING REFORM AGENDA

When the Seventh Congress met in 1991, significant reforms had already been implemented. Farmers had been given medium-term land-use rights, prices and the exchange rate were largely market determined, and laws on foreign investment, private enterprises, and companies had been enacted. Economic growth had accelerated to 6 per cent, following a recovery in agriculture and strong service sector growth as the number of individual and household businesses increased. Growth in industrial output also accelerated, but mainly as a result of previous large investments financed by the USSR in the oil and electricity sector. Exports had increased to four times the level recorded in 1986, reaching just over US$2 billion. Viet Nam had made the first important steps to a market economy with a degree of macroeconomic 'shock therapy' without suffering a period of macroeconomic decline.

The imposition of very tight monetary policies in 1988–89 was initially remarkably successful.[1] In early 1989, prices were substantially decontrolled. The official exchange rate was adjusted to a level close to the free market rate. Considerable freedom was allowed in exchanging the dong for foreign currencies, and in practice widespread circulation of the dollar in local markets was accepted. Interest rates on deposits were increased to positive real levels, and credit supply was controlled.

Despite these initial achievements, the economy still faced difficult structural problems. Three commodities (oil, rice and seafood products) dominated exports, and there were doubts about whether the acceleration in export growth could be sustained. There was resurgence in inflation, which reached an annual rate of 67 per cent at the end of 1991, even though it had been brought down to single digit levels in 1989. The fiscal situation was still fragile, with the ratio of government revenue to GDP only 13.5 per cent. Total investment, at 15 per cent of GDP, was less than half that of most East Asian economies. Foreign investment approvals were increasing, but disbursements remained low. And there were domestic and international concerns about whether initial economic improvements could be sustained.

The government continued to intervene in micro aspects of investment and personnel decisions, and sought to limit outside influences on society. The 1980 Constitution provided little protection for the private sector and foreign investors. While the number of Vietnamese permitted to travel and/or study in market economies was increasing, travel continued to be heavily restricted, and few business people and policymakers had been exposed to the development experiences of market economies. The number of foreigners working in Viet Nam had increased, but official permission was still needed for internal travel. Foreign businesses and international agencies were not allowed to recruit local staff directly. Office facilities, hotels and housing of an international standard were not available, and the limited facilities that were available were very expensive. Personal contact between Vietnamese and foreigners continued to be actively discouraged by some state agencies.

Therefore, after achieving progress with stabilisation and liberalisation over 1989–91, renewed efforts were required to build on the initial growth in trade and foreign investment and to adjust the role of government still further. And as the economy was liberalised, the reform agenda shifted to the complex tasks of building institutions which could provide an effective environment for the market economy, consolidate the gains already made and sustain the acceleration in growth.

At the Seventh Congress in July 1991, the Party re-affirmed its commitment to the *Doi Moi* process and identified macroeconomic stabilisation as a key priority for socioeconomic development for 1992–95. This commitment was made in the face of a difficult external economic situation arising from the loss of assistance from the CMEA and the continuation of the embargo. In response to a sharp resurgence in inflation in the second half of 1990, and declining exports and budget revenue in 1991, the Party Central Committee placed the achievement of macroeconomic stability and the reduction of inflation as top medium-term goals.

The state enterprise sector was to be consolidated to concentrate on key sectors and the environment for private business was to be improved. Alongside its commitment to strengthening the market economy, the Party also committed itself to maintaining progress in the social sectors. Decisions were also taken to restructure and streamline the government administration and to initiate steps to revise the Constitution to accommodate these changes. Thus 1991 saw a renewed political commitment to continue with the next stage of the reform process.

The next round of reforms also focused on such institutional measures as the creation of a relevant system of business law, the redefinition of land-use rights, to the creation of a new fabric of financial institutions and reform of public administration.

THE PURSUIT OF FISCAL AND MONETARY STABILITY

An important aspect of a government's role in the market economy is its management of fiscal and monetary policy and its impact on macroeconomic stability. In the prelude to reform, the country had verged on hyperinflation, fed by weak public finances.

Under central planning, government is in principle able to transfer resources from the enterprise and household sectors through direct control over resource allocation, incomes and prices. However, the degree to which that was possible in Viet Nam was limited by the ineffectiveness of the planning system. The reform process had further weakened control, fuelling macroeconomic instability, resulting in the very high inflation from the mid 1980s.

Moreover, reforms in the price system and enterprise reform initially weakened the old fiscal base. With the shift from a centrally planned, state-owned economy it becomes both less feasible and less desirable to fund the state budget from transfers of surpluses from state enterprises. It is less feasible because prices and outputs can no longer be so readily manipulated to generate the required surplus. It is less desirable because the essence of a decentralised market system is that enterprises should control after-tax profits as a key incentive to performance and as a device to channel investment funds into profitable lines of activity. The share of revenue from state enterprises in total government revenue fell from almost 60 per cent in 1990 to around 37 per cent in 1996.

In the reform process, many of the direct instruments of economic control had to be replaced by indirect instruments, including those of fiscal and monetary policy, which form the box of tools for macroeconomic policy implementation in mixed economies. Despite starting from an initial position of pervasive controls over actors in the economy, it was difficult to put into place the instruments of fiscal and monetary policy which are a routine feature of most mixed economies.

One source of difficulty was the interdependence between macroeconomic reform and changes in the system at the enterprise level. Effective macroeconomic policy should provide an appropriate environment for decentralised decision making at the enterprise level, but successful reform of the state enterprise sector is, in turn, a necessary ingredient for successful stabilisation.

An objective of reform is to develop an enterprise sector which is not dependent on state subsidy and is faced with a 'hard budget' constraint. In the Vietnamese case, although the reform of the enterprise sector has been slow and incomplete, the government was willing to squeeze the state enterprise sector and accept significant redundancies. However, efforts to tighten access to subsidies from the state budget were offset to some degree by the weak credit system. As the government tightened access to budgetary resources, laxity in the provision of credit to state enterprises 'softened' budget constraints.[2]

As noted above, Viet Nam—like most reforming economies—suffered a bout of severe inflation during the early stages of the reform process. The monetarist view that inflation is associated with excessive growth in the money supply can be taken as a useful starting point for a discussion of fiscal and monetary stability, but it is also necessary to explore why money supply gets out of control. This can happen because governments lose control over their own budget and have to 'print money' to accommodate their borrowing requirement. Even if government can balance the state budget, the borrowing requirements of state enterprises might also need to be accommodated by expansions in money supply. This has emerged as a critical factor in most transitional economies.

In all these cases, the reasons for instability can be seen as either resulting from the inability of government to take the necessary action to control the source of the imbalance (for example, the lack of policy instruments needed to balance the state budget) or the unwillingness of the authorities to take action because of the undesirable consequences (for example, bankruptcy of state enterprises, or increases in unemployment). Achieving stability is both a matter of political will and of the availability of appropriate policy instruments to translate intentions into practice, as was illustrated by the Vietnamese experience in attempting to achieve stability.

In 1988–89, the Vietnamese authorities demonstrated the political will to implement a rigorous IMF-style policy package (without IMF financial assistance to sweeten the bitter medicine), including positive real interest rates, drastic exchange rate adjustment and efforts to balance the state budget. An attempt was made to check inflation through a draconian stabilisation program. This program had some success but then foundered because of the inability of the government to control money supply growth. This inability was a consequence of weaknesses in the government's fiscal base and the need to avert a downturn in the real economy in the face of the collapse of trade and aid with former CMEA countries. A more effective institutional framework was needed to implement stable fiscal and monetary policies in a market economy. This task was still only partially completed at the end of 2002, despite sustained efforts over more than a decade.

At first sight, it should be relatively easy to move from the tight state disciplines of central planning to the less onerous burdens of tax payment. However, an effective tax system needs to be built on a foundation of reliable accounting, experienced tax administration and a reasonable degree of voluntary compliance, none of which existed at the outset of the reform process.

Viet Nam took steps to create a new tax collection system and to strengthen central fiscal institutions after 1989, for example through the creation of the National Treasury system and the National Tax Collection Office and efforts to broaden the tax base. As part of the overall fiscal reform, towards the end of 1990, Viet Nam introduced new profit and turnover taxes, based on a relatively simple system, which did not formally discriminate on the basis of ownership, and steps were taken to introduce an orthodox system of personal income tax.

However, a lack of transparency remained in the system. With persistent problems in collection, receipts were slow to build up. Thus, at the early stages of fiscal reforms, revenues from foreign trade taxes in the 1991 budget were estimated at 900 billion dong (around US$100 million), compared with a formal hard currency foreign trade turnover of over US$4 billion.

Strengthening the capacity of the finance ministry has been a gradual process. Key ongoing issues include the relationship between central and local government, the extent to which central policymaking is sufficiently informed by analysis of the economic impact of policy, and corruption in tax administration. The fashioning of an efficient and equitable tax system is not merely a matter of an appropriate tax code. The Vietnamese authorities designed a tax system that in many ways was admirably neutral in its treatment of public and non-state sectors. To increase fiscal effectiveness, however, tax assessment needed to be made more predictable. Adequate wages needed to be paid to tax officials and effective discipline imposed. *Ad hoc* tax breaks for the state sector and 'special taxes' imposed by local authorities continued. Despite a fiscal system that is on paper highly centralised, there was (and is) in practice a considerable degree of provincial autonomy in revenue and spending matters.

Viet Nam also faced difficult challenges in seeking to control public expenditure. Prior to the resumption of financial assistance from the multilateral financial institutions in 1993, state resources to meet the considerable needs for investment and recurrent expenditure in infrastructure, rural development and the social sectors, were woefully inadequate, especially given the cessation of Soviet aid.

While the fiscal and monetary systems remained quite crude, they were used quite effectively by government to maintain a reasonable degree of macroeconomic stability through the 1990s. For example, the government responded to the acceleration in inflation towards the end of 1994 and in early 1995 by slowing capital expenditure and tightening the availability of credit. As a result, inflation declined during the second half of 1995. Another indicator of success in macroeconomic balance was the reasonable degree of stability in the exchange rate for Vietnamese dong.

Starting from a very fragile base, there was some success in improving fiscal performance.[3] By 1996 total government budget revenue was estimated to have risen to 23–24 per cent of GDP. Further improvement in fiscal performance was set as an important objective. The target was to maintain revenue collection at 24 per cent of GDP, and to reduce the fiscal deficit and ensure that it remained under 5 per cent of GDP, as part of a strategy to contain the rate of inflation to an annual rate of 10 per cent.

Restructuring of tax rates and tax administration, reducing and/or abolishing subsidies and better control over expenditure all contributed to the improved fiscal performance, which in turn contributed to the sustained reductions in the level of inflation.

By the mid 1990s, following successful implementation of stabilisation and initial market-orientated reform measures, the government formulated development objectives for a longer-term period. In formulating the 1996–2000 Five-Year Plan, the government issued a series of decisions relating to sectoral and regional development objectives for the period up to the Year 2010, and then to 2020.

The overall national development objective was defined in terms of the need to undertake industrialisation and modernisation in order to

> build an industrialised country with modern technology and infrastructure, a rational economic structure, advanced productive relationships consistent with developing productive potential, high material and intellectual wellbeing, firm national security and defence, a prosperous people, and an equitable and civilised society (Communist Party of Vietnam 1996a:37).

Slow progress with enterprise and administrative reforms, low efficiency and competitiveness in domestic production, adverse climatic conditions and the impact of the regional economic and financial crisis led to rethinking of priorities and the revision of development plans. The Fourth Party Plenum (December 1997) emphasised that the immediate priorities were ensuring financial sector and macroeconomic stability and coping with the unfavourable impact of the regional economic crisis. The Sixth Plenum (October 1998) reaffirmed the need to sustain reforms focusing on industrialisation and modernisation, give priority to agricultural and rural industries and to other areas in which Viet Nam had a comparative advantage, and to increase economic competitiveness generally. The East Asian economic and financial crisis of 1997–98 also brought into greater focus the need to address continuing weaknesses in public finance and the financial system.

The increasing sophistication of the government in managing macroeconomic policy was demonstrated in 1998–99, when economic growth slackened as a consequence of the East Asian crisis, but the government swiftly adjusted its spending program and thereby avoided serious external and domestic instability.

MONEY AND BANKING REFORM

Efficient financial discipline is dependent on the existence of a financial system capable of applying good judgement to the provision of credit. Unfortunately, an effective two tier banking system cannot be created overnight.[4]

Viet Nam started the reform process with a banking system designed along Soviet lines. Under central planning systems, the main function of the banking system was to facilitate transactions and act as a component of the state accounting system; the banking system was not typically used as an active instrument of economic policy as macroeconomic aggregates were controlled directly through the planning system. In principle, any potential inflationary pressures resulting from excess monetary balances could be repressed by planning constraints on their use. Moreover, the allocative functions of the credit system were minimised—resources were allocated directly through the plan and the function of credit was merely to accommodate the physical allocations made by the planning system. Credit was allocated administratively and the interest rate was viewed neither as an allocative device nor as an incentive to savings. Given the limited functions allotted to monetary institutions, a banking system based on one tier of banking institutions combining the functions of central and commercial banks, was sufficient.

As the economy moved towards a more market-oriented system, it became apparent that existing financial institutions were woefully inadequate. There was no institutional distinction reflecting the differing functions of a central bank, responsible for managing monetary aggregates and overseeing key national policy instruments such as the exchange rate and interest rates, from the functions of commercial banks, operating to make allocative decisions through the provision of credit to enterprises and providing a range options for households and enterprises to hold liquid assets. Needless to say, there was a virtual absence of any other forms of formal financial intermediation or of equity markets.

The first step in financial sector reform therefore was the development of a two-tier banking system with a clear differentiation between the central (state) bank and commercial banks. The importance given by advocates of reform to the development of effective commercial banking particularly relates to the need for a proper financial context for enterprise reform. As enterprises are given greater autonomy, their access to automatic state subsidies is reduced and they are exposed to the rigours of the market, a process that lays the foundations for enhanced macroeconomic stability. The 'hard budget constraint' will be easily thwarted if enterprises have the option of unrestrained access to bank credits, while the absence of adequate credit facilities can constrain legitimate business. An effective banking system is therefore needed both to confront enterprises with the realities of market operation subject to budget constraints and to provide them with access to financial markets capable of operating according to market orientated principles.

The creation of a two-tier banking system is one step in the process of creating a mature, decentralised system of financial intermediation in which decentralised financial institutions operate autonomously and commercially, subject only to general banking regulations and directives which set limits within which they conduct day-to-day business and the learnt principles of prudent banking practice which provide a guide to business survival.

However, there are dangers in the transition. Newly created commercial banks may be subject to pressures to provide credit imprudently and may also be attracted to the potential returns from reckless lending. It may be difficult for a neophyte central bank to strike the right balance between encouraging autonomy and maintaining prudent supervision of the new commercial banks. Failure to control the process can have inflationary consequences and undermine the effort to expose enterprises to a market environment. An imprudent banking system can contribute to economic crisis—the East Asian crisis was partly fuelled by a lengthy period of imprudent bank lending (mainly by private banks).

It is not easy to create a commercial banking system with a sound portfolio of assets and reasonable profitability at a stroke, and certainly not in the context of the pressures rising from more general reform measures. Banking depends on trust and a culture of prudent banking behaviour, which needs to be acquired and demonstrated over the longer term. While established international banks can provide immediate access to effective banking, and arguably earlier and greater involvement of international banks would have been beneficial, Viet Nam, no more than other countries in the region, could not have been expected to abandon its commercial banking system to foreign domination. The practical and political constraints on the smooth development of a more commercial banking system are demonstrated by Vietnamese experience.

Formally, the basic structure of a market-based financial system emerged quite quickly. Following reforms in the banking system, the four state-owned commercial banks were, in principle, required to operate on a profit-making basis. In the early 1990s, a number of joint stock banks were also set up, some of which were in turn owned mainly by other state enterprises. These were small and operated within the framework of official interest rate policy. There were also a number of credit cooperatives and housing banks. A number of branches of foreign banks also opened.

In the early reform years, however, the Vietnamese banking system remained limited in its technical capacity to handle many basic banking functions, such as fund transfer, clearing and so on. These inadequacies resulted from technical weaknesses (absence of modern equipment, and so forth) and limitations in personnel and basic management skills, aggravated by low wages. The weakness of the banks can be seen as part of a more general phenomenon.

Even though a number of the key institutions appropriate to a market economy were put in place, making them work effectively proved difficult in the face of entrenched interests, established habits of work and a continued lack of clarity regarding the status of the state sector, especially the rights of banks to foreclose. As a result, financial discipline was lacking and the commercial banking system remains in poor shape at the end of 2002, with both the state and the banks suffering from a large overhang of questionable assets and unhealthy balance sheets. Financial intermediation remains ineffective. While an infant stock market now exists, the shares traded are too few and volumes too small for it yet to be a significant factor.

For some years, state banks in principle received subventions from the state budget intended to cover the large negative spread between deposit rates and lending rates, but in practice they were often not paid. Most state banks continued to lend mainly to the state sector, despite government statements asserting the need to treat all sectors equally. However, private sector businesses have been gaining increasing access to credit (Table 8.1).

After 1989, it was necessary to take action to prevent the collapse of a large number of state enterprises that had suddenly been deprived of access to subsidised inputs from the Soviet aid program. The financial performance of banks depended on the gross margin between loan rates and deposit rates, as well as on the performance of the loans themselves. On both counts, banks in Viet Nam faced difficulties and there have been sharp fluctuations in real interest rates.[5]

Although the state banks lacked the formal professional skills to carry out proper audits of their customers, they were in many instances well aware of the

Table 8.1 **Allocation of bank lending to enterprises in Viet Nam, 1991–2001 (end of year)**

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Lending to state enterprises											
Share of total credit	90.0	81.7	66.9	63.0	57.0	52.8	50.0	52.4	48.3	44.9	41.9
Share of dong loans	88.5	75.9	55.7	51.5	44.8	39.6	41.8	48.3	..	..	..
Share of foreign currency loans	96.5	97.9	90.7	81.3	76.3	75.8	68.3	61.8	..	..	..
Lending to private enterprises											
Share of total credit	10.0	18.3	33.1	37.0	43.0	47.2	50.0	47.6	51.8	55.1	58.1
Share of dong loans	11.5	24.1	44.3	48.5	55.2	60.4	58.2	51.7	..	..	..
Share of foreign currency loans	3.5	2.1	9.3	18.7	23.7	24.2	31.7	38.2	..	..	..

Source: Derived from data in International Monetary Fund, 2001. *Vietnam: Statistical Appendix and Background Notes*, International Monetary Fund, Washington, DC; and International Monetary Fund, 2001. *Vietnam: Statistical Appendix and Background Notes*, International Monetary Fund, Washington, DC (and earlier issues).

risks involved. Banks would seek to recoup some of the losses from subsidised loans to non-viable enterprises by charging potentially profitable enterprises rates closer to commercial rates. While such cross-subsidisation improved the balance sheets of the banks, it reduced the efficiency of their role in resource allocation.

At the start of the 1990s central banking was in its infancy in Viet Nam. In principle, as early as May 1990 the State Bank of Viet Nam was endowed with the normal powers and obligations of a central bank in a market economy. But, given its earlier role, which combined the functions of a central and commercial bank, the State Bank of Viet Nam had a branch network at province level, with a high degree of formal branch autonomy, which created the potential for political pressures for targeted credit to be brought to bear at the provincial level. The State Bank also continued to have a close relationship with the state commercial banks, which placed in question for some time the degree to which the central banking and commercial banking roles had been separated. There has, however, been a gradual process of training and institutional development, which has increased the competence of the Vietnamese banks, while the entry of foreign banks into the Vietnamese economy has increased the sophistication of banking services available in Hanoi and Ho Chi Minh City.

By 1998, significant improvements had been put in place in the banking system in providing access to capital for the private sector. Clarification that state enterprises are limited liability enterprises and the issuance of regulations restricting government guarantees to state enterprises helped in providing more equitable access to bank credit. Amendments to the implementing regulations[6] for the Land Law to allow companies, cooperatives and private enterprises to mortgage land-use rights was also important, although land-use rights can only be mortgaged to Vietnamese banks,[7] and banks have concerns about the difficulties in foreclosing on mortgages to recover bad debts.[8] The private sector frequently cites the insecurity of title to land-use rights as a constraint to private investment. Despite the remaining impediments to private sector financing, there has been a marked increase in the share of total bank lending directed to the private sector in recent years. In 1997, however, the state enterprise share of total bank credit remained at almost twice the contribution of state enterprises to GDP, and state enterprises continued to have access to non-bank state funds.

Over the 1990s, the professional competence of the State Bank of Viet Nam has steadily improved and it has increasingly been able to establish itself in an important advisory role to government on macroeconomic policy and as a key player in ongoing discussions and negotiations regarding the need to undertake further bank reform and restructuring and refinancing of the commercial banking system, which is now at the top of the policy agenda.

Banking reform is one area where the critics of the slow pace of Vietnamese reform may appear to have some justification. Nevertheless, it should also be noted that while caution resulted in the slow growth of a modern banking system it also avoided the serious risks demonstrated in the performance of other economies in the 1990s. Accounts of developments in Russia indicate how the rapid development of an uncontrolled banking system can be the source of corruption, crime and severe disorder. Also, a rapid development of new private banks could have left the economy highly vulnerable to the finance and banking crisis that accompanied the regional downturn in 1997.

NOTES

1 The 1989 stabilisation engendered a good deal of international comment and analysis. See Dollar (2001), Fforde and de Vylder's ADB study (1996); and Wood (1989) for specific analyses of the stabilisation measures. See also van Brabant (1990) and Drabek (1990).

[2] However, the concept of the 'hard budget' constraint is more ambiguous than rhetoric might suggest. In market economies, it is typical for firms to have access to credit and for creditors (including banks) to tide over firms with temporary losses and cash flow problems. A system which worked without credit would be woefully inefficient. Most enterprises require access to a credit market, and for the economic system to be efficient that market should provide access to funds on the base of the application of reasonable financial criteria. A 'soft budget' constraint implies that state enterprises (or, for that matter, private firms) have access to funds in excess of amounts justified by the application of sound financial judgements, which *ex ante* necessarily involves a strong element of judgment, exercised for example by competing commercial banks and other financial intermediaries.

[3] Little information is available on the state budget during the early period of reform. The estimates here are drawn from IMF sources.

[4] Various periods of difficulty faced by financial institutions in many fully developed market economies (for example, not only in Southeast Asia but even in Japan and the United States) suggest some of the complexities of creating an efficient credit market.

[5] For example, there was a return to negative real rates in 1990 after the positive yield offered through much of 1989. The interest rates actually charged to state enterprises could be adjusted according to their viability

[6] Article 13 of Decree 85-CP (17/12/96), 'Guiding Implementation of the Ordinance on the Rights and Obligations of Domestic Organisations with Land Assigned or Leased Land by the State', Government Gazette (28/2/97).

[7] Buildings can be mortgaged to both domestic and foreign banks.

[8] A mortgage sale generally requires the consent of the government and mortgagor (Circular 217-NHNN (17/8/96) and the sale must be conducted by an authorised body (Article 273(2) of the Civil Code).