FINANCING VIETNAM'S GROWTH
Domestic and Foreign
Sources of Development

Edited by: **Nguyen Ngoc Son**
Tran Thi Thanh Tu

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LIST OF ABBREVIATION

ADB	Asian Development Bank
APEC	Asia - Pacific Economic Co-operation
ASEAN	Association of South East Asia
BOP	Balance of Payment
DAC	Development Assistance Commitee
SOE	State Owned Enterprises
EU	European Union
EVN	Electricity Corporation of Viet nam
GDP	Gross Domestic Products
FIEs	Foreign Investment Enterprises
FTAs	Free Trade Areas
GNI	Gross National Income
HOSTC	Ho Chi Minh Stock Trading Center
HASTC	Ha Noi Sock Trading Center
IBRD	International Bank for Reconstruction and Development
ICOR	Incremental Capital Output Ratio
IDA	International Development Association
IPO	Initial Public Offering
FDI	Foreign Direct Investment
LIC	Low Income Country
MIC	Medium Income Country
NGOs	Non Government Organization
SOCB	State Owned Commercial Bank
SOE	State Owned Enterprises
ODA	Official Development Association
OECD	Organization for Economic Co-operation Development
WTO	World Trade Organization

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ACKNOWLEDGEMENT

INTRODUCTION AND SUMMARY

Vietnam officially launched the Economic Renovation, so called "Doi moi" in Viet nam. However, not until 1989 a series of mandatory comprehensive measures began, aiming at stabilizing and opening the Vietnamese economy to the world. Thanks to reforms and global integration, Vietnam has been achieving a great deal of impressive economic success, which has been highly appraised by the international community.

During the last twenty years, Vietnam has obtained the relatively high economic growth rate, specifically at the average of 7.4 percent in the period of 1990 to 2007. This high economic growth was supported by the increase of state and private investment and savings. The growth was oriented mainly by domestic investment while the domestic share of the total investment experienced a slight decrease in 2000. Thus, the gap between saving and investment has thereafter been widening, caused by the raising of investment ratio in parallel with a decline of saving ratio over GDP. Foreign saving has played a key role and contributed more and more to total investment in Vietnam.

After a series of encouraging success, the Vietnamese economy has recently been faced with more serious obstacles. In 2007 and early 2008, some unstable economic outlook pushed the Government to reduce the targeted economic growth from between 8.5 and 9 percent of GDP to 7 percent, and implement a policy package to stabilize the economy. The downturn of the Vietnamese economy lately raised many concerns about the stability and efficiency of the financial sector, especially in the context of global financial crisis.

Many recent studies show that sustaining a sound financial development, while mitigating possible financial crisis, is required for sustainable economic growth and effective poverty reduction. Globalization will create more challenges for the whole financial sector: foreign providers will be substituted for the domestic ones in some services sooner or later, and constrain the role of the government. This book focuses on analyzing and examining the hot issues in the Vietnamese financial sector, from sources of saving to managing capital inflows and the operations of the financial markets in the Economic Renovation, as well as evaluating the impacts of these funds to the economic growth and development in Vietnam.

Chapter 1 " Saving - Investment Balance and Viet nam economic growth" written by Nguyen Ngoc Son discusses the role of saving – investment in the Viet nam economic development in the period of 1995 – 2007. The author analyzes the three main sources of saving and investment such as: Government, enter-

prises and households, as well as the rotating of savings and investment among these sectors. Moreover, the author also evaluates the impact of external fund (ODA, FDI) on Vietnam economic growth since 1995 up to now and examines the roles of financial systems in mobilizing saving for investment.

Chapter 2 "Managing capital inflow: the case of Viet nam" written by Vo Tri Thanh and Pham Chi Quang focuses on the most important problem in Vietnam now: how to maintain the sustainable economic growth and financial development as well as reducing the financial risks. This study introduces some reform measures including solving the problems raising in the economy currently such as: the weaknesses of economic institutions, infrastructure and human resources, modernization State Bank of Vietnam, improving the risk management capacity in banking activities and financial control system.

Chapter 3 " Economic growth and foreign direct investment in Viet nam: an empirical analysis" provide an analysis of correlation between FDI and economic growth in 61 provinces in Vietnam from 1996 to 2005. The empirical results show that the correlation between FDI and economic growth in all provinces is positive. However, the positive impact of FDI on provincial economic growth depends much on the absorption of the economy.

Chapter 4 "Roadmap for the mobilization and utilization of ODA in Viet-nam " by Le Quoc Hoi explains the current situation of mobilization and utilization of ODA in Viet nam in the period of 1993-2007 and suggests some measures and solutions to improve the effectiveness of ODA utilization.

Chapter 5 "On the empirics effectiveness of Official Development Assistance (ODA) in economic growth in Vietnam" by Nguyen Hoang Phuong provides the empirical results of the contribution of ODA to Vietnam economic growth in the period of 1993 - 2006.

In Chapter 6 "Equitization in Vietnam: corporate governance perspective", Quach Manh Hao reviews some relating researches in corporate governance first, and then propose some recommendation for the post-equitization in Vietnam. This paper implies that a best practice in corporate governance will become more important for the equitization. The State - SCIC should behave as larger share-holder in the process of equitization aiming at improving the effectiveness of SOEs.

Tran Thi Thanh Tu analyzes the development of corporate bond market in Vietnam **in Chapter 7** "Development of corporate bond market in Vietnam". The author examines the limitations of this bond market as well as proposes some policy recommendations to enhance the development of this bond market, especially the solutions to improve the liquidity, create incentives for market makers and set up the independent credit rating agency.

Chapter 1:

SAVING - INVESTMENT BALANCE AND ECONOMIC GROWTH IN VIET NAM

Nguyen Ngoc Son

Abstract

This paper has analyzed savings and investments in three sectors: government, enterprises and households in Vietnam during the year from 1995 to 2007 for the purpose of evaluating their roles in establishing savings and investments in Vietnam. The study also evaluates the effect of savings and investments on Vietnam's economic growth from 1995 to 2007 and takes a look at the role of financial system in mobilizing and assigning financial sources among the three sectors. The author also studies the role of foreign savings, including FDI and ODA, in Vietnam's economic growth Vietnam from 1995 up to now.

The main conclusions of the study: i) Vietnam's savings and investments are high and have increased dramatically from 1995 to 2007, leading Vietnam to join in 10 countries which have the highest investment rate; ii) reflecting Vietnam's high investment rate, Vietnam's economic growth has been relatively capital intensive, the capital factor contributes up to 57.5% in economic growth; iii) the growth rate of investment has always been higher than that of savings, therefore the gap of savings and investments in Vietnam is still at high level of about 9% of GDP, making Vietnam depended on many sources of foreign investment capitals and it is the reason of increasing deficits of current account; iv) the investment efficiency in Vietnam is relatively low, coefficient ICOR of Vietnam is 5, much higher than China and India; v) in three fields of government, enterprises and households, government and enterprises borrowers and households are lenders; vi) Vietnam's financial system still mainly de-

pends on banking systems, the capital market has not developed so the banking system still have priority and nowadays Vietnamese financial system is facing with high risks such as liquidity crisis and strong decrease of stock market.

1. Introduction

There are many studies that have demonstrated that savings and investment are the key motivating factors of economic growth in every country. Savings specifies the possible growth rate of productivity. Generally, developing countries with high growth rate have higher proportion of savings than less developing ones. There are many factors influencing on savings rate such as income growth rate, population structures, age demographics and savings preferences. Services provided by the government like social allowance may affect on savings as well as taxes and budget deficits.

The relation between savings and investment and economic growth plays a central role in neo-classical model developed by Solow (1956), Cass (1965), Koopmans (1965) and Ramsey (1928). Moreover, saving and investment are the typical characteristics in A-K model started by Harrod (1939) and Domar (1946), and afterwards by Frank's (1962) and Romer's (1986). Most of these models emphasize that capital accumulation is the most important source of economic growth and the higher proportion of savings, the faster economic growth will be motivated because high savings rate is synonymous with high rate of investments. The high rate of domestic savings and investments is one of the basic specificities of East Asia Magic. Vietnam has been in the industrialization process, and savings are encouraged to increase so as to support huge capital needs for development of investments.

The research mostly focuses on the following questions:

- Which are the main factors of savings and investments in Vietnam?

- How do savings sources transfer to investment sources? By which ways?

- What are the roles of financial area in assigning savings sources?

2. Flow chart of savings - investment.

The bridge between savings and investment is shown in the chart 1:

Chart 1. Savings – Investments Bridge
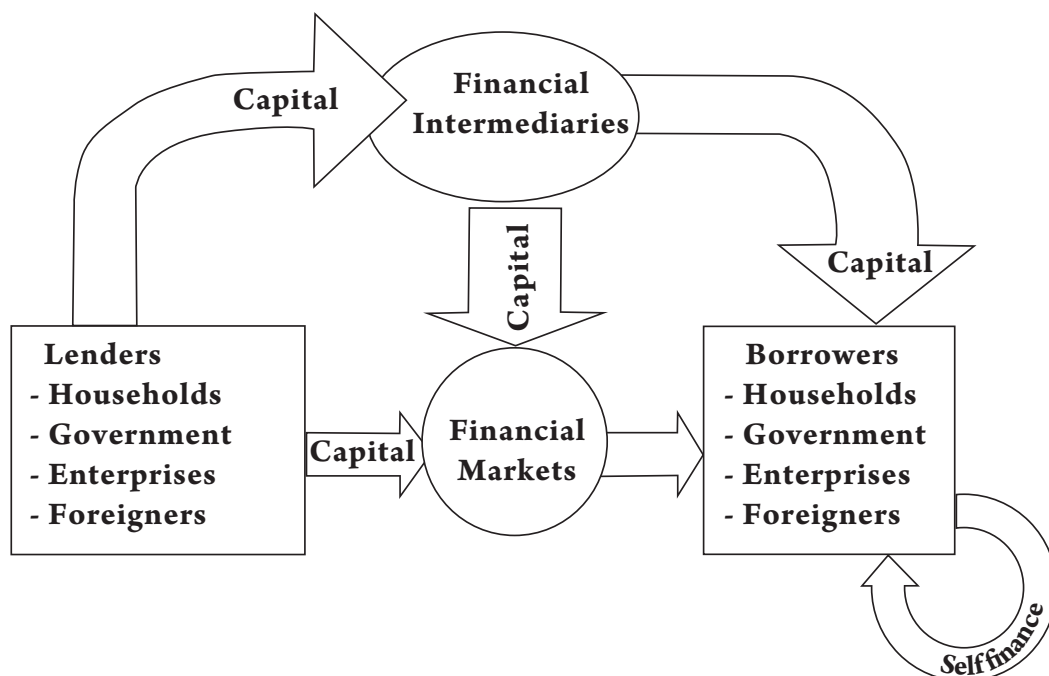
Source: Development Finance, Economic Training Program Fulbright

Chart 1 shows us the sources for establishing investment capitals including: domestic savings (Household savings - Sh, Enterprise saving - Se, Government saving - Sg and foreign savings - FDI, ODA, FII and commercial loans). The financial system only acts as an intermediary for one part of the total social investment because enterprises and households directly support most of the investment from their savings. The financial system takes the role of transferring savings from redundant economic units to deficient ones.

According to the research of the World Bank in 14 developing countries about rotating savings and investment from 1975 to 1990[1], households saved 12.9% GDP, invested 6.0% and they had surplus of 6.9% GDP; enterprises saved 8.6 %, invested 15.6% and had deficits of 7.0%; The government saved for investment 4.8%, invested 6.7% and had deficits of 1.9%. The foreign area had net lending of 2.0% GDP.

In Vietnam, from 1995 to 2007, households in average saved 10.5%, invested 4.3% and they still had surplus of 6.2%. Enterprises saved 16.2%, invested 20.8% and had deficits of 4.6%. The government saved for investment 2.4%, invested 11.7% and had deficits of 9.3%. Foreign sector had net lending of 7.6%

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[1] 14 developing countries including: Cameroon, China, Colombia, Cote d'Ivore, Ecuado, India, South Korea, Malaysia, Philippines, Portugal, Thailand, Turkey, Tunisia, Serb-Croat-Sloven. Data from 1970 to 1985

Chart 2. Savings – Investments, Surplus and Deficits in each sector in 14 developing countries and Vietnam

Housholds	6.9 (10.5)** / 6.0 (4,3)
Enterprises	7.0 (4.6) / 8.6 (16.2)
Government	1.9 (9.3) / 4.8 (2.4)
Foreigners	2.0 (7.6)

FINANCIAL AREA

Savings
Self-Investment
Investment
Surplus
Deficits
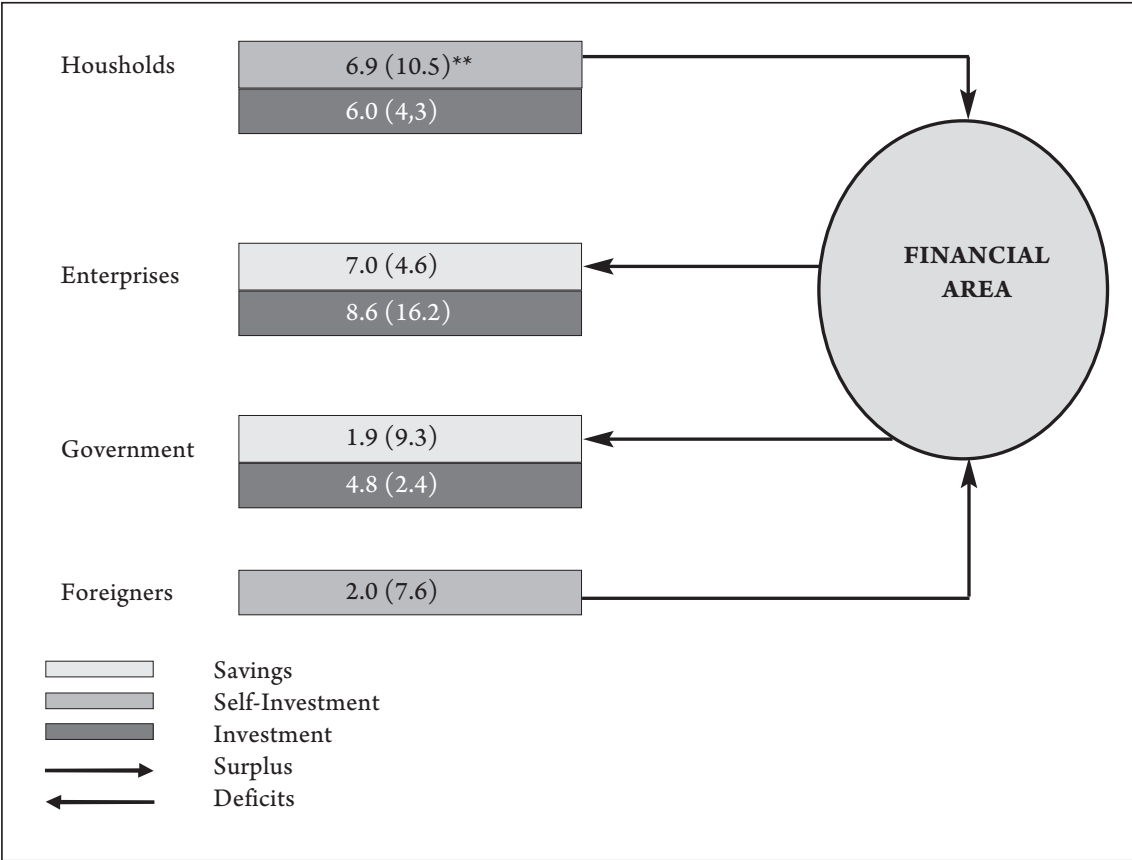
*The numbers in brackets are Vietnam's data in the period of 1995 – 2007

Source: World Bank, Financial Systems and Development, Transportation Press 2000

3. Capital - The main motivation in Vietnam's economic growth

Since 1991, Vietnamese economy has prospered with the growth rate of 8.7% and it reached the highest rate in 1995 with 9.5%. In 6 continuous years (1991-1996), Vietnam achieved the growth rate of above 8.0%. Because of financial and monetary crisis in 1997, the growth rate of Vietnam decreased to 5.8% in 1998 and 4.8% in 1999. Since 2003, economic development has had recovery and the average growth rate from 2003 to 2007 reached 8.04%. In comparison with other countries in the region, Vietnam's economic growth rate ranked the second after China and was higher than ASEAN countries such as Malaysia, Philippines, Indonesia and Thailand. The growth rate of Vietnam through periods is showed in chart 3. Obviously, from the beginning of 1990s up to now, although there have been fluctuations of GDP growth rate, the growth rate of the whole periods 1990-2007 is generally stable. According to the data

series of Vietnam's GDP development from 1991 to 2005, two researchers Le Xuan Ba and Nguyen Thi Tue Anh showed the stable index of Vietnam for that period is 0.2[2]. If comparing with Korea and Brazil – two nations great contrast on developing models, Vietnamese stableness is higher. Vinod Thomas, Mansoor et al in the book "The Quality of growth" calculated the index of stable development among countries from 1980 to 1997. The result of this research showed Korea had been the country which has high stableness in development with the index of about 0.4. In contrast, Brazil had been considered as the country with high development unstableness with the approximate stable index of 1.4[3].

Chart 3. Growth rate of economy and industries
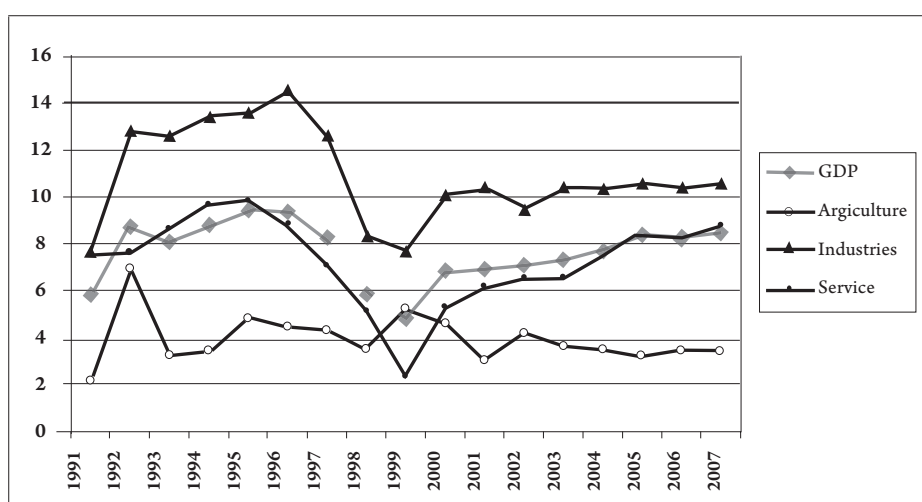
Source: Data consolidated from Vietnam's General Statistics Office

Although it is reached impressive growth rates during period from 1990 to 2007, Vietnam's economic growth mainly depends on factors to the width. The quality of growth has improved through the increase of Total Factors Productivity (TFP) in the annual growth of GDP, from 14.20% in the period of 1992-1997 to 22.6% of 1998 - 2002 and 28.2% from 2003 to now. However, the growth made from capitals accounted for 52.73% and from labor was 19.07%. It means that these two factors accounted for nearly three quarters of total three-factor-effects of growth (shown in table 1). In comparison with other countries in the region, the contribution rate of TFP to Vietnamese annual growth is much less than that of Thailand 35.0%, Philippine 41% and Indonesia 43.0%. Basing on the data about contribution rates of factors to Vietnam's economic growth, capital is still a fundamental motivation of growth.

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[2] Le Xuan Ba, Nguyen Thi Tue Anh (2006)
[3] Vinod Thomas, Mansoor Dailami et al. (2000)

**Table 1: Contribution of input factors
to Vietnam's GDP growth (%)**

Period Contribution of factors	1993 - 1997	1998 - 2002	2003 –2006
1.Contribution according to points of percentages	8.8	6.2	7.84
-Capital	6.10	3.56	3.78
- Labor	1.40	1.24	1.40
- TFP	1.30	1.40	2.07
2. Contribution according to percentage rates	100.0	100.0	100.0
- Capital	69.30	57.40	52.73
- Labor	15.90	20.00	19.07
- TFP	14.80	22.60	28.20

Source: Prof.PhD Nguyen Van Thuong and Prof. PhD. Nguyen Ke Tuan (2006)

Looking at growth rate of GDP and fluctuation of savings and investments in GDP, Vietnam's economic growth rate has attached to the high increase of the rates of domestic savings and investments in GDP since the 1990s. In the period from 1986 to 1990, the rates of domestic savings and investments were low, 2.4% and 12.6% respectively, the growth rate was only 4.3% GDP. But, in the period of 1991 - 1995, the rates of domestic savings and investments reached to 14.7% and 22.3%, the growth rate of GDP rose up to 8.2%. From 1996 to 2007, the rates of domestic savings and investments in GDP got 25.9% and 33.2%, the GDP growth reduce slightly to 7.0%. Especially, between 2001 and 2007, the rates of domestic savings and investments in GDP increased strongly to 32.1% and 39.9%, the growth rate of GDP was 7.74%. The dropping out of growth rate in the period from 1998 to 2003 was caused partly by the regional financial crisis and the down-date policies which made investment capitals less effective. It led to the rapid increase of investment rates on GDP while the growth rates of GDP had not recovered as the period before crisis. Especially, the investment rate in GDP in 2007 rose significantly to 45.6% of GDP. According to the analysis of Pham Do Chi and Le Viet Duc, the investment in Vietnam is late about 1 to 2 years comparing with growth[4] (Chart 4).

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[4] Pham Do Chi, Tran Nam Binh, Vietnam Economy steps on XXI century, page 14

**Chart 4: Relations between the growth
of investment capitals and GDP**
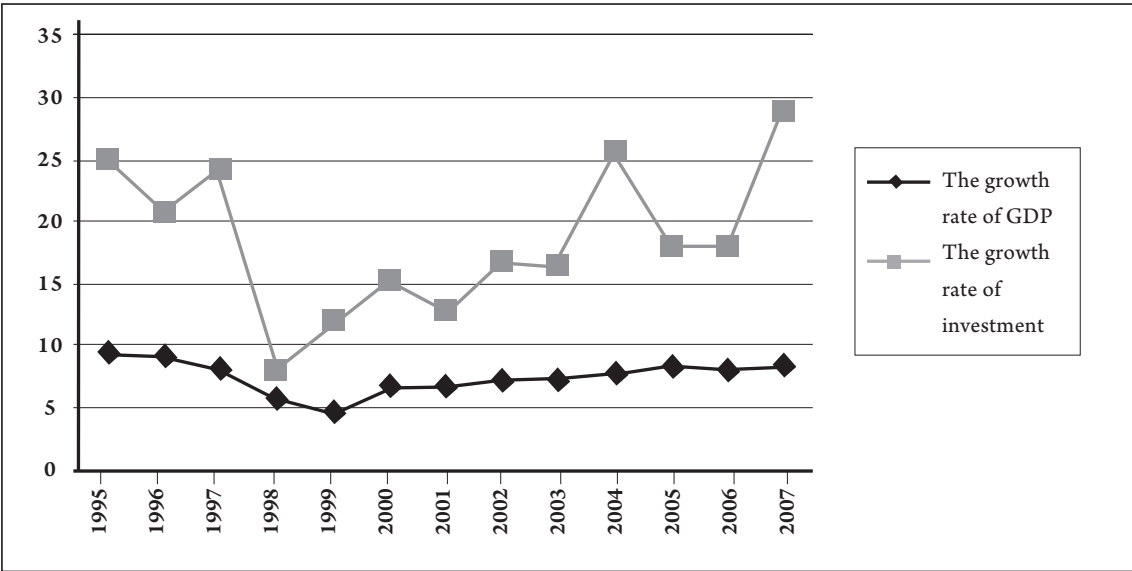
Source: the author consolidated from data of GSO

4. Conspectus of savings and investment in Vietnam

4.1 The Vietnamese trend of savings and investment in the period of 1995 - 2007.

From 1990 up to now, the total social investment in Vietnam has been rising quite rapidly and the investment rate increased to 41.0% GDP in 2006 and 45.6% GDP in 2007. This has been a high rate compared to some countries in the region, it was only lower than that in China. In average, in the period between 1995 and 2005, investment rate in Vietnamese GDP stood as the 9th of the world and that rate was higher than the global average and than that of low-income countries. (See Chart 5)

Chart 5. Investment rate in GDP among countries in the world in 1995-2005
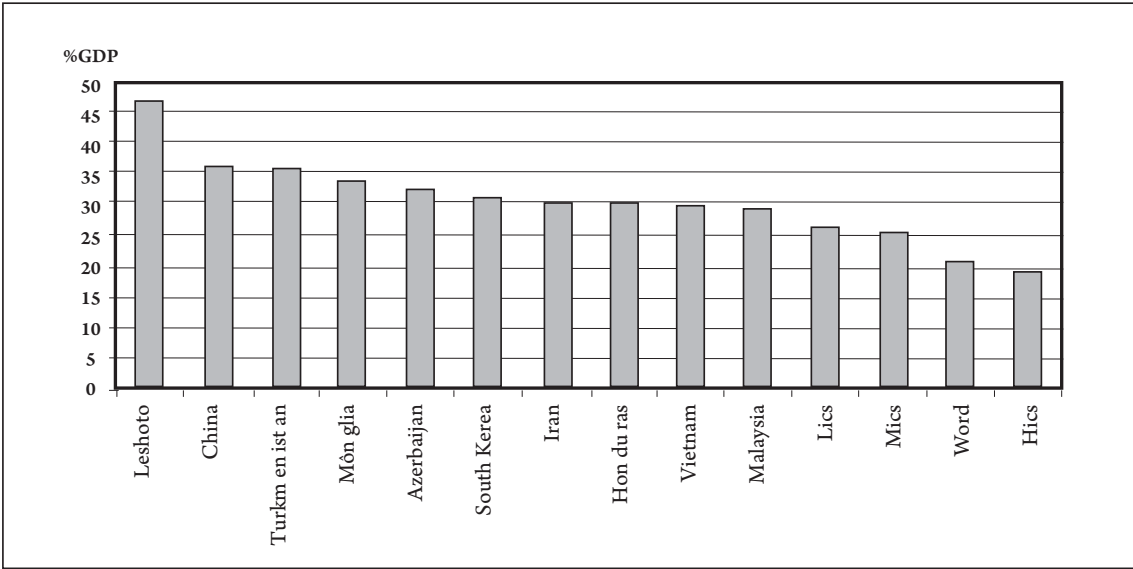
Source: World Bank, Atlas of Global development, 2005

However, if it was calculated by capital formation rates, this rate of Vietnam in 2007 was 35.8% and in average was 31.7% in the period from 1995 to 2007. Therefore, the disparity between investment rates and capital formation rates was about 5.0% of GDP in the period 1995-2007. The difference between investment rates and capital formation rate compared to GDP was caused by the total social investment including expenses for clearing the ground and some administration expenses of national targeted programs such as the Program 135, Employment Program, ect[5] (Chart 6).

The Vietnam's national savings rate has increased rather rapidly since 1990, from 2.9% in 1900 to 35.8% in 2007. It means approximately domestic savings rate of Thailand and higher than The Philippines and Indonesia. However, this rate was lower than the level 40% of Malaysia and China. It has been acknowledged that the dramatic increase of the domestic savings rate is one of many achievements of Vietnam, which contributes to create and maintain the high economic growth rate in the passing time. During the late decades of the 20th cen-

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[5] In this research, the author used investment rates compared to GDP, not used capital formation rates compared to GDP, because the data about capital formation rates in the region are not available. In the period of 1996-2000, Vietnam had 11 national targeted programs, now there are 7 programs including: Hunger diminishing and poverty reducing program; Population and family planning program; Fresh water and environmental hygiene program; Social disease deleting program; HIV/AIDS program; program of training talented athletes and building important sport centers; Employment solving program.

**Chart 6. Savings rates and capital formation rates (% GDP)
in Vietnam in 1995-2007**
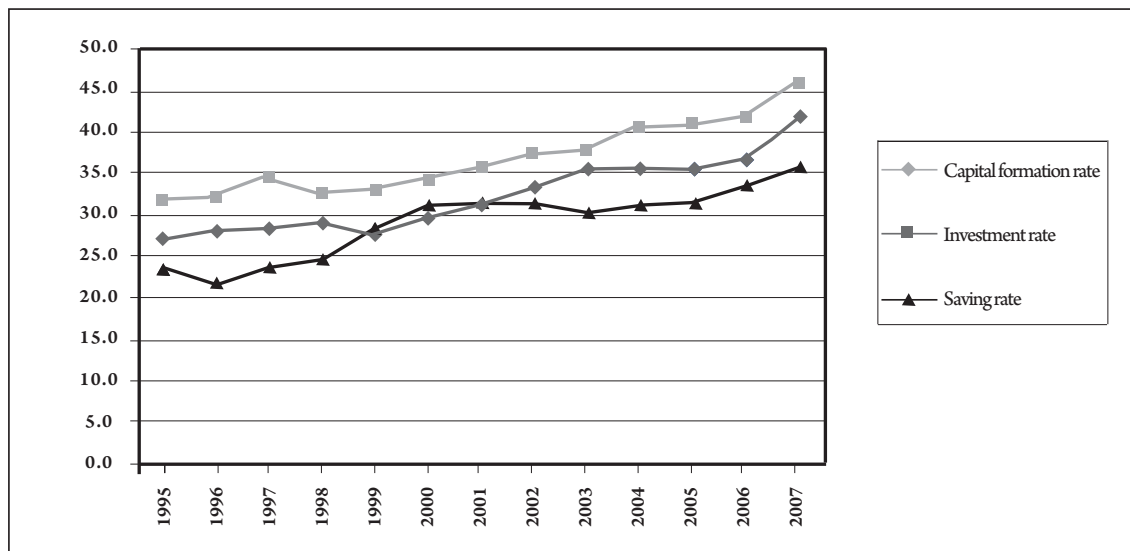
Source: The author consolidated from data of GSO

tury and in the early years of the 21st century, Vietnam's national saving continuously increased (3 times) and was higher than the increasing rate of investment (over 2 times). In this period, there were two dropping points of the savings rate: 1996 and 2003. The reasons of these two reductions were different: in 1996, it was caused by the increase of domestic consumption rate due to the optimistic mentality in the circumstance of highest growth in GDP 9.34%; and in 2002-2003 it was caused by the demand expansion policy of the government due to the affects of economic crisis in the region as well as in the world, and the deflation signals in the period 1999 - 2000.

According to Masson, Bayomi and Samei, the relation between average income per head and savings rates is in the opposite shape of U. The savings rate will rise in the first period of the development process (when GDP per capita is low) and reduce when countries reach the higher level of development with high GDP per capita. According to this model, Vietnam with the level of GDP per capita is 835 USD (low-income country), savings rate is still having the increasing trend in the near future.

According to the research "Household savings in Vietnam" of the Vietnam's economic institute, Vietnam's national savings (S) has linear dependence (98.53%) with the gross national income (GNI). This discovery affirms the ju-

diciousness of J.M. Keynes's savings model in the case of Vietnam from 1990 up to now and has no changing signals in the coming time[6].

In the period between 1995 to 2007, the Vietnamese savings rates in GDP continuously increased and reached to 41.5% in 2006 and 45.6% in 2007. The Vietnam's social investment rates in GDP were only lower than China compared with the East Asian countries. This rate rose up in the period from 1995 and 1997 and had downtrend from 1998 to 2000, which was caused by the financial crisis in 1997 and this rate just increased from 2003. Indian investment proportion nearly remained unchanged while other East Asian countries decreased strongly, usually 1/4 of the rates of 1990. Vietnam has the highest growth rate which was approximate with China.

The gap of the average investment growth rate between the period from 1999 to 2001 and the period from 2002 to 2005 in Vietnam was 4.7% of GDP in comparison with 1.3 % of the common rate of developing countries. Therefore, this gap of Vietnam was only lower than China (5.8%), whose economy has been overheating growth, and one or two small other economies in the world.

If investment is divided according to economic components including 3 sectors: state investment, non - state domestic sector and foreign investment sector, investments by state sector always accounts for high proportion of around 50.0% of the total investment capital. State investment increased from 42.0% in 1995 to 59.8% in 2001, reduced to 52.0% in 2005, 50.1% in 2006 and 39.9% in 2007. Especially, the share of investment by State had a strong increase in the period from 1998 to 2003 due to the implementation of the government's demand expansion policy. In this period, the investment of the domestic private sector and the foreign investment area dropped out. In the period of 1995-1997, foreign directed investments to Vietnam rose strongly so the investment density of this area went up and accounted for 28.1% of the Vietnam's total investment. Because of the crisis in East Asia, the amount of FDI to Vietnam fell off dramatically in the period 1998 - 2000, so the density of this area in the total investment capital only made up 18.2%. The FDI source has just begun to go up again since 2005. Investments of domestic private sector also decreased in the period of 1997 - 2002 because of the East Asian crisis. However, the dropping speed of this area was not high due to the Enterprise Law activated in 2002, which motivated investments of private area. The share of investment by domestic private sector rapidly from 2002 and exceeded over 1/3 of Vietnam's total investment.

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[6] Household Savings in Vietnam, Vietnam's Economic Institute

Chart 7. Ownership Shares in Implemented Investment in the Period 1995-2007
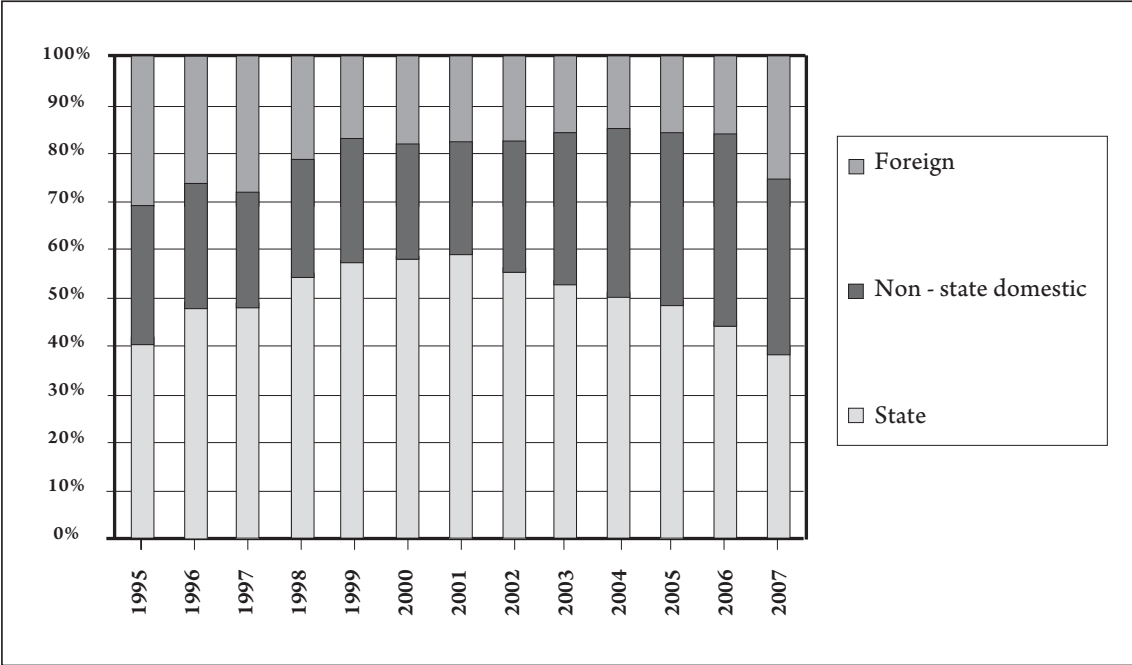
Source: The author calculated from the data provided by National Account Department, GSO

Investments by state sector accounted for high share, that made the economy less effective. Looking at the table 4, it is acknowledged that the quick increase of ICOR have the same meaning of the rapid decrease of investment efficiencies. This trend is occurring to the total investment capitals of the overall society, especially to the state sector. The increase of ICOR was the indispensable trend due to the advance of science and technology. However, the quick increase of ICOR has always been unusual and concerned in the development process of every economy. The ICOR of Vietnam was even higher than some regional countries such as Thailand, Malaysia, Indonesia, China and India. The interesting thing was that India reached the growth rate approximate to Vietnam from 2000 up to now, while their investment rates was only high as 2/3 as Vietnam. It meant that India only needed 3.5 investment units to create one growth unit while Vietnam needed 5 investment units to create one growth unit. China only needed 4 investment units to create one growth unit. Why there were differences in investment effects? According to Professor David Dapice[7], the reason from corruptions was not enough to explain because Indonesia (having

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[7] David Dapice, Development trends in East Asia, Economic Training Program Fullbringt

highest corruption level among East Asian countries, ranking 130th in 163 countries) and Malaysia (lowest corruption level in East Asia, raking 44th in 163 countries) had nearly the same ICOR in the ranking list of the International Transparence Organization. China, India and Philippines had lower ICOR, but India and China ranked 70th while Philippines ranked 121st after Vietnam 111th. Therefore, according to David Dapice, the cooperation of financial power, government expenditure efficiency and the range of credit competition will have affects on ICOR. To this aspect, Vietnam could lag behind competitive countries.

The ICOR increase of the whole economy attached with the rapid ICOR growth of state sector (from 3.7 to 9.4) and FDI area. The coefficient ICOR of FDI area was high because of by high investment rates (expensive capitals, high levels of technologies and techniques) and high labor productivity. To the government (including state budget and SOE), this matter was related to public investments, especially investments for infrastructures; investment qualities, management abilities at macro levels as well as micro levels and low labor productivity. It was a serious situation because it happened in the decisive economic sector, which had the strongest potentiality and the best development position in the economy.

Table 2. Annual average growth rates of the whole society's capitals by ownerships

Periods	Investment Capitals	Government	Non-government	FDI
1991 – 1995	22.3	21.1	11.5	46.7
1996 - 2000	12.2	20.2	8.1	1.0
2001 - 2005	13.0	10.2	20.9	9.9

Source: Vietnam Economy 20 years of innovations, General Statistic Office

Table 3. ICOR trends in the period 1995-2006[8]

Year	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
ICOR	3.12	3.34	3.80	5.59	6.59	4.80	4.89	5.01	5.08	4.91	4.68	4.88	4.90

Source: The author consolidated from data of General Statistic Office

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[8] ICOR index may calculated by many ways. In this case, ICOR is computed by formula = Property Accumulation rate / GDP growth rate.

Chart 8. Sources of domestic and foreign investment capitals
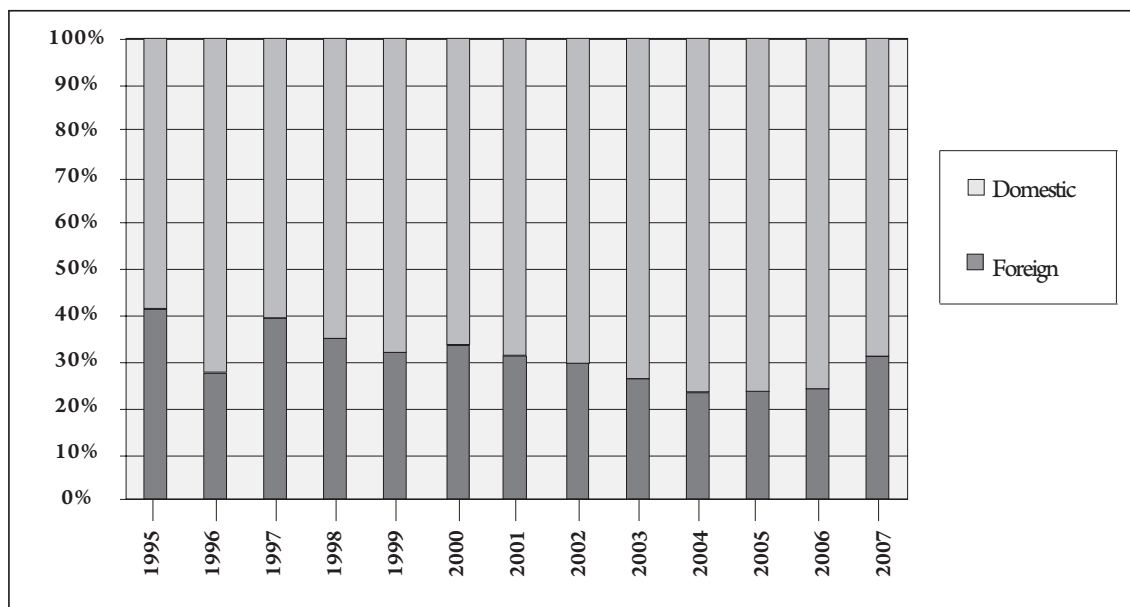
Source: National Account Department, General

If investment was taken into consideration under the domestic sources (investment source from national budget, state-owned enterprises, private enterprises and households) and foreign sources (including capitals of FDI and ODA enterprises), the foreign investment capital shares in the total investment had the dropping trend, from 41.3% in 1995 to 33.4% in 2000 and 23.8% in 2005. The share of foreign investment in the total social investment reduced dramatically in the period from 2001 to 2005 that was because: i) the economy suffered from deflation during the period 1998 to 2002, ii) the joining WTO of China directed many FDI sources to run into this country, iii) the Vietnamese investment environment was slow to adapt; iv) there was the increase of domestic private investment capitals. However, in 2006, especially in 2007, foreign investments to Vietnam increased rapidly, including direct investments and indirect investments, which made the foreign investment share of total social investment went up to 30.8%. So the gap between Vietnam's national savings rates and social investment rates rose up to 9.8% of GDP in 2007. It showed that Vietnam depended heavily on the foreign investment in economic growths. In comparison with other regional countries, especially with China (the gap between savings and investments of China was 0.9%), it was clear that the mobilization rate of foreign investments was really high in Vietnam. This was due to the socio-economic conditions among countries were different, but most of the regional countries had have the gap S-I in the range of 4-5% of GDP, so Vietnam should reconsider this problem.

4.2 Savings and investments by institutional sectors

Savings by institutional sectors have divided into government savings (including savings from national budget, ODA), savings of enterprises (including savings of state-owned enterprises, enterprises with overseas investment and private enterprises) and savings of households. The situation of savings and investments by institutional areas in Vietnam was shown in the table 4.

In the 3 institutional sectors, enterprises had higher savings shares than government and households. Especially, from 2001 when Enterprise Law was activated, savings rate of enterprises increased dramatically in quantity. While the savings share of households had reducing trends partly because one part of this savings was transferred to savings of enterprises (under Enterprise Law, some households business changed into companies). Savings by institutional sectors was shown in chart 9.

Chart 9. Saving structures by institutional sector
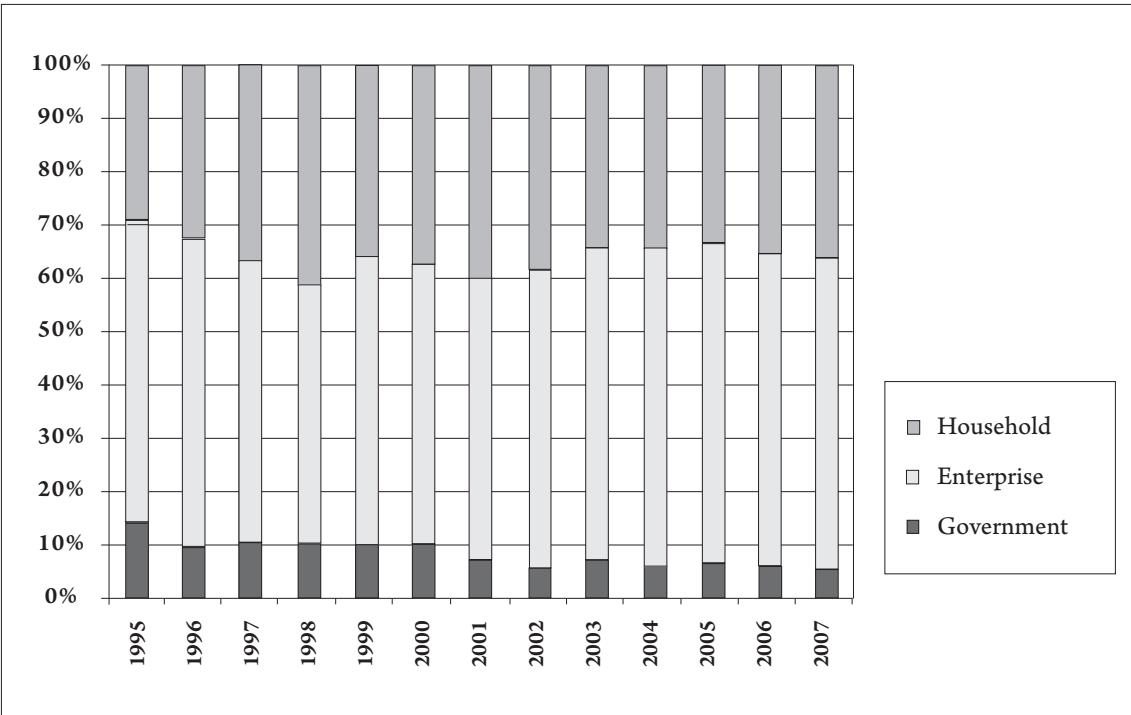
Source: General Statistic Office

Table 4. Savings and investments in Vietnam's institutional areas in the period 1995 - 2007

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Trung bình
S/GDP rates	23.5	21.8	23.7	24.7	28.2	31.2	31.3	31.5	30.3	31.2	31.5	33.5	35.8	29.1
I/GDP rates	31.7	32.1	34.6	32.4	32.8	34.2	35.4	37.2	37.8	40.7	40.9	41.5	45.6	36.7
S-I Gap	-8.1	-10.3	-10.9	-7.7	-4.6	-3.0	-4.1	-5.7	-7.5	-9.5	-9.4	-8.0	-9.8	-7.6
S-I Households	1.4	1.9	3.1	6.2	7.0	8.6	10.1	9.5	7.1	6.6	6.1	6.0	7.3	6.2
Savings	6.9	7.1	8.7	10.4	10.3	11.7	12.6	12.1	10.4	10.8	10.5	11.9	13.0	10.5
Investments	5.5	5.2	5.6	4.2	3.2	3.1	2.6	2.6	3.3	4.2	4.4	5.8	5.7	4.3
S-I Enterprises	-6.6	-6.2	-7.2	-6.1	-2.9	-1.7	-2.8	-4.0	-4.3	-3.4	-3.3	-3.6	-7.1	-4.6
Savings	13.3	12.6	12.4	11.9	14.4	16.1	16.4	17.6	17.8	18.6	19.0	19.7	20.8	16.2
Investments	19.8	18.9	19.6	18.0	17.3	17.9	19.2	21.6	22.1	21.9	22.3	23.4	27.9	20.8
S-I Government	-2.9	-6.0	-6.8	-7.8	-8.7	-9.9	-11.4	-11.2	-10.3	-12.7	-12.2	-10.4	-10.0	-9.3
Savings	3.4	2.1	2.5	2.4	3.5	3.4	2.3	1.8	2.1	1.8	2.0	2.0	2.0	2.4
Investments	6.3	8.0	9.3	10.3	12.2	13.3	13.6	13.0	12.4	14.5	14.3	12.4	12.0	11.7
ODA/GDP rates	3.6	0.4	3.7	4.6	4.7	5.3	4.6	4.4	3.6	3.6	3.2	2.9	2.7	7.3
FDI/ GDP rates	9.6	8.3	9.7	6.7	5.7	6.2	6.2	6.5	6.2	5.8	6.1	6.7	11.3	6.4

Source: National Account Department, GSO

Among 3 sectors, household sector was the net lending sector. In the period 1995 – 2007, in average households saved 10.5% GDP and invested 4.3%, so the households had net lending of 6.2% GDP. Enterprise sector saved 16.2 GDP and invested 20.8% GDP, so this sector borrowed net 4.6% GDP. Government saved 2.4% GDP and invested 11.7% GDP, so the government borrowed net of 9.3%.

Chart 10. Investment rates by sectors in the periods 1995 – 2007 (% GDP)
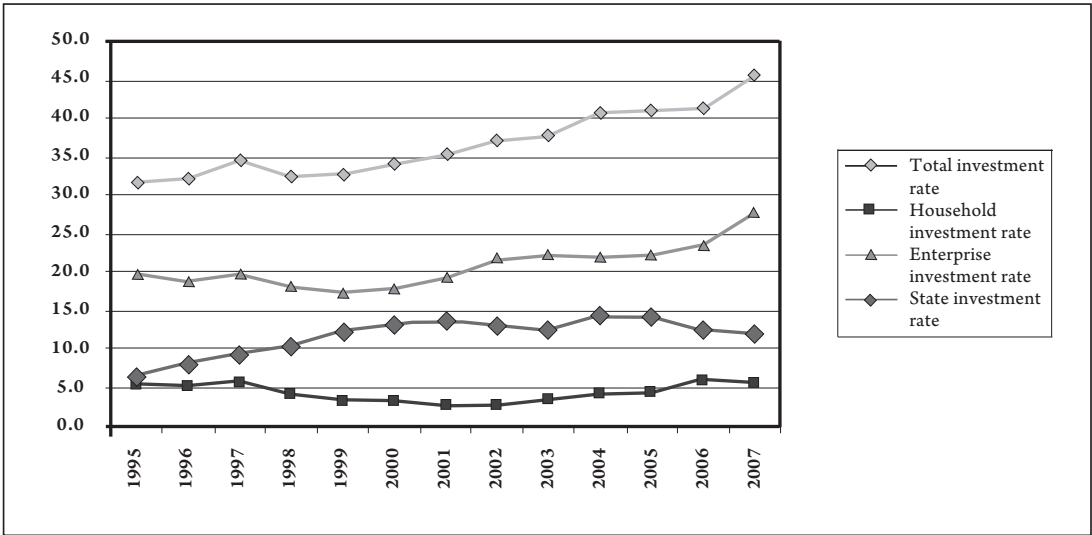
Source: The author calculated from data of National Account Department, GSO

Chart 11. The gap between saving and investment by sectors (% GDP)
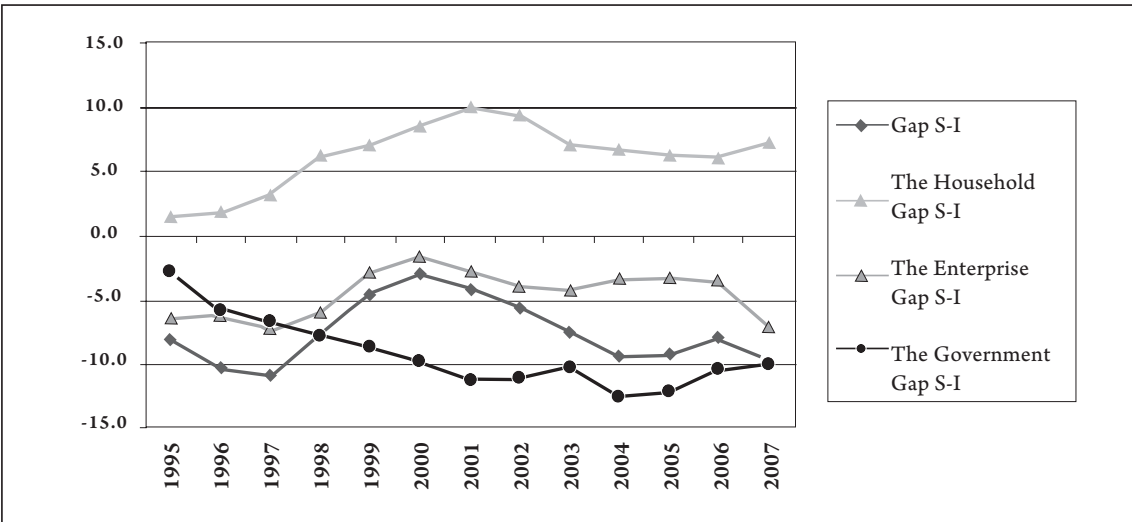
Source: The author calculated from data of National Account Department, GSO

4.2.1. Household savings and investments

Saving rates of households in GDP increased continuously from 6.9% in 1995 to 12.6% in 2001, then this rate reduced during the years of 2002-2004 and rose up again from 2004 to now. The saving rates of households in 2002-2004 reduced because of the government's demand expansion policy in the period of 1999 - 2003, which made the consumption rates of households increased (Chart 12). However, when the economic cycle had grown again (from the year 2003), the saving rate of households had also growth trends. In 3 sectors, household sector was the saving surplus sector, so it was considered as net lenders.

Chart 12. The rates of households savings and investments comparing with GDP (%GDP)
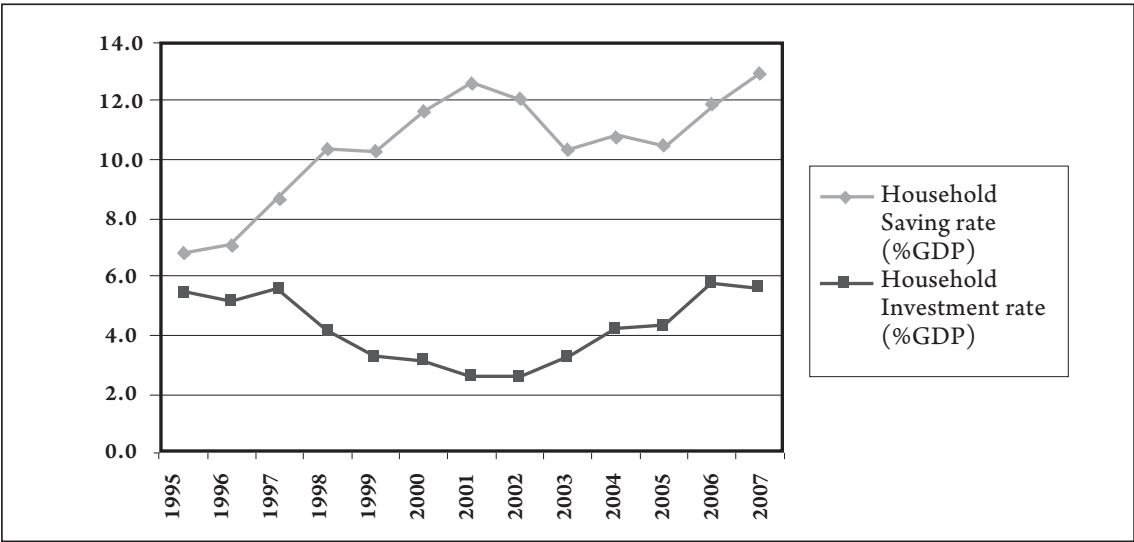
Source: The author calculated from data of National Account Department, GSO

There are many reasons which affect on savings of households such as usable income, population structures of age, government policies. In the research about household savings in Vietnam of Dang Xuan Thanh by trend functions, it was shown that household savings growths up to 94.85% could be explained by household income growth. On the other hand, according to the N.Kaldor's[9] savings model, household expenditures was not simply increased following income, but consumption behaviour and medium-term savings of households had cyclical fluctuations reflecting the period of purchase booming when living standard went up relatively to the period of falling saving rates.

The Demography structure has effected remarkable on household savings in Vietnam. According to Modigliani's savings theory of life cycles, savings

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[9] N.Kaldor (1955)

had direct proportion relations with young households and indirect proportion with old households. It meant the household savings rate rose up with the age increase process, before it reduced when people retired. From 1990 up to now the Vietnamese population structure had dramatic changes, specifically, the ages from 0 to 14 accounted for 39.1% in 1989, decreased to 26.39% in 2005; the age from 15 to 40 increased from 41.4% to 43.37%; the age from 46 to 59 went up from 12.4% to 20.57%; and the age above 60 rose up from 7.1% to 8.97%. The fluctuation in population structure of ages as above had positive influence on savings rate. However, the population rate of 0 - 14 year olds still comprised up to 28.7% in 2005 and the Vietnamese dependent ratio was still high (55%), which showed that Vietnam still had the young population structure. If the hypothesis "inverse-U savings" of Harrod was true, Vietnam's young population structure limited the savings rate of households. The decrease in population growth rate in these decades brought out the promise of higher savings rate in the future when Vietnamese population structure would change from young population structure to "golden population structure" or surplus benefits of population in 2014 - 2015. If it is compared with China, the household savings rate of Vietnam was much lower. The policy "each family has one child" has been done in China for 25 years, which turns its population structure to golden population structure (the percentage of people in working age is high). It was the premise of the increase in Chinese household savings rate. On the other hand, according to the data in 2003, Vietnam had 18. 3122 millions of households. The growth rate of household numbers is reducing gradually, now it is only about 2.3% per year, lower than the level of 2.5% in 1999. The average number of people in one family was 4.41, reduced in comparison with 4.86 in 1980. When the other things are equal, the reduction of family size will create advantages for people to increase their savings

In the income components of households, salaries and as-salary incomes accounted for 86.6% in average in the period from 1990 to 2007. The current transferring items made up 10.7% of the total income of households (Table 6). The share of current transfer is high in Vietnam partly because of the strong increase of the remiitance from the early 1990s up to now. In the period from 1995 to now, the remiitance to Vietnam continuously rose up from 285 million USD in 1995 to approximately 4.7 billions USD in 2006 and 5.5 billion USD in 2007 (Chart 13). Therefore, in the period of 1995 - 2006 to now, the remittance reached 23.4 billion USD, approximate to 31% of FDI sources and higher than disbursed ODA sources. China, India and Israel have succeeded in assembling the power of oversea compatriots. Those countries not only absorbed the remittance but also their intelligence. They considered overseas compatriots as bridges

to penetrate markets all over the world. The number of overseas Vietnamese in North America, Europe and Australia is a huge channel of mobilizing investment to Vietnam. So the government should have more open policies to attract the remittance and investment from overseas Vietnamese.

Table 5. Income structures of households (%) in the period 1995 - 2007

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Salary and as-salary income	87.2	86.5	86.2	86.2	85.9	85.8	85.2	85.1	88.0	88.1	88.7	86.3	82.4
Subsidiary	2.0	2.4	2.5	2.5	2.5	2.5	3.8	3.5	2.4	2.4	2.4	2.4	2.3
Current transferring items	10.7	11.1	11.4	11.4	11.5	11.7	11.0	11.4	9.7	9.5	8.8	9.7	15.3

Source: The author calculated from data of National Account Department, GSO

Chart 13. The amount of remittance in the period 1993 - 2007 (USD millions)
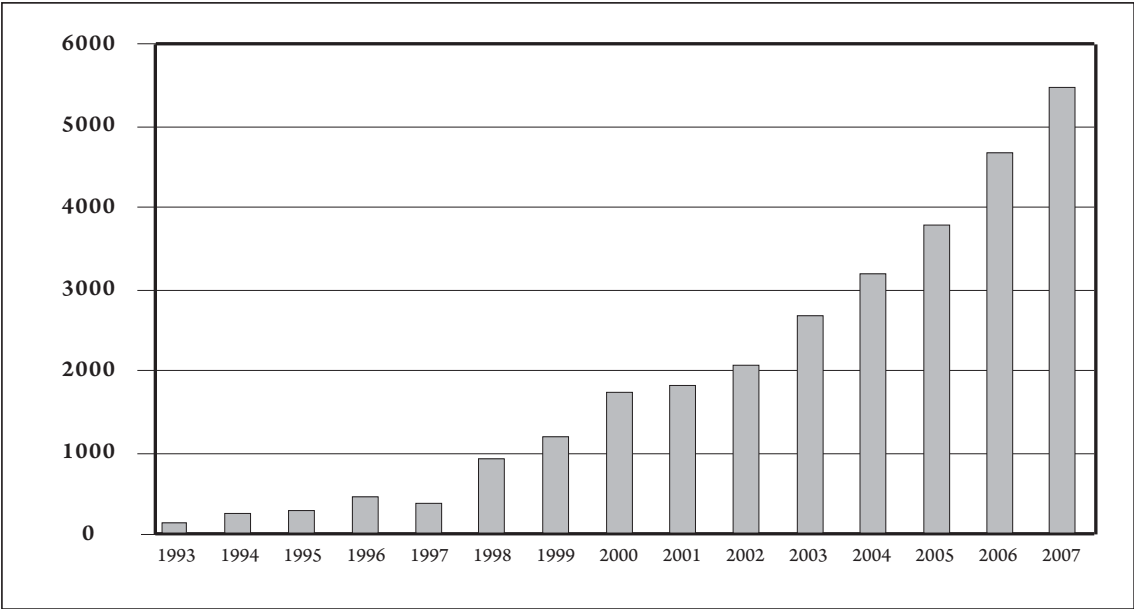
Source: Vietnam Economic Times, the economy 2007 – 2008 of Vietnam and the World.

4.2.3 Savings and investment of enterprises.

In three sectors, enterprises are biggest net borrowers. According to chart 12, it can be seen that the investment rate of enterprises in comparison with GDP reached 20.8% in the period from 1995 to 2007, much higher than that of national and household investment. In 20.8% of investment rate in GDP of enterprises, the enterprise sector saved 16.2% and borrowed 4.6%. The saving investment gap of the enterprise sector from 1995 to 1997 was 5.4 % in average, reduced to 3.5% in the period between 1998 and 2002 and increased to 8.1% from 2003 to 2007.

Chart 14. The rates of enterprises' savings and investments comparing with GDP (%GDP)
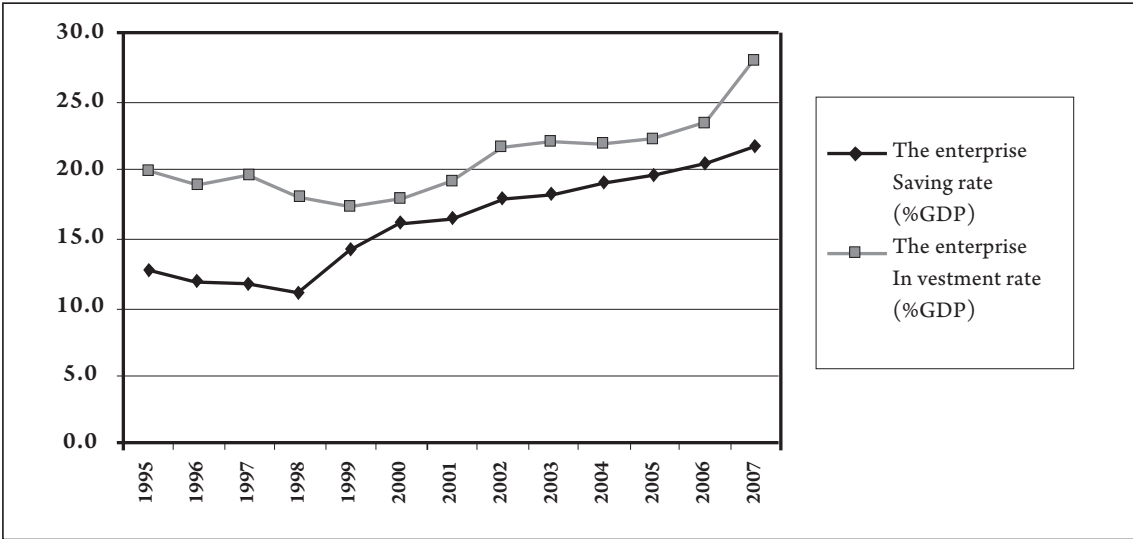
Source: the author calculated from data of National Account Department, GSO

The savings rate of enterprises varied in 2 stages in the period from 1995 to 2007. The enterprise savings rate reduced from 1995 to 1999 and increased from 1999 up to now. One of many important reasons which led to the abnormal fluctuation of savings was instability and inadequacy of the legal environment of enterprises in the transferring process. In enterprise savings, depreciation still comprised high percentage 53.2% in average from 1995 to 2007, higher than retain earnings, especially the very high depreciation percentage of state-owned enterprises was due to the fact that those enterprises accounted for 60% of the total fixed capital of the economy. Retain earnings was 46.8% of enterprise savings, it is totally similar with developing countries when depreciation made up the high percentage in enterprise savings.

Table 6. The share of retain earnings and depreciations in the total savings of enterprises

Year	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Earning proportions in savings	43.3	43.4	43.7	44.0	44.1	44.3	44.6	43.4	42.9	45.4	44.2	59.5	66.4
Depreciations proportions in the savings of enterprises	56.7	56.6	56.3	56.0	55.9	55.7	55.4	56.6	57.1	54.6	55.8	40.5	33.6

Source: The author calculated from data of National Account Department, GSO

In the period from 1998 to 2002, the saving investment gap reduced rapidly because of the East Asian financial crisis. From 1998 to 2002, the enterprise saving rate increased significantly while investment rate dropped, which made the saving investment gap decrease. In this period, the economy had deflations and the government did series of demand expansion solutions. Under the impact of demand expansion policy, investment rates rose up again and the saving investment gap again had increasing trends. However, the gap 3.7% was still lower than 5.4% the level before the crisis. The reason was that savings rates of enterprises went up rapidly under the effect of Enterprise Law. The enforcement of Enterprise Law increased remarkably the number of enterprises in the economy and effected on the rise in savings rate of this sector.

Investment of FDI enterprises had considerably contributed to the economic growth in the passing time. This sector always grew faster than the whole economy and reached a peak of 20.7% in 1997. In the most difficult year, 1999, FDI area still increased 13.0% while the general growth rate of GDP was 4.8%. At the end of 2007, the whole country had more than 9,500 foreign investment projects with the total registered investment capitals about 98 millions USD (including extra capitals). Except the projects which ran out of time, there were 8,590 valid projects with the total capitals of 83.1 billion USD. The FDI capital density increased rapidly in the period between 1990 and 1996, especially from 1995 to 1996, it reached one third of the total investment capitals of the economy. However, FDI capitals had downtrend in the period from 1997 to 2002 and only recovered from 2003 up to now. The second of the "overseas investment waves" to Vietnam are attracting attentions. Especially, FDI to Vietnam increased rapidly in 2006 and 2007, reached 10.2 billions USD in 2006 and 18.9 billions USD in 2007. The effect of FDI to Vietnam's capital market was mainly indirect rather than direct. These enterprises mostly did not increase their loans and shares in the local market. Most of parent companies of FDI enterprises usually supported for child companies in Vietnam or approached the advanced financial markets in the world.

Chart 15. FDI Commitment and Disbursement in the period 1995 – 2007
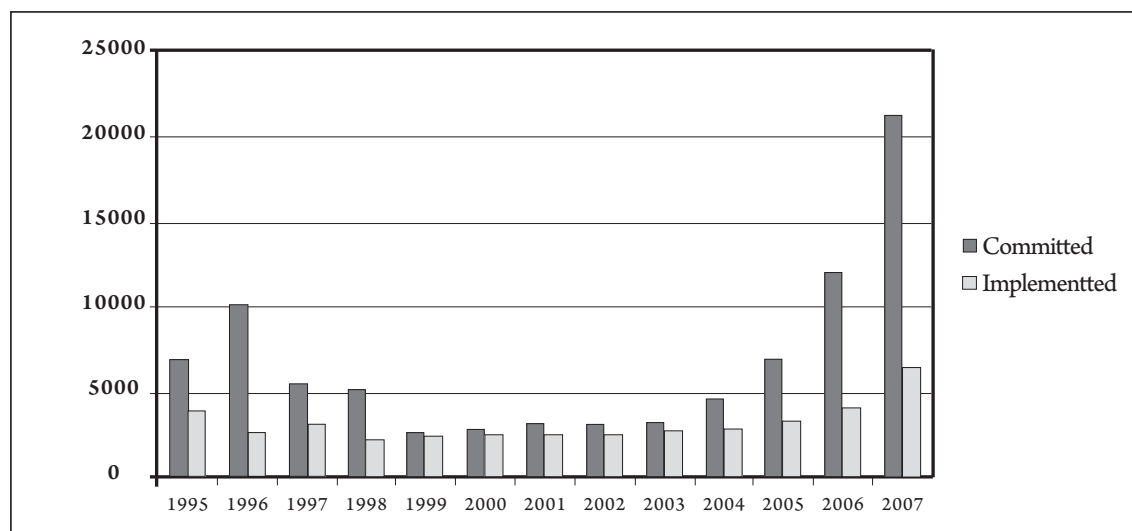
Source: Vietnam Economic Times, the economy 2007 – 2008 of Vietnam and the World

In 3 types of enterprises, the investment density of state-owned enterprises still had priority in the period from 1995 to 2007 and reached the average percentage of 38.2% of the total investment of enterprises. However, this share reduced significantly from 2000 because of the Endeavour to motivate the privatization process of state-owned enterprises. The investment share of state-owned enterprises was higher than in other countries with market economies. The group of state-owned enterprises now keeps about 60% of borrowing capitals from domestic commercial banks and 70% of overseas borrowing capitals. Up to 31st December 2007, the capitals from 70 co-operations and head of companies reached 448.269 billion VND, 1.4 times more than owner capitals. State-owned enterprises are again having trends to invest in multi-fields and multi-industries. There were 16 co-operations and heads of state companies which invested into banks with the capitals of 4.965 billion VND, 9 enterprises did security business with the capital of 316 billions, 12 enterprises invested in finance and insurance with 6.518 billions, 10 enterprises invested 933 billion to investment funds and 13 enterprises invested 2.331 billion to real-estates.

Totally, co-operations and heads of companies invested 15.063 billions to these above fields. The investment without concentration of co-operations, state-owned enterprises to the fields of real-estates, finance, and insurance has had negative effects on Vietnamese financial market currently. Moreover, state-owned enterprises continued to receive many credits and did most of public investment projects despite of the fact that they were not effective[10] based on

objective criteria. According to Fulbright's research, (Fulbright 19th May, 2008) the situation of state-owned enterprises was even more alarming than private co-operations (chaebol) in Korea in 1997. According to the report of Finance Ministry and Enterprise Innovation Committee, the rate of Dept over Equity of state co-operations was very high - 42 times in CIENCO 5, 22.5 times in CIENCO 1; 22 times in VINASHIN; 21.5 times in LILAMA; it was showed that those enterprises could not increase capital from retain earnings or extra stock issuing. Obviously, the tight control to the government's large co-operations was necessary in the current difficulty of the economy.

The positive trend in moving investment structure by types of enterprises was the rapid increase in the investment density of private enterprises, especially from 2000. The activation of Enterprise Law motivated the development of private enterprises, investment density of private enterprises in the total investment of enterprises increased from 28.3% in 1999 to 33.0% in 2000 and reached 38.7% in 2005. Therefore in 2005, the investment capital density of private enterprises in the total investment of enterprises was higher than that of two other types of enterprises. (Chart 16). However, the current situation of the economy (at the end of 2007 and at the beginning of 2008) has caused big obstacles for the development of private area. Firstly, private enterprises now have lacked of capitals while the approaching ability to bank borrowings for their business has lots of difficulties. Secondly, inflation has pushed cost of capital, salary and input materials expense to increase, which reduced competition capacity of enterprises in this area. It is very dangerous because this area has brought out major employment for the economy and has been major motivation for the export growth in these years.

4.2.3. Savings and investment of the government

The Vietnam's government saving rate was very low because in Vietnam the national budget had continuous deficit about 5% of GDP per year and net income of overseas production factors was under zero, but the national savings still reached over zero and fluctuated around the level from 2 to 3% compared with GDP. Differently with some regional countries, especially Indonesia, interest paying proportion in GDP was not a big problem. Although this account doubled during the last period in Vietnam, it only reached approximately 1.2% of GDP. It was suitable with the increase in exogenous finance sources to support for Gov-

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[10] No 2 Policy discussion, Economic training progam Fulbright. Going over crisis and strengthen innovations. 19/5/2008

Chart 16. Investment proportions of SOE, FDI enterprises and private enterprises in the total investments of enterprise area
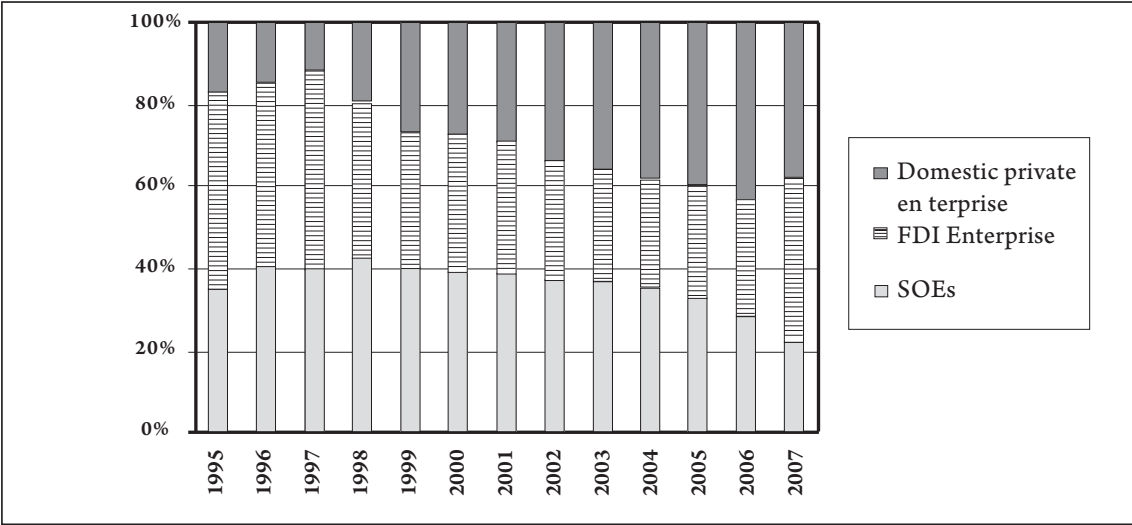
Source: The author calculated from data of National Account Department, GSO

ernment expenditures from 0.6% of GDP in 1998 to 1.6% in 2002. This exogenous finance amount was used for basic investment and made the basic investment increase continuously from 1998 up to now. One typical characteristic of Vietnamese public expenditures after innovation was the absolute as well as relative growth. The increase in public investments led to the increase in the total deficit. This deficit percentage reached 1.6% in 1998 and went up to nearly 5% in 2007[11].

Chart 17. Budget deficits in Vietnam in the period 1995 –2007
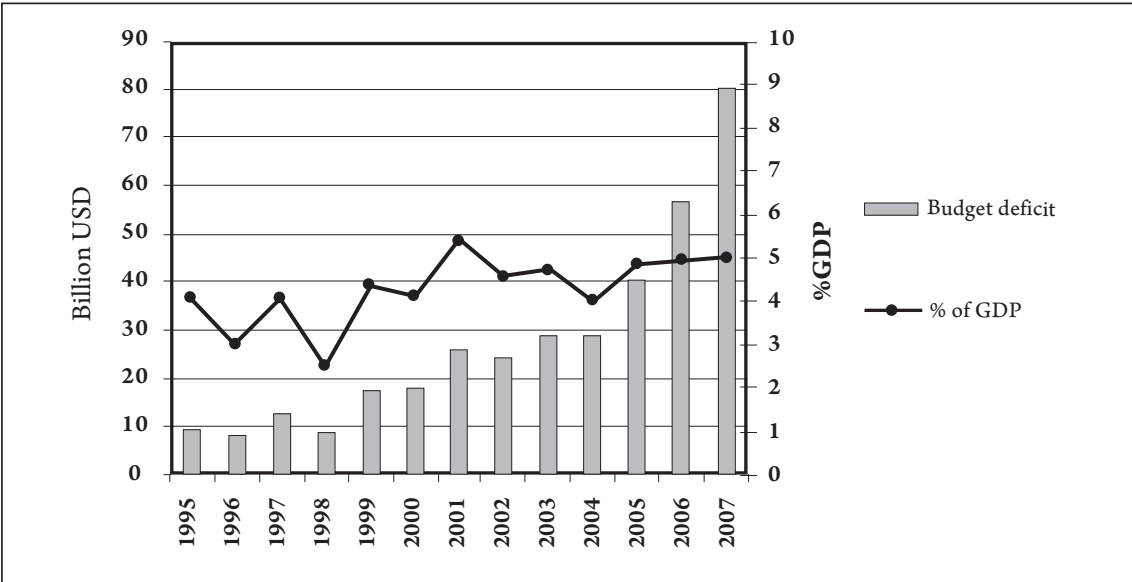
Source: Vietnam 20 years of innovations and development, General Statistics Office

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[11] Data from IMF Vietnam's budget deficits about 7% of GDP

Chart 18. The Vietnam's government saving and investment rates (%GDP)
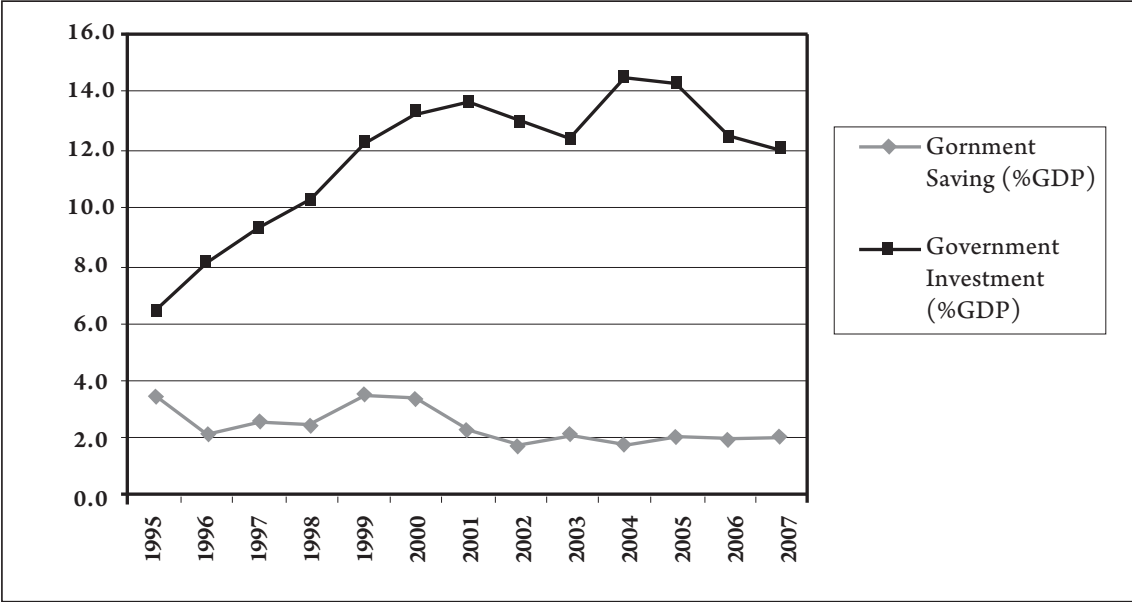
Source: The author calculated from data of GSO

According to the chart 18, we can see that investment rates of the government (%GDP) nearly increased continuously from 1995 to 2007, in which the government investment rates in comparison with GDP rose up dramatically from 1999 to 2001, due to the demand expansion policy of the government. Although the national budget had continuous deficit of about 5% of GDP per year[12] and net income of overseas production factors was under zero, the state-savings rate still reached over zero and fluctuated by around one third of the total domestic investment. This meant that the government had been having positive actions to mobilize domestic and overseas borrowing capital so they could sponsor for their investment projects. In addition to the motivating general investments of the overall society, this borrowings still kept the state- investment remained at the level of more or less than 30% of the total investment. It was the signal of "taking places effect"[13] when state-investment comprised higher percentages than other investment components in the total social investment, investment from state budget has trends to replace private investments. While investment rate of government in GDP had uptrend, saving rates reduced again from the year 2000, which gave the saving investment gap an upward trend. At the same time with this trend, foreign borrowings of Vietnam also increased rapidly through years.

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[12] State Budget Law just issued the first time in 20.03.1996
[13] Vietnam's Household savings, Vietnam Economic Institute

In the component of state-investment capital, ODA played very important roles. Disbursed ODA capitals reached more or less 4% of GDP per year and accounted for 33.4% in the total state- investment. However, the density of disbursed ODA capitals in the total state-investment capitals had a downtrend. The share of disbursed ODA capitals in the total state-investment capitals reduced from 56.1% in 1995 to 24.1% in 2005 and then increased to 36.9% in 2007. The Vietnamese disbursement rate was very low, only 45.4% in the period from 1993 to 2007. Comparing the rate of signed ODA capitals with other similar developing countries, this rate of Vietnam was rather low from 2001 to 2007, 3.5% - 4.5% in average (the average rate of countries receiving ODA in the world was 9%). ODA disbursement rate of some sponsors in Vietnam was still lower than that of that sponsors in the region and the world.

Chart 19. Commitment and Disbursement ODA in the period 1993 – 2007
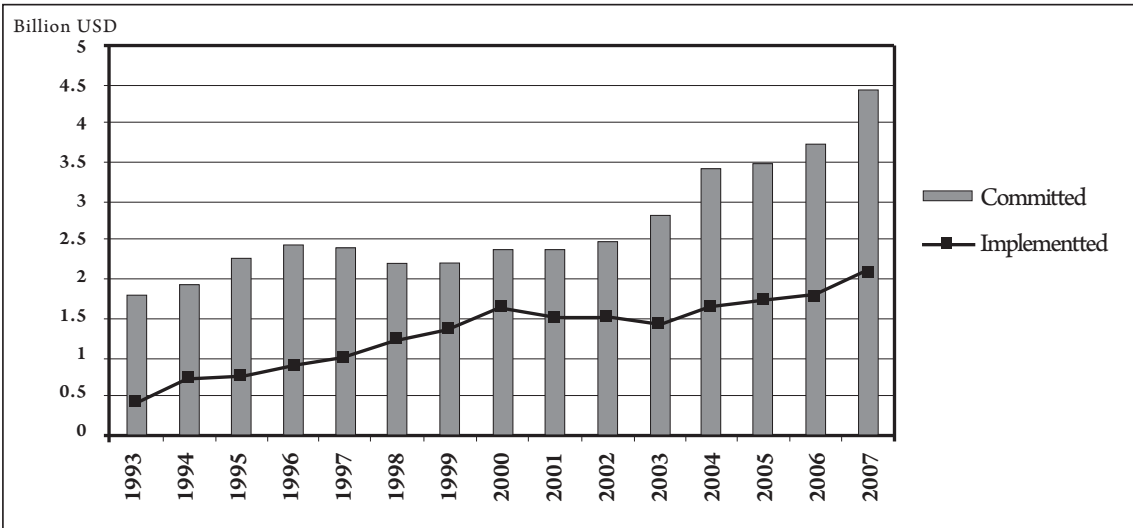
Source: International Relations Department, Ministry of Planning and Investments

Only addressing the period 2001 to 2005, ODA added 11% to the total social investment capitals and ODA which was provided through state budget made up 17% in average of the total investment from state budget. ODA became an important additional channel for the development of the economy and society. In ODA capitals, about 80% was preferential borrowing capitals, which caused the increase in overseas loans of Vietnam. Up to 31st December, 2008, Vietnamese loan was estimated about 22.4 billion USD. From 2000 up to now, the loan density of the government rose up to over 75%. The debt of state-owned enterprises reduced with the average density of 7.4%, the debt of FDI enterprises also dropped and comprised about 27.2%. This was the negative trend because debtors were the government. According to the debt lending and paying strategy

which was approved by the Prime Minister, the oversea debt of Vietnam was currently in the safe line. The total external debt to GDP ratio at the end of 2005 was 35.3% of GDP, as much as 51.5% of export turn-over, paying debt services (the amount of principals and interests) equal with 5.1% of export turn-over, public debt paying services equal with 6.0% of the total state budget income[14]. WB also assessed that Vietnam is therefore considered a country at low risk of external debts distress. However, due to the rapid increasing trend of borrowing capitals, the Vietnamese government should be more careful in the debt lending and paying strategy. Moreover, after 2010, the ODA density which has high preferential conditions in the total ODA capitals will fall off and ODA with conditions similar with commercial lending capitals will rise up so Vietnamese government should promote to apply new aid models on the large scale for Vietnam.

4.3 The saving investment gap

Now the gap between Vietnam's savings and investment was approximately 9% of GDP, reduced considerably with the rate of 10% -12% GDP one decade ago. It showed that Vietnamese economy became more balance and savings caught up with investments at the rate of about 1/3 of GDP. Maintaining and promoting this positive trend was one of important duties with forming financial policies. However, from 2001 up to now, this gap has been increasing. The shortage between savings and investments was the cause of deficits in balance of payment. Current balance of Vietnam has had a rapid change since 1996 when the deficit rate of that year reached 9% GDP. The deficit rate was decreased in 1997 and 1998 and had surplus in 1999. One of the solutions which were used to reduce the deficit was export limitation. In addition, the Asian financial crisis had effects on the economy and the flow of overseas investments, so it reduced the demand of exports.

The recovery of Vietnam's main exporting markets, mainly from Southeast Asia's partners from 1999 brought out the increasing demand of exporting goods of Vietnam. Trade and current balance continued to have the considerable surplus rate in 2000 and 2001 before the deficit came back in 2002. The deficit of current account balance was 9.85% of GDP in 2007 compared with 0.3% in 2006. Although having the high deficit rate of current accounts, the balance of payment situation of Vietnam remains sound, because the current balance was financed primarily with long-term and medium-term investments such as foreign direct investments and ODA. The ODA commitment was at the level of 5.4 billion USD and the disbursement was 2.4 billion USD in 2007.

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[14] According to international experiences, the maximum limitation of total foreign debts is 50 -60% or 150% of export turnover, debt paying services including principals and interests is 15% and 10% of total income of state budget

The capital flow of indirect investment had sudden growth in 2006 and especially in 2007 with the boom of the stock market. The high level of FDI and ODA commitment showed that Vietnam could increase the disbursement rate if the current limitations were solved. Joining WTO could be the decisive factor for the rapid growth of direct and indirect investment capital, however other factors might play important roles. These include state- owned enterprise privatization programs, more transparent investment procedures, the result of Vietnam and the USA Commercial Convention, transferring capital from developing financial markets and stable basic factors in Vietnam. From 1996 to 2002, Vietnam's foreign exchange reserves were only at a limited level. However, the reserve increased rapidly from 2003 and especially in the recent years. The foreign exchange reserves increased from 11.5 billion USD at the end of 2006 to 23 billion USD at the end of 2007, approximate to 32% of GDP (Chart 20). At the same time, the foreign exchange reserves calculated on importing weeks rose up considerably, from two importing months in 2002 to nearly four in 2007.

Chart 20. Vietnam's Currency Reserves
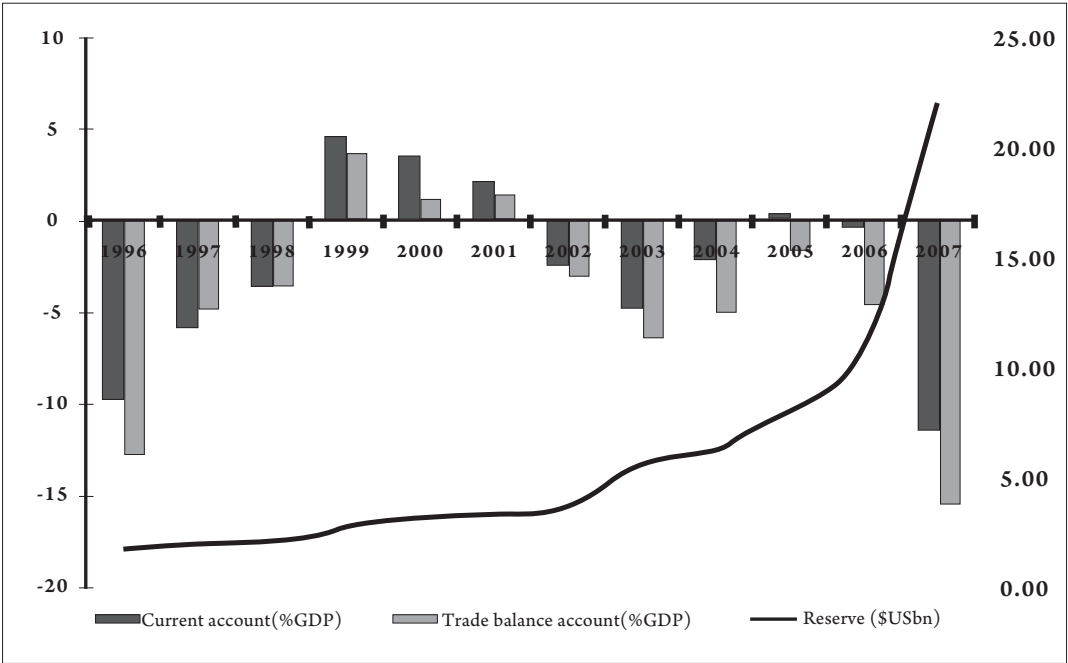
Source:Claudio Dordi, Michel Kostecki, Francesco Abbate, Andrina Lever & Paul Baker and Pham Chi Lan, Le Dang Doanh and other authors (2008)

Now Vietnam has had the inflow of capitals that compensate enough to the trade deficit. However, the high and long-lasting deficit rate could damage the economic growth in long-term. Although joining WTO would support export, the reduction in the custom barrier would make imported goods more compet-

itive than domestic ones. So, net export would have minus contribution to growth in medium term. That gave the question about the stability level in the deficit of current balance. Now, the largest part of finance and capital balance is FDI disbursement, the biggest imported component is machines and materials, therefore, long-term competition ability could be improved with the high current account deficit rate.

However, the sponsoring structure for deficits has been having considerable change with the increasing density of short-term capitals[15]. This raises the problem about the inverse ability of capital flow and the stability of the payment balance.

Chart 21. Current account deficits and supporting sources
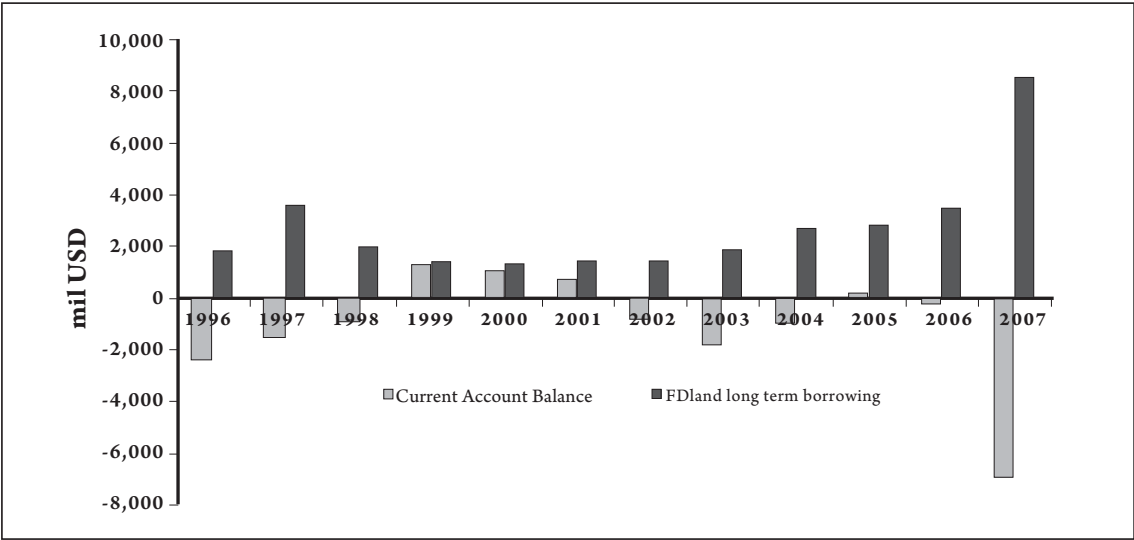
Source: State Bank of Vietnam

Although gaining many positive results, savings and investments still have some limitations and disadvantages. The absolute size of savings was still smaller than investment requirements. Not small amount of capitals was still remained in residents, this capital had not still mobilized for investment growth; it was invested in real-estates speculations, gold or foreign currencies. Foreign investments had recovering signals, especially in 2007 when Vietnam joined WTO with the registered capitals up to 20.2 billion USD. The sudden growth of FDI to Vietnam in 2006 and 2007 was the results of: i) Vietnam became the official member

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[15] ANZ assessed the amount of foreign indirect investments in 2007, which might reach 5,7 billion USD and about 7,3 billion USD in 2008. However, Vietnam's administration offices have not defined exactly the amount of inflow capital because of the distracted data between State Bank and Security Commission.

of WTO; ii) the Endeavour of the government in improving investment environment; iii) the political instability of some regional countries such as Thailand and The Philippines.

The ODA commitment for Vietnam had the rapid trend in the recent time. At the conference of CG sponsors, countries and international organizations still committed to increase ODA for Vietnam in 2008 with 5.526 billion USD. However, when foreign capital flows including FDI, indirect investment and ODA to Vietnam increase rapidly, this creates pressure on the macro monitoring of the government to manage exchange rates and inflations.

5. Financial areas in mobilizing savings and investments in Vietnam

Although the financial system was only the intermediary for one part of the total investment capitals, this system played a crucial role in distributing savings. When savings through the financial system increased, the financial depth rose up. From 1990 up to now, the depth of Vietnamese financial systems increased rapidly, the rate M2/GDP went up from 27.1% in 1990 to 82.4% in 2005 and reached the average rate of 40.99% in the period from 1990 to 2005 (Chart 22). The rate M2/GDP of Vietnam was still lower than the level 43% of developing countries which have the high growth rate of over 7% from 1965 to 1987. In comparison with China and Thailand, the financial depth of Vietnam was much lower. The rate M2/GDP of China which was 60% in the 1980s increased to 100% in the 1990s and reached to 200% in 2006. However, only in 3 years from 2005 to 2007, M2 that rose by 92% (23.34% in 2005, 33.59% in 2006 and 35% in 2007) made the rate M2/GDP of Vietnam increase to 112.1%. As a result, the increasing rate in 3 years was 3.7 times more than the growth rate of GDP, higher than the 2.5% of regional countries. The increase in M2 contributed to the GDP increase, however, the rapid growth of the money supply was one of the causes of accelerating inflation in the past two years.

The rate of Vietnamese capitalization from 2000 to 2007 reached 7.8 % on average. This is far lower than many other countries in South-east Asia and East Asia. This rate only had considerable increase in 2006 and the beginning of 2007. The financial area of China expanded rapidly with economic growth. In Vietnam, the stock market only grew in 2006 when the supply, demand and price increased. Up to the 31st December 2006, in two stock markets, there were 193 listed companies and reached the total value of market capitalization of 221,156 billion equal with 14 billion USD and accounted for 22.7% of GDP. That rate went up to 43% of GDP at the end of 2007. The government bond in the period

from 2000 to 2005 was only 4.4 billion USD, about 10% of GDP, the enterprise and local bond was 0.6 billion USD, about 1% of GDP. From 2006, the bond market had high growth rate with about 400 types of government bonds, city bonds and bank bonds listed with nearly 70,000 billion VND, about 7.7% in 2006. However that rate was much lower than the average rate of 30% among Asia countries.

Chart 22. M2/GDP in Vietnam and some East Asian countries in the period 1990-2005 (% GDP)
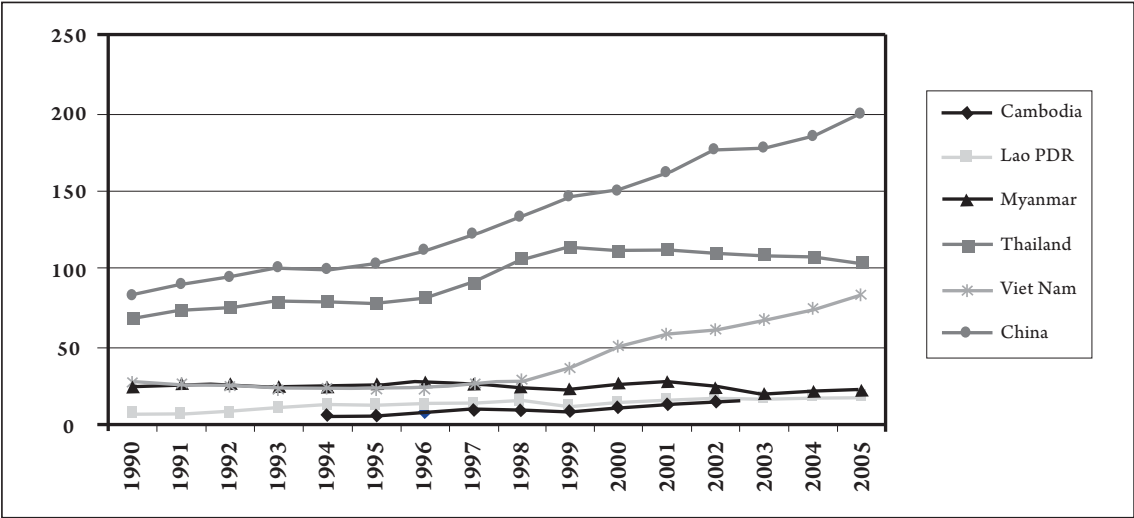
Source: The author consolidated from different sources of data

Chart 23. Capitalization rates of Vietnam's stock market
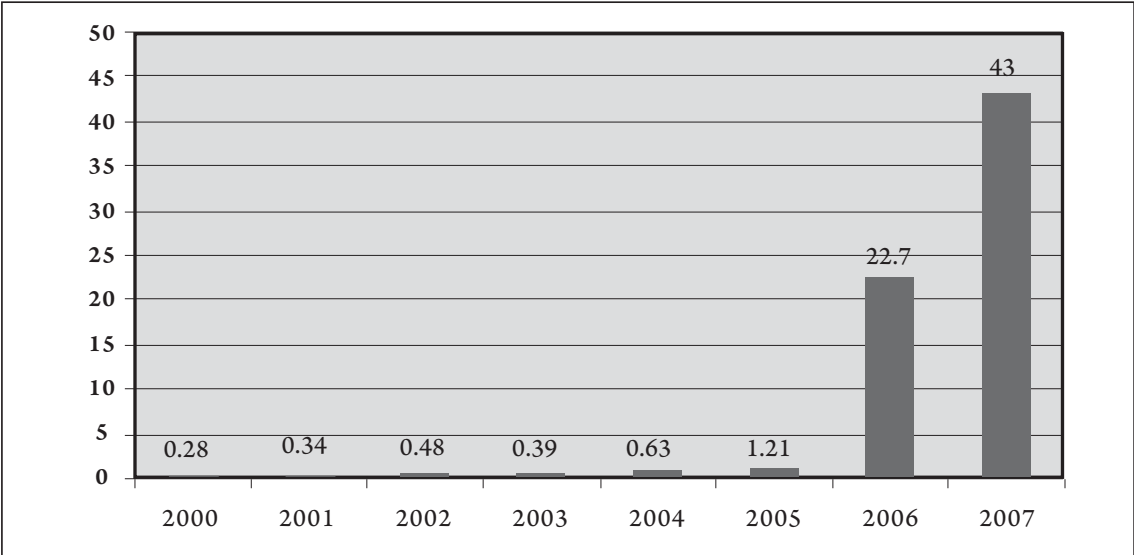
Source: Vietnam's Security Commission

The banking system, especially state-owned commercial banks still accounted for the largest part in Vietnamese financial system. The capitals which were mobilized through the banking system (mainly commercial banks) still were the main channels of capital mobilizing for investments of the overall society and the economic growth. Therefore, it showed that the low rate of capitalization in the stock market and the lending from banks were the basic domestic financial sources for investments. However, lending of banks which had high growth rate only met 60% of the financial demand of enterprises, in which 80% of lending capitals from banks was short-term, the main obstacle of supplying capitals for companies' development. Obviously, in the next time, Vietnam needs other capital sources in order to reduce the dependence of lending capitals from banks. Attracting capitals through the stock market and bonds are the better way for enterprises when need capitals for long-term investment. To achieve that target, the government should more strengthen the process of SOE privatization and complete the legal frame and polices related to Stock Law and legal documents related to the development of capital market.

Chart 24. Financial asset structures in Eastern Asia Countries

a. 1997   b 2004
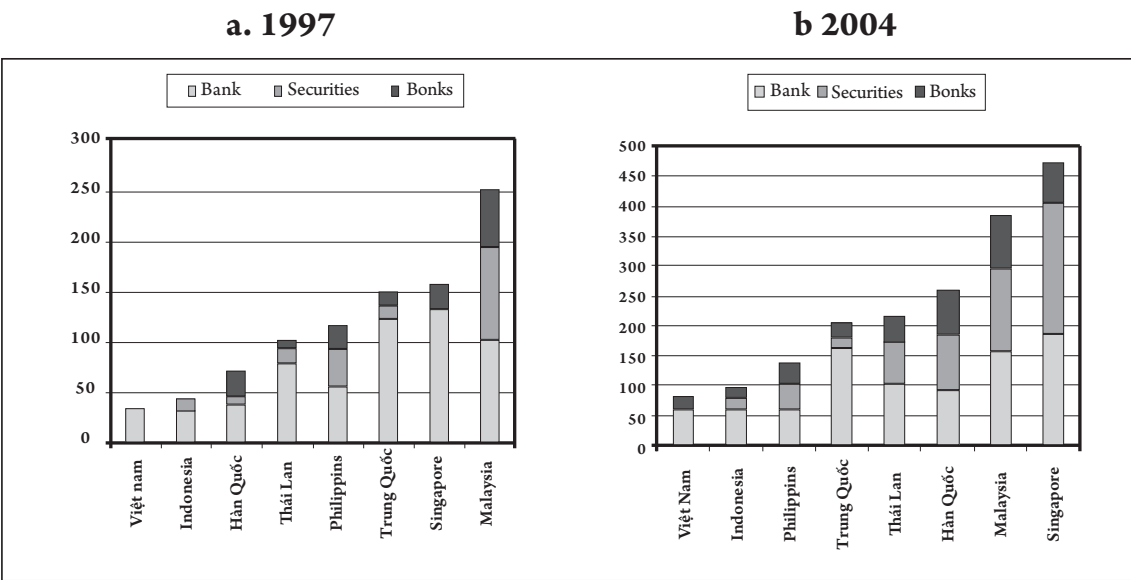
Source: Ismail Dalla, East Asian Finance, The WorldBank 2007

At the end of the year 2007 and the beginning of the year 2008, in line with the rapid increase of inflation rates, the decline of the stock market and the quick increase of interest rates, many experts supposed that Vietnam had been having similar signals of the financial crisis in 1997-1998 in East Asia.

The particular exposures are:

Firstly, the size of Vietnamese financial system is relatively small in comparison with the economy when the total financial property is only equal with 1 time of GDP and lending collection is about 75% of GDP. Moreover, the domestic financial system still focuses too much on banks. Banking credits were double compared with the price of listed stocks. The over heating increase of stock price at the end of 2006 and at the beginning of 2007 partly reduced the position of banks. However, at the end of 2007 and especially at the beginning of 2008, the price of stocks dropped out sharply. The Vn-index decreased to 400-450 points (July 2008) proving the thought of a "balloon" in the stock market. A series of IPO plans of big enterprises were postponed.

Secondly, there was over-investment and "bubble" properties. As the above analysis states, the investment rate in GDP of Vietnam reached 45.6% in 2007. This rate made Vietnam become the one of the countries having the highest investment rate in the world. Besides, the coefficient ICOR of Vietnam was 5, much higher than other regional countries in their periods similar to Vietnam nowadays. Moreover, in the investment structure, the investment rate of the government area still made up high percentages with the long lasting, inefficient super projects which caused waste and big loss for the society. About "bubble" property, it is clear that Vietnam is still a low-income country (GDP per capita in 2007 was estimated at 835 USD compared to the average rate of 906 USD) but the real-estate price in many places of Hanoi and Ho Chi Minh City is as expensive as that of Tokyo, Singapore and Hong Kong, this needs to be considered. This is really a signal of a real-estate bubble. In the recent times, the government has offered many solutions to reduce the risk of property bubbles, such as tightening credits for buying real-estates; or the government has just asked Finance Ministry to research and adjust land tax decrees in order that people who own many properties but do not use them effectively or trade properties for capital gains leading to deleterious property values to pay progressive taxes.

Thirdly, balance of trade deficit has an uptrend, especially in 2007, balance of current accounts had big deficits up to 9.85% of GDP (compared to 0.16 billion USD or 0.27% of GDP in 2006). The deficit in current accounts was mainly caused by the deficit of goods and incomes from investment. Because of the net transfer (especially private transfer) reached high surplus, particularly 6.43 billion USD or 9.06% of GDP, the deficit of current accounts was high but not equal to the deficit of commercial goods. The main reason of this situation was that the Vietnamese excess of imports over exports reached double digits (12.45 billion USD in 2007) and the rate of the excess compared with the export

turn-over in 2007 was twice as much as in 2006. (25.6% in 2007 compared with 12.7% in 2006). The deficit of current accounts is supported by ODA, FDI, and FII. If the trade deficit continued increasing and the disbursement of FDI remained unchanged, that will have bad effects on the stability of Vietnamese macroeconomics.

Fourthly, in the recent time, together with the increase of FDI as well as of foreign indirect investments to the stock market and of the the foreign exchange reserves, Vietnamese government are facing with difficulties in controlling the exchange rate and implementing the currency policies of the State Bank.

7. Conclusion

i) The saving and investment rate of Vietnam has had continuous increase from 1990 up to now, especially the investment rate reaching 45.6% to GDP, on par with that of China and higher than that of other ASEAN countries. With the investment rate of 45.5% GDP and the coefficient ICOR of 5 is said to be very high in comparison with other regional countries in their similar periods. State-investment including state budget and state-owned enterprises still accounted for high percentage (more or less than 50%) in comparison with other sources of capital. However, the investment effectiveness of this area was lower than other areas, showing through the coefficient ICOR among these areas.

ii) Vietnamese savings rate increased rapidly from 23.5% GDP to 35.8% of GDP in 2007. However, in comparison with China, Thailand, Korea and Malaysia, the Vietnam national savings rate was much lower. The younger Vietnamese population demographic has effects that are not so small on savings rate of households, which was still much lower than China. In savings for investments of enterprises, retain earnings accounted for low density. Depreciation made up for the high rate and was an important source of funds for investments.

iii) The growth rate of investment is always higher than that of domestic savings so the gap between savings-investment (S-I) have increasing trends at 9% of GDP. This shortage is supported by ODA, FDI and remittances. Although commitment and disbursement of ODA increased in the period from 1995 to 2007, Vietnam's foreign debt still was at a safe level.

iv) The large gap between savings and investment affects on the deficit of current account in Vietnam. The current account deficit had a trend of increasing, especially in 2007 at the rate of 9% GDP. The rapid increase in

trade deficit and the abnormal fluctuation of exchange rate are signals of implicit risks. Besides this, the large amount of money invested to the real-estate market and the stock market, which created the Vietnamese property "balloon". The VN-index dropped out under 500 points in early months of the year 2008, which was the evidence of property "bubble" in Vietnam. According to experts from Harvard University, Vietnam has not had a financial crisis because Vietnam has not liberalized capital, short-term foreign loans are still at a controlled rate, and foreign investment capital added with remittances partly help to balance current accounts[16].

v) Indirect investment capital flow had sudden growth in 2006 and especially in 2007 due to the boom of stock market, attractive interest rates of government bonds and the expectation about value increase of VND. However, in the beginning of the year 2008, these attractive factors were not existed, so the capital flows of indirect investment decreased strongly. The high commitment of FDI and ODA showed that Vietnam could increase the disbursement rate if the current limitations were solved. Joining WTO could be the decisive factor for the rapid growth in direct and indirect investment capitals, however other factors such as state-owned enterprise privatization programs, more transparent investment procedures, the result of Vietnam and the USA Commercial Convention, capital transfer out from developing financial markets and stable basic factors in Vietnam could also play important roles. Because of bid capital inflow, currency reserves also increased rapidly. From 1996 to 2002, the reserves of additional foreign currency of Vietnam State Bank were only at limited levels. However, the reserve rate increased rapidly from 2003 and especially in the recent years. The reserves of foreign currency increased from 11.5 billion USD at the end of 2006 to 23 billion USD at the end of 2007, approximate to 32% of GDP. At the same time, the reserve of foreign currency calculating on importing weeks rose up considerably, from 2 importing months in 2002 to nearly 4 importing months in 2007.

vi). The Vietnamese financial depth is still much lower than other countries in the region and in the world. M2/GDP has increased rapidly since 1990 but only reached over 90% in 2005 and 112.1% of GDP in 2007.

In conclusion, after the slow development in the period 1998 to 2002, the Vietnamese economy turns to the new high growth periods. The growth rate of GDP reached 8.04% in average from 2003 to 2007. Joining WTO is the premise

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[16] Vietnam Economic Times

of the economic growth in the new period. However, from the beginning of 2008, the economy had signals of over heating development and crisis, especially the financial field. Therefore, the government had to move the priority into stabilize the macroeconomics and adjust the target of the growth rate to go down to 7% in 2008. Many solutions were done to control the growth rate of credits, with the target of reducing that rate to 30% until the end of 2008. The government has given the policy package to stabilize the macroeconomics including cutting off the government expenditures, stopping ineffective public projects, postponing new projects and allowing to apply a more flexible exchange rate.

Some suggestions

Vietnam has maintained the increase in savings rate continuously since 1995 and reached 35.8% in 2007. However, in 3 recent years, the growth rate of savings was always lower than that of investments so the gap between savings and investment had increasing trends. Now the gap between savings and investments is nearly 9% of GDP. The savings rate compared with GDP of Vietnam is lower than Japan, Korea and China in the similar periods (when these countries had the average GDP per capita which was approximate to Vietnam at current time) so Vietnam still had to depend on outside investment capitals. On the other hand, Vietnamese economic growth at this time is too dependent on the capital factor, which made Vietnamese investment rate to 45.6% compared with GDP, the same with that of China who are developing too hot. So the important problem of Vietnam now is improving quality of investment, not increasing this rate, and transferring from economic growth into the depth. Moreover, Vietnam also needs to form a better mechanism to increase the saving rates, especially savings of enterprises and households. In order to reach the target of growth rate at 7.5% -8% per year from 2006 to 2010, the demand of development investment capital is very high. The capital demand for industrialization will increase the general demand of capital, it may happen that the capital supply will depend on the domestic savings and outside investment capitals. The most important thing to Vietnam now is to create a sufficient and comprehensive legal framework to ensure the capital market and currency market develop well, to maintain the stability of macro economy, and to avoid crises.

i.   Vietnam and China are facing the same problem in which to reach the over-heating growth rate, two countries have to increase the investment rate in GDP. However, in the investment portfolio, many items do not create properties, for example, the items of investment losses due to corruptions, landing compensations, especially the investment items for infrastructures

implemented by the government. The Vietnamese Endeavour to motivate the economic growth is not to increase investments because it has been at too high level, Vietnam has to focus on improving the effectiveness of using investment capitals through the strong adjustment of investment structure. Reforming formalities, policies and legal regulations are to solve obstacles of investment disbursement, enterprise expansions, unreasonable expenses burden reduction, and the open and transparent business environment for every economic components.

ii. Vietnam needs to improve the investment environment, especially to encourage the development of the private economy. Now investment of private area is still limited in comparison with state-owned enterprises and foreign investment enterprises.

iii. Vietnam must tightly control overseas capital both quantity and investment fields. The administrative regulations must be given contemporary and if necessary it needs to be kept until the economy becomes stable. It also needs the opener mechanism to attract investments from overseas national currencies. In the recent years, the overseas national currency has continuously increased, that reduced considerably the deficit between savings and investment in Vietnam.

iv. To the period from 2010 and 2010, there is an ability that Vietnam will begin a graduation process, in which Vietnam will transfer from the favorable capitals of IDA to capitals with higher interest of IBRD. The popular experience in the world is that when developing, countries have decreasing trends of using of ODA and turn to depend more on the private financial market.

v) Vietnam needs to improve the effect of financial fields by innovating stronger the economic structures. To ensure the capitals for investments of public area and private area, that promote the high economic growth in the period 2006-2010, the financial area is not only expanded but also need to use financial sources more effectively. The government should organize debt programs according to the international standards to manage oversea debt most effectively and create the frame to manage monetary more transparently and clearly.

vi) Vietnamese government need to promote and encourage the deeper and wider innovation in banking system and continue to impulse the investment market such as the stock market, debt market to support the reorganization of the bank system. It is seen that developing the stock retructure the finance market was an important solution. Because the financial structure can influence on the activity ability of enterprises. Companies usually have different

behaviors depending on the way they mobilize capitals through banking credits or through stock markets. There are more and more evidences to prove that enterprises are more creative, they prefer the way to self mobilize capitals on the stock market.

vii) The Government also need to control the risk of the financial market. As we know, the financial market usually mobilizes capitals and distributes risks. Vietnamese financial market still contains many weak points, which can make them easily be affected before the sudden running out of capital flows due to mentality changes or international financial situation changes. However, the too-intensive risk protection can delay the integration of financial sector of Vietnam.

viii) The government needs to tighten the fiscal policy and cut down ineffective public projects and transfer gradually from state-investment to private investment. The transfer from state-investment to private investment not only increases the effectiveness of investment capitals, but also reduces the government debt. The government needs to tighten the lending activities of public area, especially tighten in state-owned enterprises and loans to implement unnecessary public projects.

ix) The population structure has great influence on national savings, so that the government should reconsider the population policies. To increase savings, it needs to reduce the population growth rate, however, in the three most recent years, the population growth rate has uptrend.

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Chapter 2:
MANAGING CAPITLAL FLOWS : THE CASE OF VIET NAM

Vo Tri Thanh and Pham Chi Quang

Abstract

Thanks to reforms and international integration, Viet Nam has recorded impressive economic development achievements. Deepening integration and accession to the WTO has brought about both new opportunities and challenges to a country on its way to accelerating reform and development. The recent surge in capital inflows has led to a financial boom in Viet Nam as well as risks, especially in the context of macroeconomic policy inconsistencies, weaknesses in the banking sector and financial supervision. The macroeconomic policy responses so far (up to February 2008) seem to be less effective in stabilizing the economy and in reducing policy inconsistencies as well as financial risks. The key question for Viet Nam, now, is how to sustain economic growth and sound financial development while mitigating possible financial risks. This paper recommends a broad reform package including tackling the bottlenecks in the economy (the weaknesses of economic institutions, infrastructure, and human resources), modernizing the State Bank of Vietnam (SBV), and strengthening risk management in the banking sector and financial supervision system. The focus is also on capital market development based on improvement of its fundamentals and the reform of large state-owned corporations. In particular, this paper argues for having a firm commitment to combating high inflation and combining tightened monetary policy with a more flexible exchange rate and tightened fiscal policies. The scope and scale of the macro-policy mix should aim to test the market for necessary adjustments rather than create policy shocks. Considering the evident policy inconsistencies, prudential screening and monitoring should be strengthened to prevent speculative financial activities.

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1. Introduction

Viet Nam officially launched its Doimoi (Renovation) in 1986, but only started a radical and comprehensive reform package aimed at stabilizing and opening the economy in 1989. During the period from 1996-1999, market - oriented reforms were somewhat stalled. Since 2000, a new wave of economic reforms has been stirred up with emphasis on structural reforms (state-owned enterprise [SOE] and financial reforms and development of the private sector) and further trade and investment liberalization. The years 2000-2007 witnessed a boom in the private sector and deeper international economic integration. In 2000, Viet Nam and the US signed the Bilateral Trade Agreement (VN-US BTA), which became effective in December 2001. Since then, the country has also joined several regional integration clubs such as ASEAN + 1 Free Trade Areas (FTAs). Most importantly, Viet Nam became the 150th member of the WTO in November 2006.

Since 2005, SOE and banking system reforms have shifted their focus on large corporations, including the State-owned commercial banks (SOCBs), though the pace of these reforms has been slower than expected (see also Table 1). The first SOCB with the second-largest market size, the Bank for Foreign Trade of Vietnam (VietcomBank), after successive delays, got the approval of the Prime Minister of Viet Nam to proceed with its initial public offering (IPO) on the domestic market in December 2007.

Meanwhile, a notable observation during 2006–07 is an expansion of the banking system and a boom of the stock market coupled with massive capital inflows and much higher consumption prices and asset inflation.

Market-oriented reforms have led to major positive changes in Viet Nam. The liberalization of trade and the balance of payments (BOP) as an essential ingredient of the reform process have contributed significantly to Viet Nam's economic growth and development. The financial and currency crises in the 1980s and especially the Asian crisis in the 1990s, nevertheless, showed that the process of the BOP liberalization, if not properly implemented, could also involve risks[1].

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[1] There has been extensive literature on the nature of the BOP and financial crises. Though being different in terms of strengths, current account (CA) deficit and its financing, and the degree of capital account (KA) openings and their composition, these crises share some common causes such as inefficient investments, weaknesses in their corporate governance and the financial sectors, and inconsistencies in macroeconomic policies.

Table 1. A Chronology of Viet Nam's Economic Reforms and International Economic Integration Process (1976–2007)

1976–80	1980–88	1989–onward	1996–99	2000–07
Centrally-planned and relatively autarkic economy	Modified-planned economy 1980–81 and 1987–88: Micro-reforms 1985: The "price-salary-money reform" and its failure 1986: Doimoi began	Market-oriented reforms Trade liberalization and further integration (EU: 1992; ASEAN: 1995; APEC: 1998)	Slowdown of the reform process and Effects of the Asian crisis	Stronger commitments to further reforms but uneven implementation Acceleration of international economic integration. 2006-07: Party Congress X and new government New wave of reforms?

Source: Authors' own assessment

Experiences from various countries and the current position of Viet Nam are drawing attention to *how Viet Nam can sustain economic growth and sound financial development while mitigating financial risks.* This paper seeks to answer that question, taking into consideration the whole period before and after the Asian crisis (1995–2007), but with a focus on the recent financial and policy developments.

The paper is structured as follows. Section II briefly describes the changes in Viet Nam's major economic fundamentals and the financial sector development. Section III analyzes in greater detail the capital flows and their impacts on real economic activities as well as on macroeconomic stability. Section IV then reviews recent macroeconomic policy responses to the surge in capital inflows, aiming to assess the strengths and weaknesses of those policies in Viet Nam. Section V summarizes the major findings and makes some policy recommendations for sustaining high economic growth and sound financial development in the country while mitigating possible financial and inflation risks.

2. Economic fundamentals and financial sector development

2.1. Movement of the Major Macroeconomic Variables

Viet Nam has recorded quite high economic growth over nearly 20 years, averaging 7.4% per annum during the period 1990–2007 (Table 2). Viet Nam is currently the third fastest growing country in East and South East Asia after The People's Republic of China (PRC) and Cambodia, and it offers tremendous growth potential in the coming years. The country is expected to overcome the status of a poor country in the meantime (by the year 2008?) due to the ambitious plans of the Government of Viet Nam. There are some fundamental factors that have allowed Viet Nam to successfully implement the plan: (i) poverty was reduced substantially, from 70% by the end of 1980s to 14.7% in 2007; and (ii) a middle class has emerged in urban cities, especially in Ho Chi Minh City and Hanoi, with continuing wealth accumulation. In recent years, the country has been undergoing rapid urbanization with the urban population increasing at a compound annual growth rate (CAGR) of 3.6% between 2000 and 2006.

Table 2 suggests that Viet Nam had been successful in combating inflation. Yet since 2004, inflation has emerged as a major concern. After a spike in 2004 - 05, inflation began moderating progressively and consequently reached the highest level of 12.6% in 2007.

The structure of the economy has changed towards industrialization. The share of manufacturing in the GDP increased from 12.3% in 1990 to 21.4% in 2007. The contribution of services and the financial sector to the GDP did not change correspondingly; there was, however, an impressive contribution by the financial sector to the GDP in 2006 and 2007, at 1.9% and 2.0% respectively, reflecting rises from the steady state level of 1.8% during 2000–05 (Table 2).

The rather high economic growth corresponded with a significant increase in investment and in both public and private savings (Table 2). The growth has still been driven much by state investment (which is still inefficient), though its ratio in total investment has tended to decline since 2000 (Table 3)[2]. However, since 2000, the savings-investment gap has been widening as the investment ratio is increasing while the savings ratio has tended to stagnate. A simple regression has shown that there could be a time threshold in which an increase in income

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[2] State investment includes investment from budget, state credit, and SOEs' retained profit in vestment. Note also that about 28% and 38% of the GDP are accounted for by the SOE and state sectors, respectively.

Table 2. Economic Size, GDP Growth, Inflation, Investment and Domestic Savings

	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
GDP (VND bil.)	41.955	228.892	272.036	313.623	361.017	399.942	441.646	481.295	535.762	613.443	715.307	837.858	973.791	1.144.000
GDP (USD bil.)	6	21	25	27	27	29	31	33	35	40	45	53	61	71
GDP per capita ($)	98	288	337	361	361	374	402	415	440	489	554	635	715	835
GDP growth (%)	5.1	9.4	9.3	8.2	5.8	4.8	6.8	6.9	7.1	7.3	7.7	8.4	8.2	8.5
Share of GDP	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Agriculture	38.7	27.2	27.8	25.8	25.8	25.4	24.5	23.2	23.0	22.5	21.8	21.0	20.4	20.0
Industry-Const.	22.7	28.8	29.7	32.1	32.5	34.5	36.7	38.1	38.5	39.5	40.2	41.0	41.5	41.8
Manufacturing	12.3	15.0	15.2	16.5	17.1	17.7	18.6	19.8	20.6	20.5	20.3	20.7	21.3	21.4
Services	38.6	44.1	42.5	42.2	41.7	40.1	38.7	38.6	38.5	38.0	38.0	38.0	38.1	38.2
Fin. Institutions	1.2	2.0	1.9	1.7	1.7	1.9	1.8	1.8	1.8	1.8	1.8	1.8	1.9	2.0
Inflation (%)	67.5	12.7	4.6	3.6	9.2	0.1	-0.6	0.8	4.0	3.0	9.4	8.4	6.7	12.6
Total investment	14.4	27.1	28.2	28.3	29.1	27.6	29.6	31.2	33.2	35.4	35.6	38.9	41.0	41.2
Domestic savings	2.9	18.2	17.2	20.1	21.5	24.6	27.1	28.8	28.7	27.4	28.5	30.3	31.3	31.2
Budget saving	3.4	1.5	3.2	2.2	2.5	3.1	3.3	3.4	4.3	5.0	6.0	5.3	5.6	3.9
Other savings	-0.5	16.7	14.0	17.9	19.0	21.5	23.8	25.4	24.4	22.4	22.5	25.0	25.7	27.3

Note: All data of 2007 in this paper are estimates.
Source: GSO (various issues) and data provided by Ministry of Planning and Investment (MPI), and the authors' calculations.

could reduce the private savings ratio. A one percentage point increase in economic growth can decrease in the short run and long run of about 0.8 percentage point and up to 2.1 percentage points in the other-than-budget saving ratio[3]. Meanwhile, foreign savings have played an essential role and have consistently contributed 14.2% - 21.2% to total investment in Viet Nam.

Recently, total retail sales of goods and services have increased by more than 22% per annum, much faster than the nominal GDP. This observation reinforces the conclusion that the savings ratio has stagnated. Moreover, the income gaps between urban and rural areas and between the rich and the poor have also increased quite significantly.

Table 3. Shares of Total Investment by Ownership (1995–2007)

	Total	State investment	Budget	State credit	SOEs	Non-state investment	FDI
1995	100.0	42.0	28.5	8.4	5.1	27.6	30.4
1996	100.0	49.1	32.4	9.5	7.2	24.9	26.0
1997	100.0	49.4	29.4	11.7	8.3	22.6	28.0
1998	100.0	55.5	30.0	15.7	9.8	23.7	20.8
1999	100.0	58.7	29.7	18.8	10.2	24.0	17.3
2000	100.0	59.1	31.1	18.4	9.6	22.9	18.0
2001	100.0	59.8	32.4	16.9	10.6	22.6	17.6
2002	100.0	56.3	30.9	17.6	7.8	26.2	17.5
2003	100.0	52.9	23.8	16.3	12.8	31.1	16.0
2004	100.0	48.1	23.9	12.2	12.0	37.7	14.2
2005	100.0	47.1	25.6	10.5	11.0	38.0	14.9
2006	100.0	46.4	25.1	10.3	11.0	37.7	15.9
2007	100.0	47.2	22.2	7.9	17.1	31.6	21.2

Source: Data provided by the MPI.

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[3] The regression is stp = 12,292 – 0,054*gt2 + 0,629*spt-2 with the sample of 1990-2005

    (0,00)   (0,04)   (0,00)

(R-bar)^2 = 0,916; D-W = 1,597; Cusum-square test is stable at 5% significance level.

Where stp is other than budget saving ratio and gt is economic growth rate (see Vo ed. 2007).

For instance, AgriBank is assigned to primarily provide credit to the agricultural and rural sector.

2.2. Development of the Banking System

<u>**Key Policy Reforms**</u>

Until 1988, Viet Nam had operated under a mono-banking system with the State Bank of Vietnam (SBV), the country's Central Bank which performed both central and commercial banking functions. In 1988, the banking industry became a two-tier system, with four SOCBs created to assume the SBV's commercial banking activities while the SBV retained the central banking responsibilities. Given the state-driven nature of the Vietnamese economy, up until the recent economic reforms, the SOCBs traditionally focused on lending to the SOE sector.

Barriers to entry were reduced in 1991, opening the market to competition from both foreign players (subject to strict restrictions) and joint stock commercial banks (JSCBs). But over-competition among JSCBs eventually brought about a round of restructuring and mergers, particularly during 1999–2001, and as a result, the number of the JSCBs fell from 51 to 34 by 2006. Since 2005, some JSCBs such as Asia Commercial Bank (ACB) and Sacombank have been listed on the stock market. The SOCBs have been under restructuring since 2001 and some are now under equitization, being listed on the stock market.

The banking sector was further liberalized following the VN-US BTA and commitments in the WTO framework (Box 1). Viet Nam's commitments were subjected to the relevant laws and regulations as promulgated by the competent authorities of Viet Nam to ensure consistency with Article VI of the GATS and Para 2(a) of the Annex on Financial Services. In addition, the provision of banking services and products was subjected to relevant institutional and juridical forms.

<u>**The Banking System and Its Major Characteristics**</u>

There are at present over 75 banks operating in Viet Nam, comprising five SOCBs, one policy bank (VSPB), 34 JSCBs, 31 wholly - owned branches of foreign banks and 5 joint venture banks, and more than 900 people's credit funds (PCFs) (Table 4). In addition, there are 47 representative offices of foreign banks operating in Viet Nam.

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Box 1. Viet Nam's WTO Commitments

Under Viet Nam's commitments to the WTO, foreign credit institutions are permitted to establish a commercial presence in Viet Nam in a number of forms including representative offices, branches of foreign commercial banks, commercial joint venture banks with foreign capital contribution not exceeding 50% of charter capital, and banks with 100% foreign-owned capital. The banking market is set to open up to full foreign competition.

During the 5 years from the date of Viet Nam's WTO accession, Viet Nam may limit the right of a foreign bank branch to accept deposits in Vietnamese Dong from Vietnamese citizens with which the bank does not have a credit relationship to a ratio of the branch's allocated capital according to the schedule below:

- 1 January 2007: 650% of allocated capital;

- 1 January 2008: 800% of allocated capital;

- 1 January 2009: 900% of allocated capital;

- 1 January 2010: 1,000% of allocated capital;

- 1 January 2011: Full national treatment.

Viet Nam may limit equity participation by foreign credit institutions in equitized Vietnamese State-owned banks to the same level as equity participation by Vietnamese banks. For capital contribution in the form of buying shares, total equity held by foreign institutions and individuals in each of Viet Nam's joint stock commercial bank may not exceed 30% of the bank's chartered capital, unless otherwise provided by Viet Nam's laws or authorized by a competent authority of Viet Nam. A branch of a foreign commercial bank is not allowed to open other transaction points outside its branch office. Upon accession, foreign credit institutions are allowed to issue credit cards on a national treatment basis.

Table 4. Banks and Non-Banking Credit Institutions in Viet Nam (2006)

	Type of credit institution in Viet Nam	Number
1	State Owned Commercial Bank (SOCB)	5
2	Vietnam Social Policy Bank (VSPB)	1
3	Joint Stock Commercial Bank (JSCB)	34
4	Joint Venture Bank (JVB)	5
5	Foreign Bank Branch	31
6	Finance Company	6 (5 belong to State General Corporations)
7	Finance Leasing Company	11 (6 are affiliates of SOCBs)
8	People's Credit Funds (PCFs)	Central People Credit Fund (24 branches) + 926 Local credit funds

Source: SBV (2007). The SOCBs are: Bank for Agriculture and Rural Development, Bank for Foreign Trade, Bank of Investment and Development, Industrial and Commercial Bank, and Mekong Housing Bank

Viet Nam's banking sector is often considered both heavily fragmented and concentrated. Credit structure by sector has only changed slightly despite a considerable shift in economic structure. Indeed, the shares of total outstanding loans to the agriculture-forestry-fishery and industry sector in 1995 were 26.5% and 37.5% respectively; in 2005, the corresponding figures were 29.7% and 39.8% (SBV 2006). The highly fragmented banking market caused by assigned commercial banks has, to a certain extent, restrained risk - sharing within the banking system and narrowed borrowing choices of businesses.

In 2006, Viet Nam's top 15 banks together controlled 92.4% of market share by assets (excluding foreign bank branches). In 2006, the SOCBs shares had still accounted for nearly 70% of total deposits and 65% of total credits. However, since 2006, the role of the JSCBs has changed significantly and in 2007, they already accounted for much larger shares in total deposits and total credits (Table 5). In terms of operating features, the SOCBs own the largest distribution networks (AgriBank: 1468; VietcomBank: 207; BIDV: 500; ICB: 832). The JSCBs have also quickly developed a network since 2005 (ACB: 111; SacomBank: 161, Eximbank: 59, Techcombank: 120); in terms of size, however, their branches would qualify only as sub-branches of the SOCBs.

Table 5. Market Share of the Credit Institutions in Viet Nam (%)

	2000	2001	2002	2003	2004	2005	2006	2007
Market share in deposits								
SOCBs	77.0	80.1	79.3	78.1	75.2	74.7	68.8	59.3
JSCBs	11.3	9.1	10.1	11.2	13.3	15.7	21.8	30.4
Foreign bank branches + JVBs	10.3	10.0	9.4	9.3	9.7	8.0	8.1	8.8
PCFs	1.0	0.8	1.1	1.1	1.0	1.0	1.0	1.0
Others	0.4	0.0	0.1	0.3	0.8	0.6	0.3	0.5
Market share in lending								
State owned commercial banks	76.7	79.0	79.9	78.6	76.9	73.0	64.5	55.1
Joint stock commercial banks	9.2	9.3	9.5	10.8	11.6	15.0	21.2	28.6
Foreign bank branches + JVBs	12.4	10.4	8.8	8.9	9.5	9.6	9.3	9.0
PCFs	1.4	1.2	1.7	1.5	1.4	1.5	1.4	1.3
Others	0.3	0.1	0.1	0.2	0.6	0.9	3.6	6.0

Source: Data provided by the SBV and authors' estimates.

Financial depth has also changed significantly (Table 6). Until 2004, Viet Nam was still seen as an economy with a rather shallow financial depth. Fast growing credit with an annualized average growth rate of 33.4% fueled by strong credit demand from both the corporate and retail markets since 2004 promoted financial deepening. As a result, in 2007, there were sharp increases in financial deepening with indicators such as the credit/GDP ratio (reaching 82.5%), and M2/GDP (112.1%, increasing from 23.8% in 1996). The outstanding credit of the banking system to SOE had gone down dramatically from 52.7% of total outstanding credit in 1996 to 31.5% in 2007. This movement in the credit business of Viet Nam's banking industry reflects fundamental changes in client appraisal based on normal market practices.

In recent years, the banking industry has significantly developed its financial strength by cleaning up banks' balance sheets and increasing capital through issuing new stocks as well as increasing financial reserves. As a result, the financial position of banks has been improved significantly in terms of capital adequacy and non-performing loans (NPLs) (Figures 1-4). For example, the NPLs of the SOCBs were reduced from 13% in 2000 to about 3% in 2006[7].

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[7] There are, however, some problems with the officially announced NPLs. Some suggest that the figures for NPLs would be 3 times higher if the estimates are based on rigorous international accounting standards.

Table 6. Total Credits and Deposits

(VND trillion unless indicated otherwise)

	1996	1999	2000	2001	2002	2003	2004	2005	2006	2007
Broad M. (M2)	64.7	160.4	222.9	279.8	329.0	411.2	532.3	690.7	922.7	1.282.6
% change	22.7	56.6	39.0	25.5	17.6	24.9	29.5	29.7	33.6	39.0
% GDP	23.8	40.1	50.5	58.1	61.4	67.0	74.4	82.4	94.8	112.1
Credit to economy	50.9	112.7	155.7	189.1	231.1	296.7	420.0	553.1	693.8	943.6
SOE share (%)	52.7	48.2	44.9	42.1	38.7	35.5	34.0	32.8	31.4	31.5
Others share (%)	47.3	51.8	55.1	57.9	61.3	64.5	66.0	67.2	68.6	68.5
% change	20.1	55.0	38.2	21.5	22.2	28.4	41.6	31.7	25.4	36.0
% GDP	18.7	28.2	35.3	39.3	43.1	48.4	58.7	66.0	71.2	82.5

Source: IMF (2006, 2007); Credit figures in 2007 have been adjusted by the latest SVB estimates.

Figure 1. Equity/Total Assets of 4 SOCBs
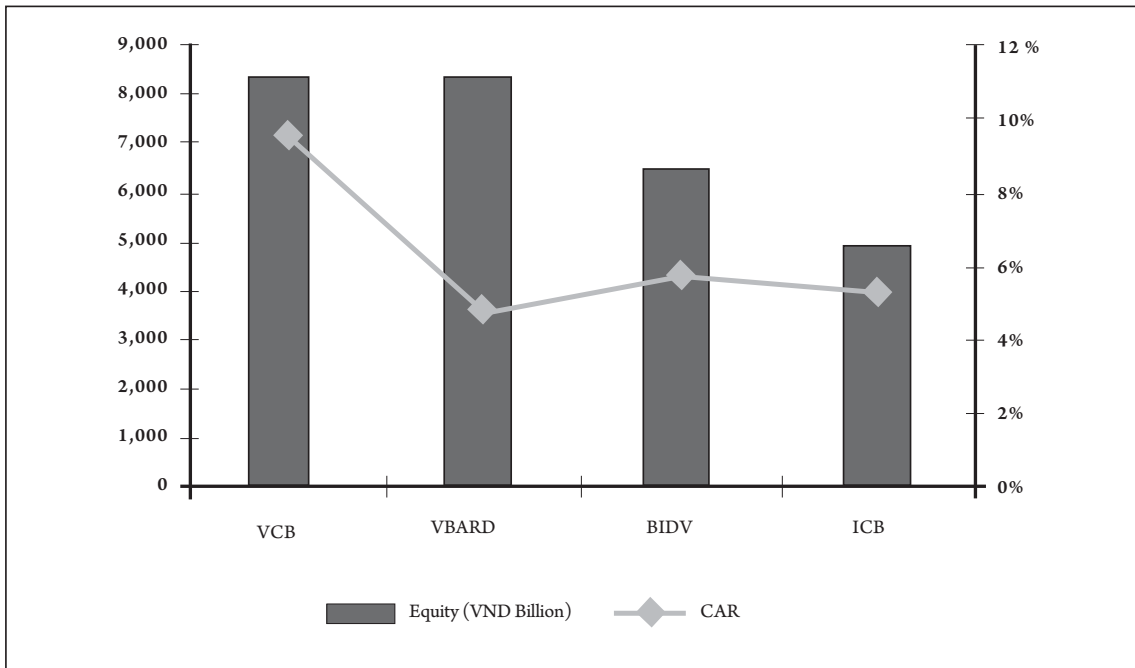
Source: Pham et al (2007).

Figure 2. CAR of SOCBs Compared to JSCBs and Other Countries (%)

Category	Value
ASEAN	15.64%
OECD	12.38%
JSCBS	10.88%
VCB	9.57%
BIDV	5.80%
ICB	5.24%
VBARD	4.79%
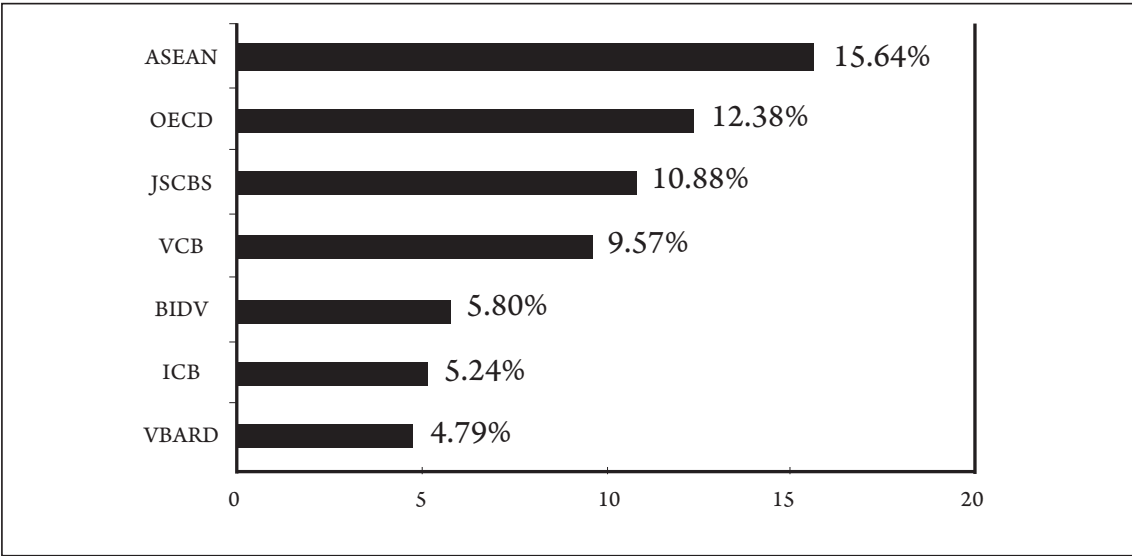
Source: Pham et al (2007).

Figure 3. Capital Adequacy Ratio
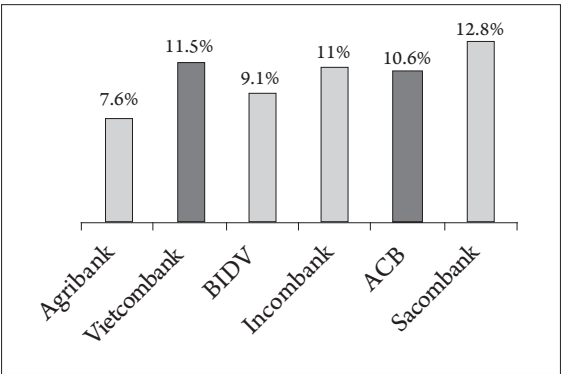
Bank	Value
Agribank	7.6%
Vietcombank	11.5%
BIDV	9.1%
Incombank	11%
ACB	10.6%
Sacombank	12.8%

Source: Company audited financials and reports (where available), newswires (as of 31 December 2006).

Figure 4. Gross NPL Ratio
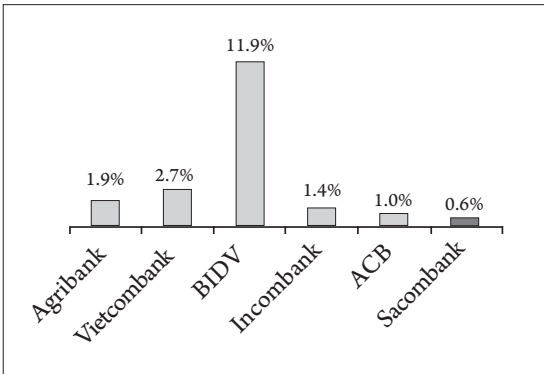
Bank	Value
Agribank	1.9%
Vietcombank	2.7%
BIDV	11.9%
Incombank	1.4%
ACB	1.0%
Sacombank	0.6%

Source: Company audited financials and reports (where available), newswires (as of 31 December 2006).

Banks' profitability is uneven relative to asset size. The incumbent SOCBs have relatively high provisioning expense levels, reflecting a legacy of loans to the SOEs, whereas the newer JSCBs have lower provisioning expenses. As a result, profitability measured by ROE (Figure 5) and ROA (Figure 6) of SOCBs tends to be lower than that of JSCBs (with the exception of VietcomBank).

Figure 5. Return on Average Assets

Figure 6: Return on Average Equity
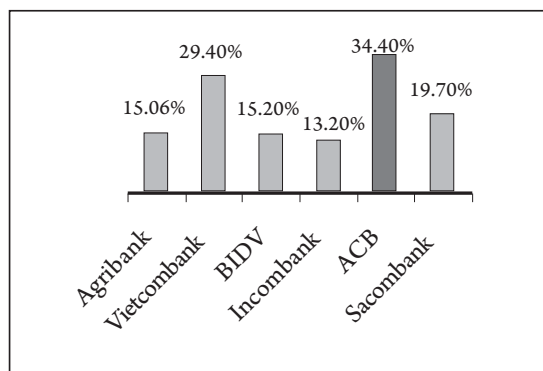
Source: Company audited financials and reports (where available), newswires (as of 31 December 2006)

Source: Company audited financials and reports (where available), newswires (as of 31 December 2006).

The differences in profit between SOCBs and JSCBs are also clearly explained by the structure of the assets of those banks as described in Figure 7. The asset structures show that the outstanding debt/total assets ratio in JSCBs (54.35%) is much lower than that of the SOCBs (62.81%), except again the unique case of VietcomBank (44.24%). This indicates JSCBs' lower riskiness in terms of asset allocation, and hence, JSCBs have more chance to increase profitability by increasing asset allocation for credit. The outstanding debt/total assets ratio of JSCBs is slightly higher than the average ratio of ASEAN banks (51.91%) and lower than that of OECD banks (56.48%).

Figure 7. Outstanding Debt/Total Assets of SOCBs Compared to JSCBs and Other Countries (2005)
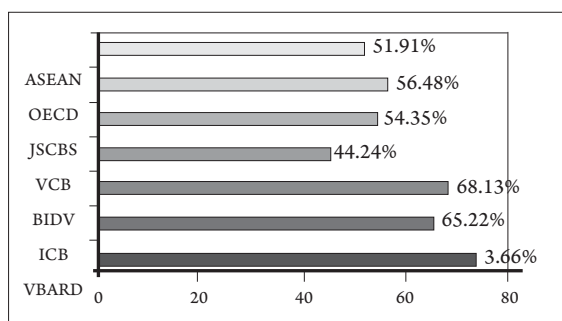
Figure 8. Performance of SOCBs Compared to JSCBs and Other Countries (2005)

Source: Pham et al (2007).
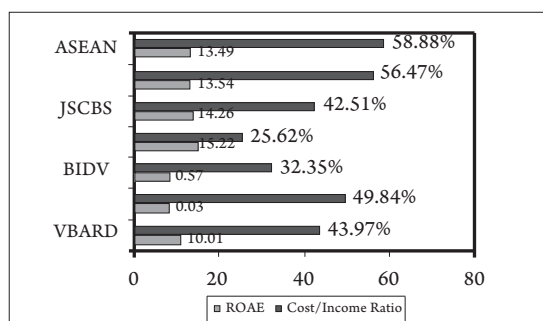
However, in terms of efficiency proxied by ROAE and Cost/Income ratios, Viet Nam's commercial banks, including both SOCBs and JSCBs, are less efficient than their counterparts in ASEAN and OECD. Details from Figure 7 indicate that SOCBs are generally less efficient than JSCBs, and in turn, JSCBs are less efficient than other foreign banks in ASEAN and OCED.

Current Dimensions of Banks' Development and Behavior for Seizing New Business Opportunities

Due to increasing competitive pressure from deepening integration, especially after the VN-US BTA and WTO accession, Viet Nam's local banks have rushed into expanding their business operations by setting up new branches and developing retail banking activities. These areas are basically to build the local banks' competitive advantages against potential foreign competitors. The heightened network and business expansion of banks has given rise to an urgent need for human resources at every level of the banking industry, from senior executive managers to more junior level staff. That is not said about the human resources demand from newly established banks. As an estimate, the banking industry would need about 40,000 people from 2007 to 2010, which the Vietnamese economy is unable to meet.

Up to 2006, more than 70% of the banks' income came from lending. The last 3 years have witnessed a diversification trend in banking services, especially in developing a card market and retail banking. In 2007, consumption and real estate related lending by some JSCBs accounted for 20%–30% (and 30-40%) of the total credits, respectively. Other fee-income businesses of banks have increasingly contributed to their income. In recent years, the off-balance sheet business has gradually prospered, accounting for an average of 20-25% of income for the sector.

Furthermore, the M&A trend has boomed in recent years, especially since 2006. This trend has been enhanced mostly by large State General Corporations (such as PetroVietnam, EVN, VNPT, etc.) intent on acquiring small/rural JSCBs and making them become dependent entities. Consequently, in addition to the core businesses, these corporations could heavily and directly get involved in the financial markets. Not only have major corporations implemented such diversification plans, the banks themselves have also attempted to be universal. Many banks have become engaged in insurance, securities, investment banking activities (equity acquisition and investments in the real estate market) and have had strategic partnerships with large corporations, mostly the State General Corporations or newly established State Business Groups.

The past 3 years have also seen a lot of marriages between the JSCBs and foreign financial institutions. Several JSCBs have made extensive efforts to secure strategic investments with foreign banking partners (Table 7). By building strategic partnerships with very well-known global names, the JSCBs can develop their brand name and take advantage of new products, skills and expertise from the partners. However, the strategic partnerships could also be easily broken, especially if the partner entered to the partnership as a speculative investor rather than a strategic investor.

Besides the mentioned-above trends, in 2007 and for the first time since 1996, the SBV reviewed applications for establishing new local commercial banks and applications from foreign banks seeking to operate locally-incorporated, wholly-owned banking subsidiaries. In December 2007 and January 2008, the SBV approved in principle the setting-up of 9 new JSCBs and the licensing of branches of 3 new foreign banks. Furthermore, the SBV is reviewing the granting of full licenses for HSBC, ANZ and Standard Chartered to set up wholly owned banks in Viet Nam.

In 2007, the Prime Minister also approved in principle the equitization of 3 SOCBs (VietcomBank, MHB, and BIDV). However, only the IPO of Vietcombank was conducted in late December 2007 after it was continually delayed.

Table 7. Foreign Strategic Investments in Vietnamese JSCBs

Target Bank	Acquirer	Acquisition Announcement Date	Stake Acquired	Target Bank Asset Size*	
				VND trillion	USD bil.
Sacombank	ANZ Bank	24 Mar 2006	10.0%	24.9	1.5
Asia Commerce Bank	Standard Chartered	17 Jun 2005	8.6%	44.6	2.8
Techcombank	HSBC	28 Dec 2005	10.0%	17.5	1.1
VP Bank	OCBC	21 Mar 2006	10.0%	10.2	0.6
Orient Commercial Bank	BNP Parisbas	17 Nov 2006	10.0%	6.4	0.4
Southern Bank	UOB	25 Jan 2007	10.0%	9.2	0.6
Techcombank	HSBC	25 Jan 2007	10.0%	17.5	1.1
Habubank	Deutsch Bank	01 Feb 2007	20.0%	11.6	0.7
Eximbank	SMBC	30 Mar 2007	15.0%	24.9	1.5
PVFC	Morgan Stanley	13 Nov 2007	10.0%	34.5	2.15

Note: As of 31 December 2006.
Source: Company announcements, newswires.

II.3. Stock Market Evolution and Its Recent Boom

Key Policy Reforms

The most memorable moments in developing the stock market in Viet Nam were the establishment of the State Securities Commission (SSC) in 1995 and two securities trading centres, the Ho Chi Minh City Securities Trading Centre (HOSTC) in 2000 and the Hanoi Securities Trading Centre (HASTC) in 2005[8]. To promote stock market development, several policy measures were undertaken.

- In parallel with the establishment of the two securities trading centers, the legal framework on listing conditions, information transparency and exposure, and supervision, has been significantly improved (Decree 48/2001/CP, Decree 144/2003/ND-CP, Law of Securities in 2006, etc.).

- The process of equitizing SOEs, especially the large ones, has been gradually tightening to their listing on the stock market.

- The development of financial intermediaries has received more attention. Recent emergence of several financial institutions such as securities companies, investment management funds, and investment funds has created an important pre-condition for development of the stock market.

- The opening up of financial markets with more foreign participation has been undertaken gradually. The equity share of listed companies that foreign investors can hold increased from 20% to 30% in 2003 and to 49% in 2005. Regarding securities services, under the WTO commitments, joint ventures can have foreign capital of no more than 49% upon the accession, but of 100% after 5 years.

- Depending on the health of the stock market, some incentives such as easing the conditions for listing on the market (in 2003) and a provision of corporate income tax deductions for firms listed on the HASTC (in 2006) have been introduced[9].

Recent Evolution of the Stock Market: the Boom and Shrink

After a short-lived surge up until June 2001 (peak of VN-Index=571), the HOSTC had cooled off. Up to 2005, the stock market was generally very weak

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[8] The HOSTC was transformed into Ho Chi Minh City Stock Exchange (HOSE) in May 2007.

[9] The Personal Income Tax Law approved in 2007 states that investors should pay income tax on capital gains (20%) or 0.1% of each transaction from the stock investment. The enforcement will be effective from the beginning of 2009. Due to a sharp decrease in stock price indexes, in December 2007, the Ministry of Finance (MOF) requested that the Government delay the application of the law.

and ailing on both the supply and demand sides. In 2006 and 2007, it skyrocketed in terms of market capitalization, number of listed companies and investors' accounts, participation of securities companies, and investment management funds. The corresponding figures are listed in Table 8. Notably, the total value of the over-the-counter (OTC) stock market is estimated to be 3–4 times higher than that of the former one.

Table 8. Some Key Indicators of Viet Nam's Stock Market (2001–07)

	2001	2004	2005	2006	2007
Market capitalization (%GDP)	0.3	0.5	1.1	22.8	43.0
VN index	235 (peak=571)	241	307	752	≈927 (peak=1,170 in March)
HASTC-Index	..	..	91.3	243	≈324 (peak=460 in March)
Number of listed firms	10	26	41	193	253
HOSTC/HOSE	10	26	32	106	138
HASTC		...	9	87	115
Investment funds	0	1	1	3	4
Securities companies	8	13	14	55	78
Investment management funds	0	?	6	18	25
No. of investors' accounts	8,774	21,616	29,026	≈130,000	≈330,000
Institutional	71	193	257	≈ 400	≈ 500
Foreign	0	207	427	1,650	8,140

Source: The SSC and other sources (end of year)

In fact, the boom began in the 2nd half of 2006. The VN-index rose by 144% in 2006 and 40% in the first quarter of 2007, reaching a peak of 1,170 on 12 March 2007. It has since fluctuated within a range of 900–1,100, but has tended to decline from October 2007. Similar trends could also be observed at the HASTC (Figure 9). As of early March 2008, the VN-index and HASTC-index stood at below 600 and 200, respectively.

Figure 9. VN-/HASTC Indexes and Transaction Volumes
(29 Dec 2006–31 Dec 2007)
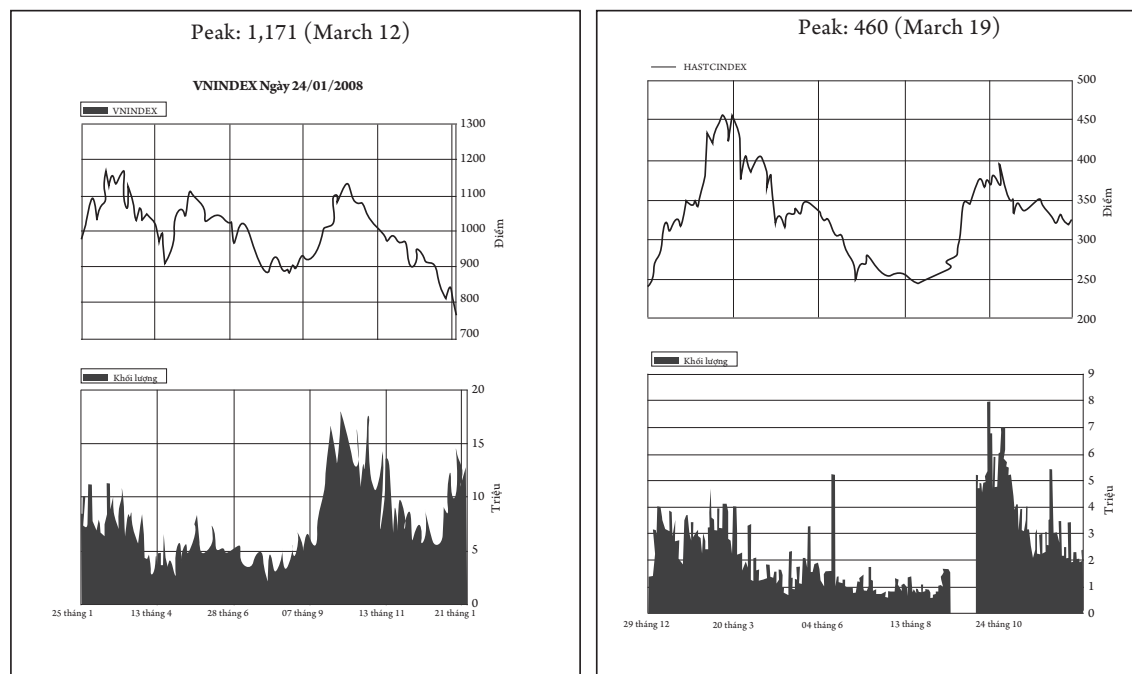
Source: SSI.

Key factors behind the market boom during November 2006–March 2007, inter alia, can be attributed as follows:

- The first is Viet Nam's high economic growth period and the country's bright prospects after the accession to the WTO.

- The second is firms' rapid response following the tax incentive in 2006. A sharp increase in market capitalization for HOSTC (Figure 10) is mainly due to new listings since November 2006 (predominantly equitized SOEs).

- The third is exuberance and sizeable foreign participation, including overseas Vietnamese in Russia and Eastern Europe. Foreign portfolio investors have shown a keen interest in investing in Viet Nam's equity market not only because of Viet Nam's strong economic growth and bright outlook, but also because of an appetite and room for higher risk–higher return assets in their portfolios.

- The fourth is herding behavior spread amongst local short-term individual investors in the context of insufficient information disclosure and transparency. The boom in stock prices is not attributed to foreign investors alone. Domestic investors, accounting for the major proportion of market capitalization, have also been very active in bidding up prices.

Figure 10. Market Capitalization of Firms Listed on HOSTC
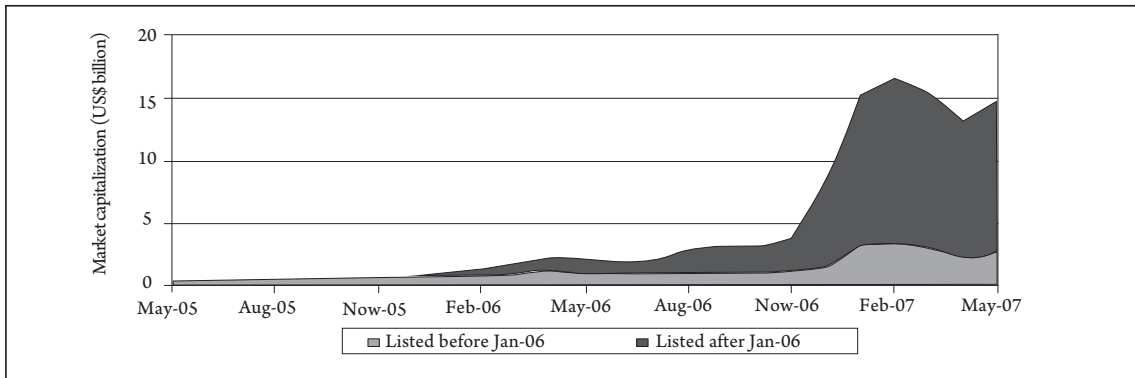
Source: World Bank (2007).

The recent sharp decline of the stock market price indexes can be attributed to various factors, namely, tightening of lending by commercial banks due to stock investment and monetary policies, high inflation rate and higher VND deposit interest rates, and a possible recession of the US economy. However, while local (individual) investors have tried to avoid the market, foreign investors have been more interested in buying rather than selling the stocks they own. On 6 March 2008, the SCIC was forced to intervene in the stock market by purchasing several stocks (mostly blue chip) to prevent further decline in stock prices.

Salient Features

Market liquidity of Viet Nam's stock market is still modest. The average daily turnover stood at USD 51.5 million in August 2007 compared to USD 8.3million in 2006. Table 9 suggests that up to 2007, market liquidity in HOSTC is slightly comparable with that of the Colombo and Philippines Stock Exchanges.

Furthermore, the stock market has seen wide fluctuations in prices of both individual stocks as well as the overall index. Individual shares have frequently hit their daily trading price limits of 5 percent on HOSTC and 10 percent on HASTC in both directions. Dramatic increases in prices inevitably led to questions as to whether the market was overheated. After reaching a peak of 1,170 on March 12, the index fell by almost 23 percent over the following 30 days, leading commentators to posit that a correction was underway. Trading volumes fell sharply and net buying by foreign investors dipped from USD 150 million in February to almost zero at the end of March and of 2007.

Table 9. Global Indices Growth and Liquidity

	2006 % yoy	CAGR 03-05	2006 Average daily turnover USD mil.	2006 Annual turnover: Market cap. (x)	2005 Annual turnover: Market cap. (x)
HSTC	144.5	21.3	8.3	0.3	0.3
Shanghai SE	130.4	(8.2)	3,078.6	0.8	0.8
Shenzhen SE	97.5	(13.2)	1,765.4	1.9	1.3
Jakarta SE	55.3	44.1	203.5	0.4	0.5
Mumbai SE	46.7	42.5	895.9	0.3	0.3
National SE India	34.0	33.1	1,767.7	0.5	0.6
Hong Kong SE	43.2	18.7	3,468.3	0.5	0.4
Philippines SE	42.3	25.6	46.9	0.2	0.2
Colombo SE	41.6	34.3	4.2	0.1	0.2
Kuala Lumpur SE	21.8	10.6	314.5	0.3	0.3
Karachi SE	5.0	36.3	573.1	2.8	2.9
Thailand SE	(4.7)	24.5	419.4	0.7	0.8

Source: World Federal of Exchange, KSE, HCSTC, Reuters.

The ratio of price to earnings per share (P/E ratio) is commonly used to gauge over-exuberance in equity markets. However, the P/E ratio is also a notoriously fickle indicator in rapidly developing markets. Fundamentally, the higher the P/E ratio for a stock, the more investors expect the company to deliver strong incomes in the future, or that future incomes have a low risk accompanying them. P/E ratios tend to vary by industry and the maturity of firms, and it is very difficult to point to a level of P/E which is considered high or reflects an overvaluation of the stock. Historically, while the P/E ratios in excess of 30 have provided signs of overvaluation, it is not unusual to find P/E ratios greater than 75 or 100 for companies in high tech areas. Concerning the P/E ratios of companies on the Vietnamese stock market, the IMF (2007) suggests that the average E ratio is rather high, while World Bank (2007) concludes that this is not abnormal.

Figure 11 provides a distribution of P/E ratios for firms listed on HOSTC. Most firms have P/E ratios in the 10-20 range. However, several of the larger listed firms have P/E ratios in excess of 30. The average P/E for the market stood at 33 in mid-May 2007 compared with around 36 at the end of 2006. An accurate measure of earnings is required for the Vietnamese stock market, because the

figure is highly vulnerable to accounting manipulation. The presented figures are only trailing P/E ratios as they rely on the previous year's earnings. It can be argued that in a fast growing economy, it is better to look at forward P/E ratios based on expected earnings over the following 12 months. The expectation is that faster growth in earnings tends to bring the P/Es down to more normal levels. For example, if the earnings-per-share grows by an average of 25 percent over the next 12 months, the forward P/E would be around 26.

Figure 11. Trailing P/E Ratios for Firms on HOSTC
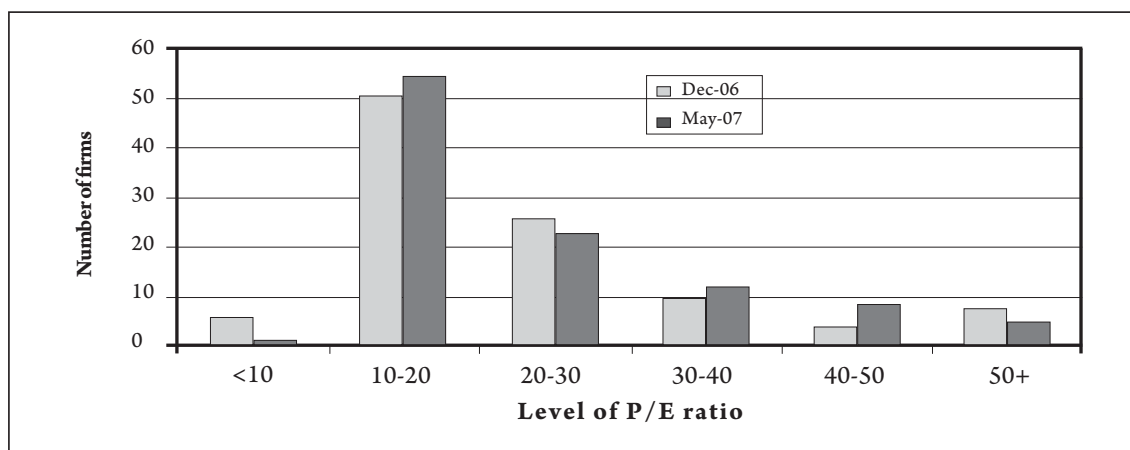
Source: HOSTC.

II.4. Development of the Bond Market

Policy Measures

According to the State Budget Law of 1993, the Government can no longer finance the budget deficit by printing money. Since the mid-1990s, it has paid more attention to the issuance of bonds for financing budget deficit and development needs. However, improvement of the legal framework for bond market development has been rather slow. The first decree on the issuance of government bonds was only in 2000 and it was amended in 2003. In 2006, the Government issued Decree No. 52/2006/ND-CP on the modalities for corporate bond issuance. And a decree on the issuance of government and corporate bonds in international markets was drafted in 2007, and is now under consideration for approval.

Characteristics of the Bond Market

Viet Nam's bond market remains relatively underdeveloped despite a recent expansion. At the end of 2007, there were 570 outstanding bonds in the securities market, with a market value of about VND 115.660 trillion, or 10.1% of the GDP.

Most of them are government bonds (85%). Other debt securities include municipal bonds (Ho Chi Minh City and Hanoi), Development Assistance Fund's (ADF's and now Development Bank's) bonds, education and infrastructure bonds, SOCB recapitalization bonds, BIDV bonds, Vietcombank convertible bonds, and some other corporate bonds[10].

Despite continuing improvement, the market is still illiquid as investors hold the bonds to maturity. Long-term bonds (10–15 years), making up about 40% of the total, are typically purchased by insurance companies and held to maturity, while 60% of 2-3-5 year bonds (mostly 5-year) are held by SOCBs.

The market is also highly segmented due to multiple issue channels, methods, and registers, and to the lack of market making function. The State Treasury currently issues more than 100 issues per year of VND-denominated treasury bills, with terms of 6, 9 and 12 months, and bonds of 2, 3, 5, 10 and 15 years through four different channels and methods[11]. Treasury Bonds accounted for more than 80 percent of the Government's debt securities issued in 2003 and 2004 (Table 10).

The designated financial institutions are locally called "primary dealers," but they do not have market making obligations. The State Treasury issues an issuance calendar of auctions and underwritings every quarter. Treasury-Bond auctions are held every week, bond auctions on the securities markets every two weeks, and bond underwritings every two weeks. In addition, the SBV also issues its own short-term securities for liquidity management purposes from time to time.

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[10] <u>Municipal Bonds:</u> Ho Chi Minh City and Hanoi are permitted to issue bonds equivalent to 100% of their annual investment budget (for other cities, the applicable limit is 30%) subject to the Ministry of Finance's approval. <u>DAF Bonds:</u> The DAF (now VDB) has become one of the largest financial institutes in Viet Nam, and has outstanding loans equivalent to about of 20% of the GDP, half of which are financed through ODA.

<u>Education and Infrastructure Bonds:</u> The National Assembly has authorized issuance of total VND110 trillion (about USD 7 bil.) of the education and infrastructure bonds for the period 2005–2040. SOCB recapitalization bonds: In 2001, as a part of the government's restructuring program for SOCBs, NPLs worth VND10.9 trillion (2.5% of the 2000 GDP) were provided in the form of recapitalization bonds (9.7 trillion) and cash.

[11] The methods and channels are (i) treasury bill auctions to designated banks through the SBV as the fiscal agent for the State Treasury and as the registrar, (ii) bond auctions to designated banks, insurance companies, finance companies and securities firms through the STCs with the SCC as the registrar, (iii) underwriting by a syndication of designated banks and securities firms with each underwriter as a registrar, and (vi) direct placement of bonds with the public through a national network of about 600 State Treasury offices with each Treasury office as a registrar. At present, the Treasury stopped retail issuance of bonds to individual investors to reduce transaction costs.

Table 10. Government Securities Issue Amount by Channel and Method

	2003		2004	
TB auction through SBV	15,130	86.7%	18.411	82.9%
Bond Auction on STCs	672	3.9%	1,419	6.4%
Underwriting	1,650	9.5%	2,390	10.8%
Direct Placement	-	0.0%	-	0.0%
Foreign currency bond auction through SBV	0	0.0%	0	0.0%
Total	**17,452**	**100%**	**22,220**	**100%**

Source: HOSTC and Reuters.

Some new developments should, however, be noted. In October 2005, the Government issued its first international bonds since the Brady issues in the 1990s, amounting to USD 750 million, with a yield of 7.125%, which was lower than Indonesian and Philippine bonds[12]. Meanwhile, the S&P rating upgraded Viet Nam's credit rating outlook from BB- positive to BB stable in September 2006. The funds were on loan to Vinashin, the shipbuilding state-owned corporation. The Government is now considering raising another USD 1 billion through a new sovereign issue, the proceeds of which will largely be devoted to the construction of the Dung Quat oil refinery; the rest will go to Viet Nam National Shipping Lines (Vinalines) for purchasing new vessels, and to Song Da Corporation for the construction of a hydro plant. These corporations have yet to obtain international credit ratings.

Beginning in the second half of 2006, foreign buyers started to show an interest in Vietnamese bonds, as many think that they are being undervalued and ripe for higher returns. Foreign participation has created a new liveliness in the bond markets, especially on the HASTC. Forty-four Government bond tenders took place in 2007, which helped raise VND 18.939 trillion in capital. The secondary bond market in Hanoi has also experienced rather strong growth. At the policy level, the Government has been trying to strengthen the five-year bond as a liquid benchmark issue through big-lot auctions. A specialized bond market will be built up at the HASTC. Government bonds, municipal bonds, and

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[12] The issue has widely been regarded as successful and the spread over US treasuries has declined from 256 basis points at issuance to about 110 basis points as of April 2007.

government-guaranteed bond tenders and transactions will take place in this specialized market.

In 2006, Vinashin announced Viet Nam's third and thus far largest corporate issue of 3 trillion dong (10-year bonds with an annual coupon of 9%). The bond was reportedly oversubscribed three times, with 95 percent being sold to foreign investors. EVN had issued a corporate bond that was also sold mainly to foreign investors (10-year bonds with an annual coupon of 9.6% for the first year and 9.96% thereafter). In 2008, EVN and PetroVietnam are likely to issue their own bonds.

III. Capital flows and their impacts

3.1. Foreign Direct Investment Inflows

The Foreign Investment Law was passed in December 1987. During 1988-2007, Viet Nam attracted 9,492 FDI projects with committed capital of USD 83.2 billion in total, 52.7% of which were realized[13]. After reaching a peak in 1996, FDI inflows into Viet Nam had declined since Asian crisis. However, since the 2nd half of 2004, it has expanded rapidly, reaching more than USD 10 billion and USD 21.3 billion in terms of commitments in 2006 and 2007, respectively (Figure 12). The sudden increase of FDI in these recent years reflects investors' confidence in Viet Nam's reform and international integration process and development prospect as well as the restructuring of FDI in Asia in some labor-intensive industries such as outsourcing logistics, electronics, garments and manufacturing from the People's Republic of China (PRC) to Viet Nam[14].

Until the end of 2007, the realized (accumulated) FDI was allocated in the manufacturing industry (42.7%), oil and gas (18.8%), hotel and tourism (8.1%), construction (7.2%), offices and apartments (6.2%), building urban areas and industrial zones (2.8%), (Figure 13).

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[13] The figure for implemented/realized FDI is different from that of FDI in BOP.

[14] Intel has decided to establish a USD 1 billion semiconductor assembly and test facility in Viet Nam that is not only a landmark for Viet Nam, but also a clear indication of a growing trend. In the same sector, Hong Hai–Foxcom (Taipei,China) has plans to invest up to USD 5 billion over the next five years at several sites in Viet Nam to manufacture electronic goods and computer products, from digital cameras to music players, motherboards and other computer components.

Figure 12. FDI in Viet Nam: Commitments and Realization (1988–2007)
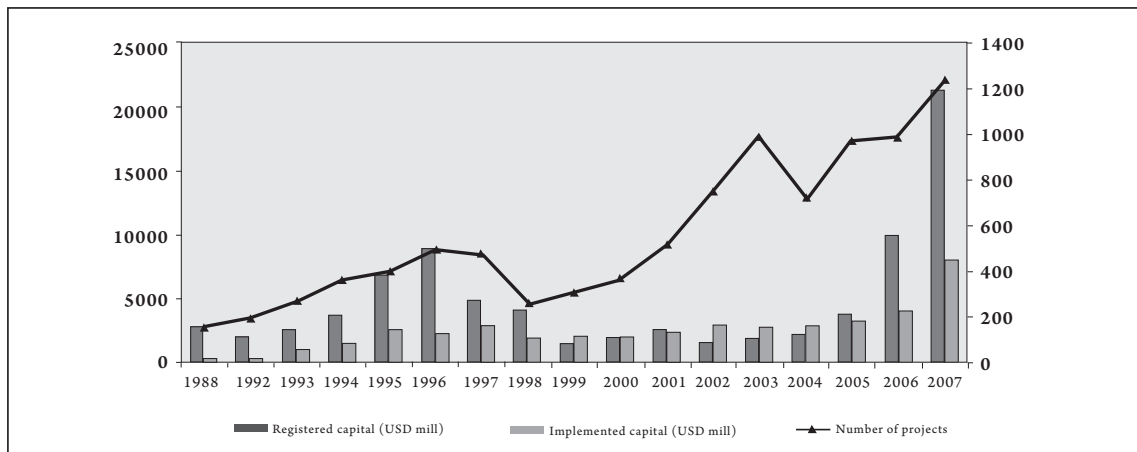
Source: MPI

Figure 13. Realization of FDI by Sector (% of the Total to October 2007)
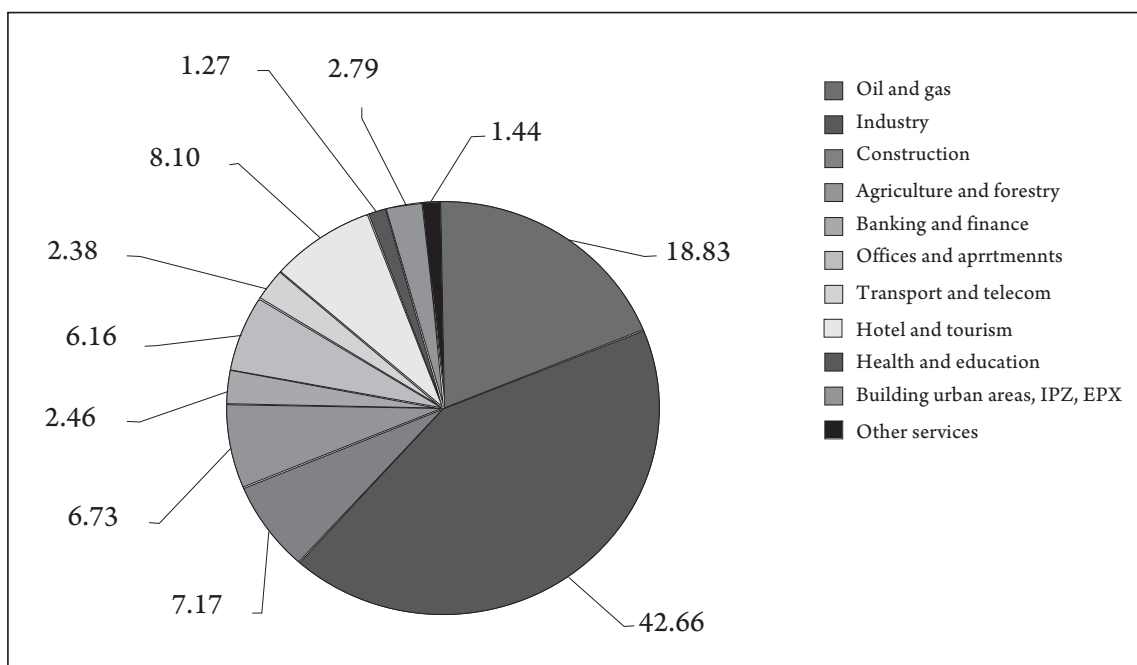
Source: MPI.

Source: In the 1990s, FDI was concentrated in import substitution industries. However, since 2000, there has been a trend towards the export manufacturing sector and services sectors. The share of FDI in total export turnover (excluding oil exports) accounted for only 23.4% in 1996 and 22.2% in 2000, but then rose sharply to 36.9% in 2006 (Table 14). There has been also a radical change in the FDI trend in recent years. Almost all registered FDI in Viet Nam has changed structurally and has become focused on industry and

construction and the services sector. During 2004 and 2007, the total registered FDI in these two sectors increased 74.9% and 56.0%, respectively, compared to a modest increase in the agriculture sector at 26.6% (Table 13). As a result, until October 2007, the total registered FDI in these two sectors accounted for 94.2% of the total, while that in agriculture accounted for only 5.8%.

Table 13. Accumulated FDI as of Oct 2007 Compared to Oct 2004

	Projects (USD mil.)	% change	Registered Capital (USD mil.)	% change	Realized Capital (USD mil.)	% change
Industry and Construction	5,418	61.2	46,114	74.9	21,258	19.4
Agriculture	911	32.4	4,306	26.6	2,085	25.5
Services	1,837	89.0	24,346	56.0	7,618	17.3
Total	8,166	62.6	74,766	64.8	30,961	19.3

Source: Data provided by the MPI and authors' calculations.

In the early 1990s, the foreign invested enterprise (FIE) sector played a rather insignificant role in Viet Nam's economy. But since the mid-1990s, it has become an integral part of the economy. In 1996, FIEs directly employed 222,000 workers and accounted for 7.4% of the GDP. In 2006, these figures increased to nearly 1,130,000 employees and 17.1% of the GDP (Table 14). As mentioned earlier, the FIE sector is currently a driving force for Viet Nam's exports and the development of various manufacturing industries such as textiles and garments; machinery and equipment; office, accounting and computing; electrical machinery and apparatus; radio and communication equipment and apparatus; medical, precision, and optical instruments; motor vehicle and transport equipment; and furniture (Appendix A).

Table 14. FIEs' Contribution to Viet Nam's Economy

	1992	1996	2000	2004	2005	2006
FIE contribution to the GDP (%)	2.0	7.4	13.2	15.1	16.0	17.1
Share of FDI in total investment (%)	22.0	26.0	18.0	15.5	15.7	16.4
Exports by FIEs, excl. oil exports (USD mil.)	112	920	3320	8601	11,144	14,620
- Share of FIEs' exports (%)	5.3	23.4	22.2	33.1	34.4	36.9
No. of employees in FIEs (1,000 persons)	n.a.	220	379	739	935	1,129

Source: MPI.

However, FDI still has limited spillover effects and benefit sharing in the regional production network. Viet Nam generally exhibits a similar trade pattern as in the cases of other East Asian economies, but only at the early stage (Box 2).

Box 2. Viet Nam's Engagement in the Regional Production Network

In general, Viet Nam is following a similar trade pattern experienced by other East Asian economies, but still is at an earlier stage of regional trade engagement (Vo and Nguyen 2006).

- *Firstly*, the East Asian economies began their growth relying strongly on exports of labor-intensive products but they have gradually gained a comparative advantage shift to increasingly capital and technology-intensive products. At present, Viet Nam's manufacturing exports are concentrated in labor-intensive products such as textiles and garments, footwear, and furniture with low value added in the production value chains.

- *Secondly*, East Asia saw a huge expansion of trade in intermediate goods such as machinery parts and components and a rising regional intra-industry trade. Viet Nam seems to be following a similar pattern. Viet Nam's regional intra-industry trade index increased from 2.2 in 1985 to 19.0 in 2000, but it is much smaller than that of other East Asian economies. East Asia has become the largest source of Viet Nam's imports of parts and components for industrial production.

- *Thirdly*, while trade in intermediate goods is mainly within East Asia, a majority of the markets for the final products is still extra-regional. The significantly increasing role of the EU and the US as important destinations for Viet Nam's exports can also be seen in the case of Viet Nam. Since the enactment of the Viet Nam-US BTA in December 2001, Viet Nam's exports to the US have increased from USD 1.05 billion in 2001 to about USD 5.0 billion in 2004.

- *Fourthly*, the People's Republic of China (PRC) has played an increasing role as a trade partner, especially in intermediate goods and components in East Asia. PRC has also become a key trade partner of Viet Nam, but with characteristics of the "North-South" trade and a huge deficit on Viet Nam's side (the deficit increased from USD 0.2 billion in 2001 to more than USD 5 billion in 2006[15]).

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[15] Note that in recent years ASEAN -5 has had a large surplus in trade with the People's Republic of China (PRC).

II.2. Official Development Assistance

Official development assistance (ODA) was resumed in 1993 and, together with FDI, has also significantly contributed to investment and GDP growth in Viet Nam. From 1993–2007, total committed ODA for Viet Nam reached USD 41.2 billion, of which USD 30.7 billion (or 74.5%) was signed, and USD 19.7 billion (or 47.9%) was disbursed (Figure 15).

Figure 15. Pledged, Signed and Disbursed Values of ODA (1993–2007)
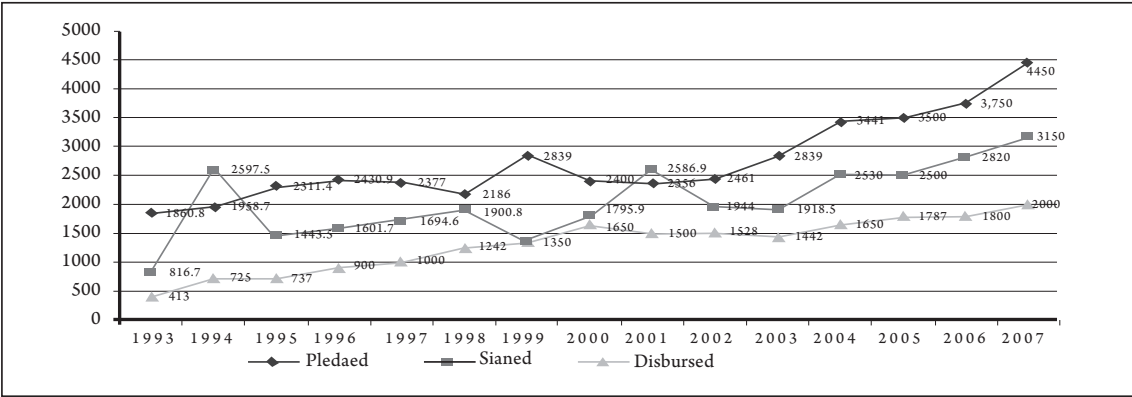
Source: MPI.

In the years from 1993-2005, ODA represented about 11.4% of the total investment and 50% of the investment from the State budget (MPI 2005). Until recently, ODA allocation in Viet Nam had been in favor of more developed areas. But it has gradually been allocated in a more equal manner: less developed areas also tended to receive more of the ODA allocation.

Table 15 points out the sectors and areas that ODA has focused on. They include infrastructure development, poverty reduction (particularly in isolated areas), human resources development and institutional improvement. ODA has supported the enhancement and formulation of various important laws such as the Enterprise Law, the Land Law, the Investment Law, the Competition Law and the Anti-Corruption Law. ODA-financed projects also helped strengthen the managerial capacity of officials and the personnel of ministries, sectors and localities, and improve their professional and English levels substantially.

Despite encouraging achievements with resulting remarkable increases of ODA so far, the mobilization and utilization of ODA has been exposed to a typical set of weaknesses and limitations, including[16]:

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[16] See Institute of Vietnam Economy (2007).

**Table 15. Structure of Signed ODA by Sector and Area
(1993–2005)**

Sectors/Areas	Total ODA	Loans	Grant
Agricultural and Rural Development, Poverty Reduction	14%	10%	4%
Energy and Industry	21%	20%	1%
Transportation and Telecommunications	25%	24%	1%
Science, Technology, and Environment	12%	9%	3%
Health Care, Education and Training, Social Development	10%	5%	5%
Others	18%	14%	4%
Grant Total	*100*	*100*	

Source: MPI.

- Limited awareness and understanding on the nature of ODA, which is in many cases understood as a "free gift";

- Slow materialization/concretization of directions, guidelines, policies and strategies on ODA mobilization and utilization into specific programs and projects, leading to passive role of governmental agencies in their cooperation with donors in a number of cases;

- Weak institutional arrangement and human capacity for ODA management and utilization. Human resources involved in ODA-financed programs and projects remain weak in professional capability, international cooperation skills and foreign languages. Organizational and operational regulations of ODA-financed programs and project management units remain inadequate;

- ODA management and legal framework for utilization exposes many constraints: inconsistencies between regulatory documents on ODA management and utilization and those on ODA allocation; lack of enforcement regarding regulatory documents on ODA mobilization and utilization; inadequate harmonization in ODA management processes and procedures of Viet Nam and donors, reducing investment efficiency and increasing transaction costs; and

- Limited monitoring and evaluation with regard to ODA projects and programs. This limitation is arguably due to the lack of strict compliance and inadequate disciplinary actions with regard to financial reporting, payments and settlement regulations.

3.3. Portfolio Investment Flows

The development and outlook of Viet Nam's economy and securities market has been appealing to many foreign investors. Foreign portfolio investment (FPI) inflows, together with the presence of a number of foreign investment funds, became a real new phenomenon in 2006. Foreign portfolio inflows accounted for 2.2% and 10.4% of the GDP in 2006 and 2007, respectively (Appendix B). Foreign portfolio investors have shown a keen interest to invest in Viet Nam's equity market due to their appetite for higher risk-higher return assets and prevailing liquidity in the global economy.

There were 436 foreign investors as of 2005, including 38 institutional investors and 389 individual investors. However, the number of foreign accounts increased by nearly twenty-fold from 2005 to 8,140 in 2007. The trading volume of foreign investors is rather high, accounting for 21% of the total market trading volume in 2006. This number increased to 29% by the end of 2007. In 2007, the trading value increased significantly to around 55% of market trading value (Dang, 2008).

In 2006, there was around USD 1.3 billion of FPI in Viet Nam, of which 70% was invested in stocks, bonds and real estate, and 30% was held as deposits in the banking system. In 2007, FPI increased sharply to USD 7.4 billion (Appendix B).

The exuberance and sizeable foreign participation, including overseas Vietnamese in Russia and Eastern Europe, has contributed to pushing up the financial boom and investments in the real estate market.

- In May 2007, foreigners accounted for a 25% share of HOSE capitalization or just under USD 4 billion (Figure 16). This amount is higher than actual inflows as it incorporates capital gains since the inflows took place.

- Equity acquisition has been considered a partnership strategy for investments in various areas, especially in financial activities, real estate, energy and infrastructure development.

- Since the 2nd half of 2006, the appetite of foreign investors has shown more favor towards both Government and corporate bonds. The participation of foreign investors has contributed to the growth of a secondary Government bond market in Hanoi. As previously mentioned, there are 75% and 95% of EVN bonds and Vinashin bonds, respectively, that have been sold to foreign investors.

Figure 16. Market Capitalization of HOSTC by Ownership
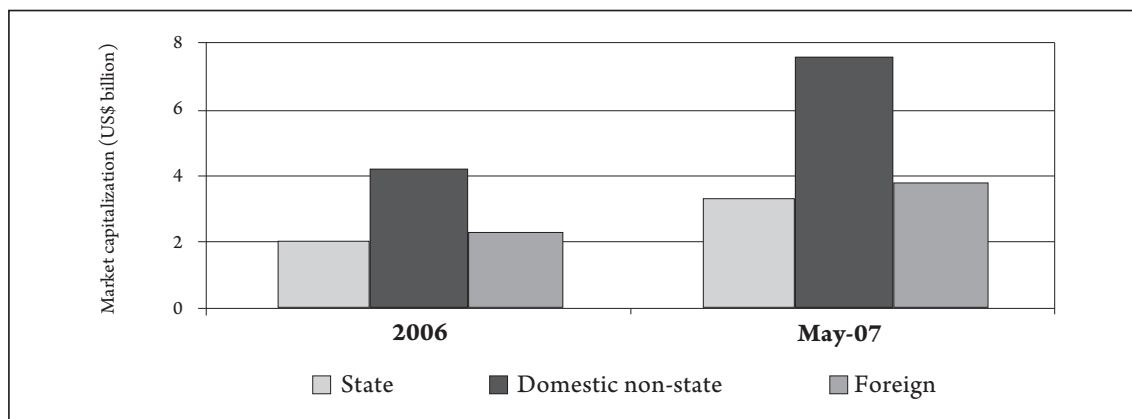
The above-mentioned increase of FPI was further explained by the transfer items on the BOPs. Private remittances increased substantially, from 0% of the GDP 1990 to 5.1% of the GDP in 2000, and further to 6.2% of the GDP in 2006 and 8.7% of the GDP in 2007 (Appendix B). The IMF (2006) supports the portfolio approach for Viet Nam because remittances appear positively correlated with the favorable economic conditions in Viet Nam, its overall investment climate and relaxation of the regulatory environment, particularly in the late 1990s[17]. Anecdotal evidence has shown that a large proportion of remittances has recently been used for investment in real estate and the stock market.

3.4. Capital Inflows and Macroeconomic Stability

In the last five years, there were high trade deficits but much less the CA deficit as in the mid-1990s. An exception is 2007, which had a very high CA deficit, reaching 9.9% of the GDP. Furthermore, the way of financing trade deficits in recent years has also been altered. In the mid-1990s, trade and CA deficits were largely funded by FDI. But since 2005, remittances and portfolio inflows have played an increasing role in financing trade deficit[18]. Also, as a result of huge capital inflows, foreign exchange reserves have recently accumulated rapidly, increasing from USD 3.0 billion in 2000 to USD 11.5 billion in 2006, and further to a record-high of around USD 23 billion (32.3% of the GDP) by the end of 2007.

Since the agreement on debt restructuring with the Russian Federation in 2000, Viet Nam's external debt has decreased substantially. In relative terms, the

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[17] For example, remittances are not subject to tax and can be withdrawn in foreign currencies.
[18] See Appendix B for more detailed information on Viet Nam's BOPs.

total external debt as a proportion of the GDP went down from 41.1% in 2000 to about 30.2% in 2006 and 30.8% in 2007 (IMF). The debt service ratio (5–6% recently) is well within a controllable level. There are, however, some concerns:

- Debt-induced financing has constituted a majority of capital inflow, and hence, the costs of financing CA deficit may increase;

- FDI inflow has also entailed considerable commercial loans;

- Capital utilization efficacy, especially in the public sector, is low. Moreover, the issue of Government bonds on the international market for lending to the SOEs is always associated with the moral hazard problem; and

- Errors and omissions in the BOP are high due to statistical errors which may reflect shortcomings in controlling short-term capital flows (Figure 17). Furthermore, to a given extent, it also slows up the trading volume in Viet Nam.

Figure 17. Errors and Omissions of Viet Nam's BOPs (% of KA Balance)
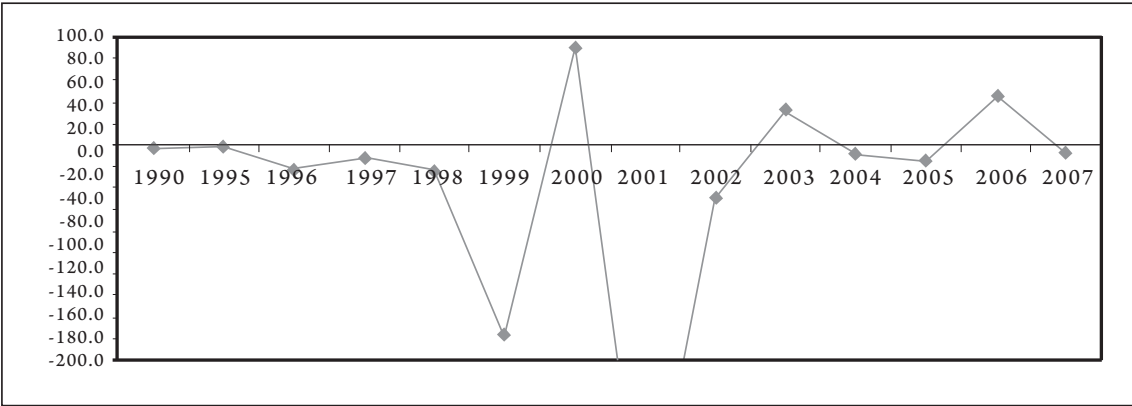
Source: Estimations from Appendix B.

As mentioned before, a surge in capital inflows, especially during 2006-07, was also associated with domestic credit expansion, higher inflation and asset prices. But the outcomes, to a significant extent, have been dependent on responses of key macroeconomic policies.

4. Major financial issues and recent policy responses

Despite the possibility of sustaining high growth over the medium-term, vulnerabilities in economic growth and the financial systems still remain in Viet

Nam. There are a number of reasons for such a concern. To a certain extent, Viet Nam's economy still relies significantly on external resources to finance its investment-savings gap. Meanwhile, domestic capability to efficiently serve and absorb those resources is quite limited and the economy has been financially nurtured by rather ailing banking systems. Moreover, the economy can be hit by international trade and capital flow shocks or a global recession.

The Banking System

The first issue concerns the non-performing loans (NPLs) of the banking industry. It has gone down significantly in recent years but the sustainability of loan quality is seriously questionable in the future. Some major factors may increase future NPLs. The large SOEs' and public investments inefficiency, and the conflict of interest issues related to the lending of funds raised through bond issuances of SOEs could result in the loss of repayment capability of those borrowers. Moreover, the risks associated with real estate and securities-related loans, which were substantial in several JSCBs, are quite high in the context of high inflation and an asset bubble.

Obviously, one of the key measures in conjunction with restructuring the banking system is to reform the SOE sector. Since 2005, SOE reform has changed significantly in nature, with its focus shifted to large SOEs with the goal of their equitization and listing on the stock market. Several state business groups were established, hoping to gain stronger competitiveness in the new environment and international markets thanks to improvements in their efficiency and management capability. At first, the transformation of large SOEs was allowed as an experiment; but later on this somehow became a movement and nearly all of them have engaged in various kinds of business activities, including financial ones. There are concerns about the transparency of the SOE reform process and risk management of these business groups.

The banking industry has also faced a prolonged double mismatch problem (maturity mismatch and currency mismatch). Normally, short-term deposits account for 75% of total deposits, but the share of medium-and long-term loans in total credit rose from 22% in 1995 to about 40% in recent years (this figure is much higher for some JSCBs in 2007). At the same time, commercial banks have only been allowed to use about 25–30% of short-term deposits to make medium and long-term loans. The risks seem to be magnified in the presence of direct lending and conflict of interest issues, especially when related to loans of questionable real estate deals and other big projects.

The currency mismatch was most severe during 1999-2002 due to sharp increases in foreign currency deposits and a decrease in foreign currency loans,

measured as shares in total deposits and total loans, respectively (Figure 18). It has recently been narrowed, but remains problematic due to its sensitivity to the exchange rate and interest rate fluctuations, especially in the context of a rather high degree of dollarization[19]. The SBV has attempted to gradually eliminate dollarization. However, this is no easy task as some contradicting policies continue to be in place (such as policies for encouraging remittances) and in the context of having capital flows.

Figure 18. Ratios of FX Deposits to Total Deposits and FX Loans to Total Credit
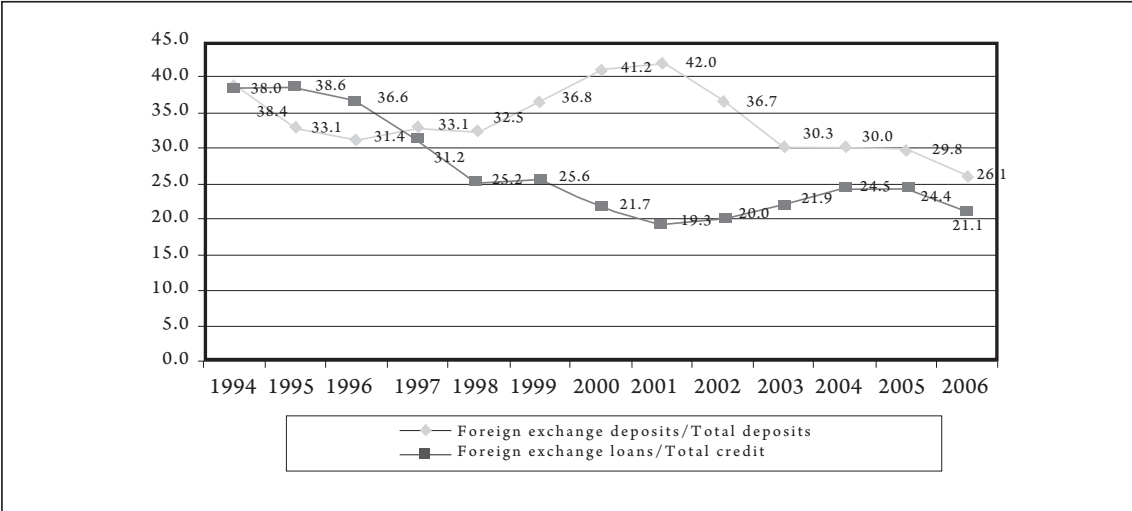
Source: SBV and authors' estimations

The problem of macroeconomic policy consistency should be looked into for greater clarity. Consistency between monetary and exchange rate policies is approached as, according to Johnston and Otker-Robe (1999), the relationship between exchange rates (ERs) and interest rates at a point in time and the sustainability of these policy mixes over time. The consistency at a point in time can be best demonstrated by the conditions of covered and uncovered interest rate parities (CIP and UIP)[20]. These two parities indicate the interdependent

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[19] Measured as ratio of foreign currency deposits to M2, dollarization in Viet Nam remained stable between 20-23% in the mid-1990s. It started to increase in 1997 to reach a peak of 31.7% in 2001, before dropping to 24.4% in 2005 and less than 20% in 2007.

[20] The CIP equation is: $i_{t,k} = i^*_{t,k} + fd$; where, $i_{t,k}$ and $i^*_{t,k}$ are rates of return on domestic and foreign assets of the same maturity and are otherwise identical, except that they are denominated in different currencies, and fd is the forward discount on the domestic currency for that maturity. The UIP holds if investors are assumed to be risk neutral, expectations are formed rationally, and the expected future depreciation of the home currency ($\Delta s_{et,t+k}$) equals the forward discount: $i_{t,k} = i^*_{t,k} + \Delta s_{et,t+k}$

relationship between the domestic interest rate and ER at a point in time, when investors consider different returns on various financial assets to maximize return on their portfolios. The policy consistency over time determines the sustainability of the chosen policy mix. The risks and costs of this kind of policy inconsistency are ineffectiveness of monetary policy and encouragement of speculative activities. This point can be illustrated by two case studies: the intensification of dollarization during 1998–2001, and the "mini-crisis" in 1996–97 (Box 3).

The present situation seems to be reversed due to the weakening USD and increasing VND-denominated interest rates (Table 16). The VND became more attractive than the USD (a reason for the declining degree of dollarization). This has contributed to the encouragement of VND-based foreign exchange investments in such as local bonds, real estate, equity markets, and foreign currency borrowings for imports (given high inflation and expectation of stability/appreciation of nominal ER). Some of these kinds of investments can also be speculative.

Box 3. Dollarization, Double Mismatches and Speculative Activities

Following the UIP condition, it can be observed that during 1997-2001, given the expectation of further exchange rate (ER) depreciation and lower VND-denominated interest rates, the public had shifted from the preferred portfolio in favor of USD (Table 16). This was particularly the case in 2000 when the FED raised the prime rate to remarkable levels. Due to capital controls, commercial banks attempted to attract foreign-currency deposits for deposits abroad to earn the differential spread. The deposits abroad rose remarkably, from USD 537 million in 1998 to USD 2.088 billion in 2000 and 1.197 billion in 2001 (Appendix B). In other words, the macroeconomic policy inconsistency in favor of holding USD was a major underlying determinant of the dollarization in tensification during 1999-2001, and in certain circumstances this encouraged commercial banks to speculate on currency gains rather than focus on productive investments.

The mini-crisis in 1996–97 is another illustration of the danger of macroeconomic policy inconsistency and problem of double mismatch (Vo et al 2003). In 1996 the very high VND-denominated interest rates attracted a substantial increase in banking deposits, while credits were hardly expanded due to the high lending rates and tight regulations on credit ceilings. Reserves in commercial banks rose substantially and many banks had excessive reserves (some banks even refused to accept more deposits). This

Table 16. Annual Savings Interest Rates of USD and VND, 1992–2007 (%)

Year	CPI-based inflation	VND depreciation rate	VND savings interest rate	Real VND savings rate	Return on VND in USD	USD savings interest rate	Difference in rates
	0	1	2	(3)=(2)-(0)	(4)=(2)-(1)	5	(6)=(4)-(5)
1992	17.5	-8.13	34.10	16.60	42.23	4.05	38.18
1993	5.2	2.62	20.40	15.20	17.78	3.20	14.58
1994	14.5	1.92	16.80	2.30	14.88	3.50	11.38
1995	12.7	-0.33	16.80	4.10	17.13	4.50	12.63
1996	4.5	0.33	9.60	5.10	9.27	4.80	4.47
1997	3.6	11.57	9.60	6.00	-1.97	5.00	-6.97
1998	9.2	12.70	9.60	0.40	-3.10	5.00	-8.10
1999	0.1	0.89	5.25	5.15	4.36	4.70	-0.34
2000	-0.6	3.54	4.45	5.05	0.91	4.43	-3.52
2001	0.8	3.90	5.95	5.15	2.05	3.00	-0.95
2002	4.0	2.11	7.20	3.20	5.09	2.50	2.59
2003	3.0	2.20	7.40	4.40	5.20	2.50	2.70
2004	9.4	0.40	7.70	-1.70	7.30	2.60	4.70
2005	8.4	0.90	8.40	0.00	7.50	4.20	3.30
2006	6.7	0.87	8.80	2.10	7.93	4.70	3.23
2007	12.6	-0.20	9.10	-3.50	9.30	5.00	4.30

Note: The end of period ER is used to calculate the depreciation rate.

Source: Nguyen (2002) for the data up to 2001 and authors' estimates for the 2002–07 data

situation created incentives for banks to evade government controls. A letter of credit (LC) was one important channel for evasion since up to that time LCs were excluded from credit ceilings. LCs were seen as an off-balance activity of banks, generating opacity on the balance sheets of banks.

Firms also attempted to evade regulations on limits of foreign-currency borrowings (only importers and other import-related activities can obtain loans in foreign currencies). Although at that time Viet Nam had imposed certain restrictions on CA and KA, the flows of funds from abroad through deferred payments on LCs had been outside those restrictions. Domestic enterprises were allowed to have their trade credit guaranteed by commer-

cial banks through deferred LCs. In fact, this was equivalent to enterprises borrowing short-term foreign currency loans from abroad through domestic commercial banks. Moreover, in an environment of a very high VND interest rate and limited foreign currency loans, but with stability and rigidity of exchange rates as an implicit government guarantee against foreign exchange risk, there was, of course, a strong incentive for domestic firms to borrow from abroad. Thus both commercial banks and firms had incentives to lend and borrow through LCs.

As a result, domestic firms (both SOE and private enterprises) borrowed a large amount of short-term USD loans. The amount of LCs was estimated to have accumulated to USD 1.5 billion by early 1997. Net flows on short-term debt increased significantly, from about USD 120 million in 1993 and 1994 to USD 311 million in 1995 and USD 224 million in 1996. It had become thereafter largely negative in 1997.

The consequences were severe. First, it widened the CA deficit at an alarming level (Appendix B). Second, a large part of this short-term borrowing was channelled into a speculative real estate market, resulting in a market boom. But the market turned into bust later, in early 1997, when those firms could not pay back the debt. Third, it weakened the banking system and the financial sector as a whole. Around 40% of the LCs (equivalent to 3 percent of the GDP) guaranteed by commercial banks became bad debts.

As a result, the SOCBs and some other JSCBs defaulted on these guaranteed short-term debts, leading to the concern about the level of foreign exchange reserves and about Viet Nam's commitment to international financial arrangements. The SBV had to use foreign reserves to bail out these commercial banks. It was estimated that the stock of foreign reserves fell by the equivalent of 5 weeks of imports. Viet Nam's sovereign credit rating was lowered from Ba3 to C.

Moreover, the evasion of banks weakened the effectiveness of the monetary policy because the direct control mechanism was eroded, distorting monetary aggregates. In addition, it generated upward pressure on the exchange rate. Due to a sharp increase in demand for foreign exchange by the end of 1996 and early 1997, the SBV broadened the band between selling and buying rates of foreign exchange from 1% to 5% in February 1997. In addition, in mid-1997, the SBV set strict limits on the amount of deferred LCs and tightened controls over commercial banks' LC guaranteeing. To import goods on the restricted goods list a deposit equivalent of 80% of each LC was required instead of the previous 0-30% level. As a result, during the second half of 1998, the value of late LC payments fell from around USD 350 million to some USD 200 million at the end of 1998.

Another issue is that the management capability at both the macro- and micro-levels cannot keep pace with the new development dimensions of the banking sector. In fact, there are still shortcomings in the banking industry as much as there is still a weak financial capacity of commercial banks (low CAR, low reserves and low loan quality) and weak risk management. According to a survey by Ernst & Young, the banks' application of 19/25 principles (3/25) does not fully comply with the BASEL Core Principles (Nguyen 2007). Furthermore, the underdevelopment of a regulatory framework with limited supervision and monitoring capacity of the key bodies, the SBV, the MOF and the SSC, makes banking activities less transparent and more fragile. As mentioned by Vo et al (2007),

Viet Nam's banking system is still vulnerable due to limited supervision, monitoring and governance capacity. On-site monitoring and supervision is constrained due to inadequate quantity and quality of human resources. Off-site supervision, meanwhile, fails to meet contemporary requirements in compiling and processing information. Lending supervision has yet to cover all credit-related financial institutions due to lack of effective collaboration amongst authorized agencies and de-facto institution-based financial system governance. Certain international practices and standards have been recently adopted; yet banking governance standards generally have yet to meet the CAMEL and BASEL provisions.

The SBV is now undergoing more radical reforms to be a modern, relatively independent central bank. The Government also began reforming the entire supervision system towards the establishment of a new single supervision system like the FSA (Financial Service Authorities) in the UK.

The Stock and Bond Markets

During a stock market boom, the greatest concerns of the Vietnamese authorities have been how to control speculative activities that make the stock market too volatile and at the same time, how to facilitate long-term investment for the development of the economy as a whole. Facing such challenges, the SSC has repeatedly warned investors of risks associated with overheating in the market's development, followed by the SBV's measure to restrain loans to bank-backed securities companies in December 2006. Within a few days, the SSC promulgated six measures to improve regulation and monitoring of the securities market's operations, including: (i) postponing the lifting of maximum shares of listed companies permitted to foreign investors; (ii) cooperating with the SBV to monitor lending for security investment, repo transactions and other transactions related to security collateralization of commercial banks; (iii) investigating securities companies which reportedly discriminate between customers, and/or

misuse information; (iv) requiring listed companies to disclose and disseminate their operational and financial results as of 2006 to better inform investors in the market; (v) re-registering representative offices of foreign investment funds in Viet Nam; and (vi) promoting further information disclosure so that investors can make better informed, rational investment decisions.

However, the reaction of the stock market proved that such policy measures were not significantly effective. There has not yet been a clear sign of market fever relief (Figure 9). In order to protect the stability of the banking system in particular, and the financial system as a whole, with the fear that stock-collateralized loans could become NPL, in April 2007, the SBV decided to impose a ceiling of 3% of total lending for stock-collateralized loans (Direction 03/QD-NHNN). The VN-Index afterward has fluctuated with a declining trend.

Development of the stock market in Viet Nam is obviously very much dependent on the SOE reform process. To be aware of the problem, the Government has focused on reforming large SOEs with a determined action plan. According to a public announcement plan, there are about 2,100 SOEs at present, of which about 1,500 have been or will be equitized over 2006-2010. This suggests also that close to 80 corporations and large firms will have to go public. Moreover, 550 SOEs were to be equitized in 2007. However, in 2007, only 65% of these SOEs were successfully equitized. As stock market indexes have been declining, the Government was observedly puzzled over the trade-off between the financial surplus it could gain from initial public offerings (IPOs) and implementation of the committed SOE reform schedule. In turn, this has created a serious disequilibrium in the stock market. With the IPOs of some large state-owned corporations (e.g. Dam Phu My, Bao Viet Insurance Company, and Vietcombank), the market sentiment is that the Government is desirous of getting a greater financial surplus from such IPOs.

Furthermore, there are also some concerns about the role of the State Capital Investment Corporation (SCIC), which was set up in 2005 closely following the model of Singaporean Temasek. Motivations are to remove a conflict of interest concerning line ministries or provinces and to achieve a more rational and efficient use of state capital through divesting state shares, including outright sale, and seeking strategic partners and mergers. The SCIC is also determined to increase transparency when utilizing state capital, including in operations of entities in which it invested. Although the SCIC has a profit oriented mandate, whether it could be a market stabilizer remains questionable. Risks due to the agent-principal relationship can arise if there is not effective supervision over the SCIC and the SCIC does have sufficient expertise in dealing with complex financial activities (more about the SCIC in Box 4).

Box 4. Role of the SCIC

The SCIC began operations in August 2006 to concentrate state share-holding in the equitized SOEs under one single entity. Important companies in its portfolio include VinaMilk, Pacific Airlines, FPT, and Bao Minh. By the end of March 2007, the SCIC had received ownership rights from 433 equitized SOEs with a total book value of about 3.4 trillion dong. By the end of 2007, the SCIC expected to receive ownership rights in 1,033 enterprises, excluding banks, with state holdings of 7.2 trillion in book value and an estimated market value of 36 trillion dong.

The SCIC has classified equitized SOEs into three groups, A, B, and C. It will concentrate on strengthening or restructuring enterprises in Group A, which operates in sectors considered strategic. Group B enterprises with good potential will be supported for listing on the stock market. Group C comprises enterprises where the state does not need to invest in them over the long term. SCIC will gradually sell state shares in companies of this group. In 2007, it planned to sell stakes in 50 companies with a total book value of about 227 billion dong (USD 14.2 million).

One area that needs to be clarified is the role of the SCIC in relation to the General Corporations or Economic Groups which operate under the holding company structure. At present, it appears that SCIC will receive ownership rights on a case-by-case basis. Reportedly, for the two banks to be equitized later this year, Vietcombank and MHB, it has been instructed by the Prime Minister to receive the rights.

Source: World Bank (2007).

Until now, policy responses for developing an effective bond market, which is quite a long-term process, have been insufficient and inappropriate. Equity markets may exist where bond markets fail to thrive. The bond market in Viet Nam is still very modest and lacks necessary components including the following[21]:

- An appropriate legal framework with the effectiveness of a judiciary system;

- High quality of information and adoption of strict accounting and disclosure standards;

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[21] See, for example, APF and ADBI (2001) and Jeffrey and Pomerleano (2002).

- The presence of independent risk-rating and other information generating agencies;

- An efficient and reliable clearing and settlement arrangement; and

- Some forms of tax incentives during the initial stage of development.

Moreover, the bond market in Viet Nam is heavily dominated by Government bonds. It is necessary, however, to strengthen the role of the Government as the primary issuer.

With the opening of the economy, full participation in the regional and international bond markets is unavoidable. Viet Nam has been involved in all dimensions of regional financial cooperation, including the regional surveillance system, the Chiang Mai Initiative (CMI), the regional bond market development and monetary policy and ER coordination. However, the effectiveness of such involvement is very limited and obviously depends very much on how the country can effectively develop its domestic bond market. The practical issues of engagement in the ASEAN stock market link and in the regional bond market are basically theoretical now and have yet to be put into practice.

Foreign Capital Inflows [22]

Viet Nam continues to be on the right track for attracting FDI with a more liberal and neutral investment environment. Recently, the Government has moved towards unifying domestic and foreign investment regulations, aiming to establish a level playing field for both domestic and foreign investors. Commitments to the WTO, especially those of the services sector, are quite broad and deep and are in favor of FDI. Major obstacles, however, still exist such as red tape and corruption, an inconsistent and barely transparent system of legal documents and unpredictable policy changes. The recent slow pace of FDI realization[23] has also revealed major bottlenecks in attracting FDI in an efficient manner due to weaknesses in the infrastructure and a shortage of skilled laborers.

ODA inflow has been the result of the gradual strengthening of a set of common commitments between the Vietnamese Government and the donor community in line with the Hanoi Core Statement (HCS) on aid effectiveness (Table 17). In particular, in 2006, the Government issued Decree 131/2006/ND-CP

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[22] Decree 22/1999/ND-CP is the 1st legal document on the FDI outflows. Since then there has been some relaxation on foreign exchange transactions and borrowings for overseas direct investment purposes.

[23] The realized FDI as a share of the total FDI commitment in 2006 and 2007 was only 41.0% and 37.8%, respectively. These figures are much lower than that in 2005 (84.7%) and the average during 1988-2007 (52.7%).

Table 17. Central Principles of the Hanoi Core Statement

Ownership	The Government is the leader/owner of the development agenda.
Alignment	Donors use plans, systems and procedures of the Government to the best possible extent.
Harmonization	Donors and the Government jointly harmonize ways of aid delivery
Managing for results	The Government adopts results-based management, and donors use frameworks of the Government results wherever possible for measuring success.
Mutual Accountability	Donors and the Government jointly agree to share accountability for aid effectiveness.

Source: PGAE (2005).

(in replacement of Decree 17/2001/ND-CP in 2001) to accelerate decentralization of ODA management and utilization, giving full responsibility to project executing agencies for appraisal, approval and implementation of ODA-financed programs/projects. However, some shortcomings in this field such as the modest effectiveness of anti-corruption programs and the lack of capacity for monitoring and evaluation, especially at local level, necessitate more radical solutions. Last but not least, having transparent and effective public-private partnership (PPP) schemes are still questionable.

Regarding portfolio flows with trade in services, financial liberalization and WTO commitments implementation, FIEs were allowed to be transformed into share-holding companies (since 2004). The Government also provided guidance for purchasing and selling securities by foreigners at the STC. Moreover, the Ordinance on Foreign Exchange Management issued in December 2005 gave permission for individuals to obtain overseas borrowings and domestic economic entities to make overseas lending if they met necessary conditions. Soon after, it led to some uncontrollable problems related to external debt monitoring. As a result, the SBV had to delay issuing a Circular for guiding the implementation of the Ordinance. As a reflection, although the KA is now relatively open for capital inflows, Viet Nam needs to think seriously about the sequencing of full KA liberalization in conjunction with improvements in the financial supervision system.

Macroeconomic Policies

In an economy open to capital inflows, policy consistency over time requires the authorities to have either a very strong commitment to a pegged ER or pursue a flexible ER. However, efforts to maintain macroeconomic policy consistency are constrained by the well-known "impossible trinity" or "impossible

tri-lemma," which states the impossible coexistence of exchange rate stability, free movement of international capital, and monetary autonomy[24]. Policymakers can have several macroeconomic policies to respond to capital inflows such as sterilization, revaluation of the nominal exchange rate/greater exchange rate flexibility, and fiscal austerity. Other policy measures such as liberalization of capital outflows, controls on capital inflows, and trade liberalization can also be implemented. The effectiveness of such policies is presented in Appendix C.

Appendix C shows that not only single possible policy response to a surge in capital inflow is perfect in terms of achieving both goals of macroeconomic stability and economic growth. ER flexibility and appreciation seem to be the best effective response to large capital inflows because it avoids side effects attendant to other policy responses. But it could also create a policy in consistency that is very much dependent on external conditions, such as the position of the foreign currency the local currency is pegged to. That in turn would encourage short term speculative capital inflows. Sterilization is often costly and ineffective, but remains most the commonly used since policymakers are generally reluctant to allow the exchange rate to appreciate because of fears of undermining export competitiveness and the resulting lower economic growth. Fiscal tightening could be a good option, yet it faces several limitations, especially in terms of approval and action. Moreover, it could lead to lower investment and hence, a lower economic growth rate if public investment still accounts for a large share of total investment.

Recently, SBV's conduct of monetary policy turned out to be more complicated as it faced two problems, namely, increasing macroeconomic policy inconsistencies (Table 16) and the "impossible trinity" as capital inflows surged, especially in 2007. The SBV has had to consider a trade-off between exchange rate stability and inflation targeting policy. Basically there have been two main arguments to the dilemma facing the SBV. The first is that appreciation can hurt exports and economic growth; yet historically the SBV has pursued a rather weak VND policy in order to promote exports. The second is to let VND appreciate which seems to be in line with macroeconomic fundamentals and foreign exchange behavior of many other East Asian economies and moreover, it could be a sign for the economy that the VND is no longer only in a position of depreciation (JP Morgan 2007). So what is the choice by the SBV in practice?

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[24] If a country attempts to achieve ER stability and monetary independence, it needs to introduce capital controls. If a country attempts to have full financial integration and monetary independence, it needs to adopt the floating ER regime. If a country attempts to achieve ER stability and full financial integration, the very rigid fixed ER such as a currency board system or a currency union should be considered.

In general, the SBV and the Government are more concerned about the possible negative impact of appreciation on exports and the slowdown of economic growth. In January 2007, the SBV widened the trading band of the VND/USD from ± 0.25% to ±0.5% around its daily reference rate. The VND/USD appreciated in nominal terms of only 0.2% for the whole year of 2007. At the same time, the SBV kept all official interest rates such as refinancing, discount and basic rates unchanged since early 2006 in order to provide a stable signal to the market (Figure 19), although the rates set by commercial banks increased slightly (Table 16). While stabilizing the nominal ER, the SBV quickly built up its foreign exchange reserves, which increased from USD 11.5 billion in 2006 to USD 23 billion by the end of 2007.

Figure 19. Evolution of the Interest Rate Policy Set by SBV (% Year)
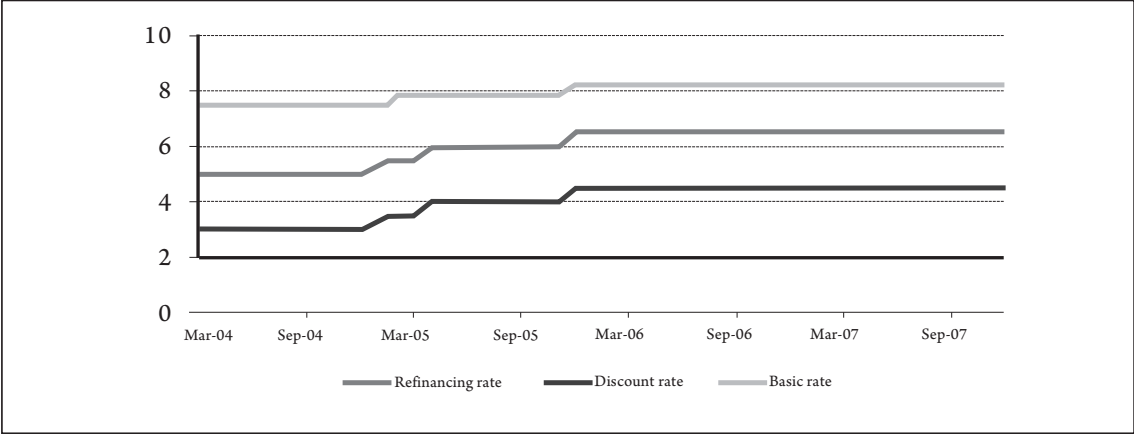
Source: SBV.

As inflation accelerated in the first half of 2007[25], the SBV only attempted to sterilize the excess liquidity through the OMO and the increased reserve requirements. It is reported that the SBV regularly withdrew up to VND 11,000–14,000 billion (USD 688-875 million) per week from circulation since May 2007. At the end of the year, this figure rose to as much as VND 15,000–16,500 billion (USD 938–1.031 million) (World Bank 2007). Since June 2007, the SBV has raised its reserve requirements. For VND deposits under 12 months, the compulsory reserve rate increased from 5% to 10%; for VND deposits between 12 and under 24 months, from 2% to 4%. Correspondingly, rates for foreign currency deposits are from 8% to 10% and from 2% to 4%.

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[25] During 2007, the price of petroleum increased four times––in January, March, May and November, and decreased one time, in August. As a result, the price/liter increased from VND 10,500 to VND 13,000 (or 23.8%).

But the sterilization was ineffective and costly (CIEM 2008). The money supply (both M2 and domestic credit) expanded sharply in 2007 in comparison with that of previous years since 2003, which was already high (Table 6). The inflation rate jumped from 9.4% in 2004, 8.4% in 2005 and 6.7% in 2006, to 12.6% in 2007. The SBV was recognized by the Government to be "perplexed" in conducting monetary policy, which was considered a major cause, together with cost-push and demand-pull reasons, of higher inflation. Moreover, in the context of the weakening USD and increasing international commodity prices, keeping the stability of the nominal VND/USD also means a significant import of international inflation.

To be more proactive in controlling the money supply, the SBV in the last few months introduced several policy measures:

- By the end of December 2007, the trading band of the VND/USD was cautiously widened to ± 0.75% and as a result, the nominal VND/USD appreciated by 0.3% over the first two months of 2008;

- In January, lending restrictions for stock investment changed from 3% of total loans outstanding to 20% of charter capital, which limits potential growth in such investment credit;

- Since 1 February 2008, the rates of compulsory reserve requirements have been raised to 11% (from 10%) for VND and foreign currency deposits under 12 months, and to 5% (from 4%) for those deposits between 12 months and under 24 months;

- Also since 1 February 2008, all official interest rates have been increased, from 6.5% to 7.5% for the refinancing rate, from 4.5% to 6.0% for the discount rate, and from 8.25% to 8.75% for the basic rate; and

- In particular, in the second week of February 2008, the SBV decided to issue by 17 March 2008 365-day-bills worth VND 20,300 billion with a coupon of 7.8% and requested a compulsory purchase by 41 commercial banks.

What can be observed in the following days ahead is that some JSCBs, which have a maturity mismatch problem because a significant proportion of their lending consists of medium and long-term loans (e.g. those going to the real estate market and consumption of durable goods), will not have sufficient liquidity to meet the new policy measures. The inter-bank market became too heated with overnight rates of 25–30%. As a result of the "liquidity chaos," the SBV was forced to pump out VND 33,000 billion. Those banks were, however, in a difficult position in terms of liquidity because they held T-bills/bills issued by the SBV. They increased their annual VND deposit interest rates to 14.6% to mobi-

lize as many as deposits they could. The race for higher deposit interest rates among commercial banks began. It calmed down only by the end of February 2008 as the SBV-issued directive requested that all commercial banks not raise annual deposit interest rates more than 12% and promise to meet the liquidity of the banking system through the inter-bank market with reasonable rates.

The liquidity chaos once again shows how high the cost could be if the policy of keeping the nominal stability of ER persists in conjunction with the maturity mismatch problem in the banking system or even only in some commercial banks (due to weak supervision) and the inappropriate policy actions leading to more serious macroeconomic policy inconsistencies. The fact that the SBV had to use some administrative measures to control the situation will have higher costs due to distortions in resource allocation. This action, though temporary and necessary, can be seen as a step backward in the process of improving monetary instruments[26]. The movements of the some key macroeconomic variables in the first two months of 2008 will make the policy option more complicated. Inflation rose by more than 6%[27]. The rise in deposit interest rates by banks could soften the liquidity problem but it imposes a higher risk for several banks.

Fiscal tightening can be a good response to capital inflows. It contains inflationary pressure and reduces pressure on real appreciation and increases interest rates. However, up to now, Viet Nam has had no serious intention of using fiscal policy as a policy complement to monetary and ER policies in response to capital inflows. For a long time, fiscal policy has followed the "golden rule," meaning the budget should have savings, i.e. total revenues are higher than current expenditures (Table 18) and the budget deficit cannot be financed by seigniorage.

Room for reducing the budget deficit seems to be small. However, the budget deficit is rather huge. Budget revenue still relies heavily on crude oil exports and import tariffs. The former item has fluctuated much and moreover, because of some technical problems, the volume of crude oil exports will not increase unless new oil resources are found. The latter item has significantly decreased over time due to trade liberalization (Table 18). There is also uncertainty about the impact of tax reforms (e.g. personal income tax, asset tax, etc.) on the budget revenue.

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[26] Basically, the SBV liberalized foreign currency and VND interest rates in 2001 and 2002.

[27] Inflation is often high during the months before and after the Lunar New Year. But inflation at 6% is still high by normal standards. The impact of the most recent monetary measures can be seen later. Note that in January the Government increased again public salaries by 20% and also the petroleum price from VND 13,000/liter to VND 14,500 (or 11.5%).

Table 18. Budget Revenues and Expenditures (2001–2007)

	2001	2002	2003	2004	2005	2006	2007
Proportion of total revenues (%)							
Total revenues	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Crude oil revenues	24.5	21.4	18.6	21.6	27.5	29.5	21.97
Trade taxes (import tariffs)	21.4	25.5	19.6	15.5	17.0	15.7	18.12
Proportion of total expenditures (%)							
Total expenditures	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Investment expenditure	31.0	30.5	28.5	25.8	27.2	27.1	27.6
Current expenditure	55.8	53.1	49.8	44.5	55.8	51.3	55.9
Grants and interest payments	11.5	13.4	13.2	13.4	13.1	12.8	13.4
Ratio in terms of GDP (%)							
Total revenue	22.3	23.1	28.2	31.4	26.8	27.8	27.4
Total expenditure	27.0	27.7	31.4	35.8	31.6	32.8	32.4
Budget balance	-4.7	-4.5	-3.3	-4.3	-4.9	-5.0	-5.0

Note: The IMF's latest Article IV estimated a fiscal deficit of 6.9% in 2007 (Cited from ANZ 2008).

Source: MOF and authors' estimates.

On the expenditure side, the Government is facing increasing pressure on infrastructure development and upward adjustment of salaries for public servants (because of higher inflation rates, the Government was forced to raise public salaries several times, by 10%–20% each, during 2004–2008). Nevertheless, investment expenditure is recognized as inefficient in terms of selecting projects and disbursements (at least 20–30% of investment expenditure can be saved).

V. Policy recommendations

The prospect for Viet Nam's development is bright according to a number of forecasts: the economy will likely continue to grow at an annual rate of 8–9% in coming years. To materialize the slogan "Prosperous people, a forceful country, and an equitable, democratic and civilized society," the major development goals set by the government of Viet Nam reflect its strong determination to develop itself, with significant attention to both the economic and social aspects of people's lives. Specifically, these goals are:

- To sustain high economic growth;

- To shed the status of a poor country by 2010 (there is a possibility that this objective will be realized in 2008); and

- To accelerate the industrialization and modernization process so that by 2020, the country will basically be a modern, industrialized country.

In spite of the recent significant expansion of the financial system, room for financial development remains very large. Viet Nam is still largely bank-based, and the capital markets are only at an early stage of development. Not only does the financial system appear to have a bright future thanks to high economic growth and rapid urbanization, but Viet Nam's population is also very young, of which 60% is under 35 years old. As anecdotal evidence shows, these young people are early adopters of banking and financial services. Access to financial services and activities, however, is still limited. About 50% of household savings is not deposited in banks. The number of personal accounts in banks is just about 8% of the total population and retail banking services account only for 6% to 12% of bank revenues (VinaCapital 2006).

There exist, however, enormous challenges to Viet Nam in achieving its development goals and in realizing its potential for financial development. The country is still in transition, with low income, and needs to strive for industrialization. Weaknesses and vulnerabilities persist in some critical areas, such as the SOEs, the financial system and efficiency of public investment, and others. Private firms have recently flourished, yet very few of them can become leading ones in the field. Furthermore, the infrastructure is still underdeveloped. In particular, infrastructure services and utilities like transportation and electricity remain too expensive and/or inefficient, resulting in a high cost of doing business in Viet Nam. Growth performance in the past few years has been impressive, but to go further, Viet Nam also needs better human resources and institutional capacity. Yet, it seems that the capacity is not yet adequate, which can be mainly attributed to problems of public governance and the quality of the education and training systems. Avoiding wider poverty and income inequality, and reducing social risks and adjustment costs of trade liberalization and international integration are all challenges that Viet Nam needs to resolve on its way to sounder and more sustainable development.

At the same time, the reform process is becoming more complicated as it touches the production factor markets and the large SOEs, which are socio-economic sensitive and related to the concept of socialist orientation. Moreover, macroeconomic instability and financial vulnerabilities are still a threat, and have

Table 19. Signs of Financial Vulnerabilities in Viet Nam's Economy

Key macroeconomic indicator-based assessment		Asian crisis lessons-based assessment
1. Appreciation of VND	High pressure.	1. The scale of capital flows, especially short-term flows: quite substantial.
2. Trade deficit	Tends to widen.	
3. Private consumption	Some signs of booming in cities.	2. Direction/distribution of short-term flows: a large proportion going to real estate and stock markets.
4. Fiscal expansion	High budget deficit and high pressure on both investment and current expenditures.	
5. External debt	Tends to relatively decline; seems to be sound over medium-term.	3. Degree of macroeconomic policy inconsistency: serious.
6. Domestic savings	Quite high (30–31% GDP), but large and widened S-I gap.	4. Quality of financial supervision and corporate governance: some improvement through "learning by doing" but still weak.
7. Investment efficiency	Declined in the early 2000s, but improved over the last three years, but still concerns of large SOEs and public investment efficiency.	

Source: Authors' own assessment.

become more apparent as the country integrates the regional economy with the world economy (Table 19). The underlying factor is the mismatch between the lively business reality in relation to new money-making opportunities on the one hand, and weaknesses in the financial institutions' and firms' risk management and financial supervision capacity on the other hand.

There are three well-known pillars which are interrelated and reinforced by each other for assuring sustained economic growth and development: (i) strong economic fundamentals; (ii) a sound and healthy financial sector; and (iii) macroeconomic stability. The policy package option for Viet Nam, therefore, should aim at sustaining high economic growth and sound financial development while mitigating financial and macroeconomic risks. Obviously, Viet Nam needs to have a broad approach to economic and financial reform as well as more specific policy measures to deal with the present macroeconomic instability. Followings are some ideas for this policy package option.

Directions for Broader Reforms[28]

The first and foremost important reform direction for Viet Nam is to continue undertaking a decisive institutional reform–one that will transform the existing state-led economic institutions into efficiency-enhancing institutions. This is not only about making the legal framework more consistent with a market-based economy and international commitments, but more importantly, it is also about reforming the large SOEs and establishing an efficient and effective administrative and enforcement system.

The second is to start moving up along the value chain, while fully utilizing traditional comparative advantages. It is essential for Viet Nam to: (i) diversify export products and strengthen non-price competitiveness; (ii) attract efficient FDI; and (iii) improve infrastructure (especially, the transportation system and electricity supply) and labor and management skills (at both the macro and micro levels) since these two present bottlenecks for development. What Viet Nam needs to do now is to maximize the benefits of efficient FDI inflows. In that sense, improving the overall business environment and creating a playing field are critical. A liberal and neutral environment is much better than financial incentives for attracting efficient FDI. This can be done via institutional improvements, market factors, human resources development and cutting down business costs. While public investment still has an important role in economic development, it should be redirected to areas with significant positive externalities for business activities such as infrastructure and information provision. ODA should be utilized more efficiently and transparently in accordance with the central principles of the Hanoi Core Statement. Institutional and human resources capacity building for Viet Nam is the key as decentralization of ODA management and utilization has been carried out substantially. Increasing participation of foreign and private firms in public projects in a transparent manner is also essential for reducing the burden on state investments.

The third is to strengthen surveillance and financial supervision capacity. This necessitates amendments and improvements of the existing regulatory framework to cope with the new dimensions of financial activities and development[29]. The financial and BOP statistics are still not accurate and consistent, and they do not conform well to international standards, despite considerable improvements with respect to their collection, processing and dissemination. Unless their quality is improved, early warning systems for detecting vulnerabilities in the financial system cannot be developed and used with high credibility.

The key regulators––namely, the Ministry of Finance, the SSC and the SBV, could be unified into a single body to detect vulnerabilities associated with the financial sector and capital movements. It could be more cost-effective, but its effectiveness is questionable. As stressed in the study by Corbett (2007), there is still no consensus view about whether a multiple or single system works best. Different countries may well need different systems, and the transition from multiple supervisors to a single, integrated supervisor is a complex process that can be costly. A high quality regulatory environment (low cor-

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[28] Some ideas are taken from Vo et al (2007).

[29] Two laws, the SBV Law and Credit Institutions Law, have been substantially revised and amended.

ruption, etc.) that supports private property rights, information transparency and market discipline are more important than the specifics of who regulates what and how. Whatever the case, the SBV should be renovated into a more modern and relatively independent central bank, while the money market should be developed with more monetary instruments available to both the SBV and market participants.

The fourth is to develop a healthy financial system. As the capital markets are only at an early stage of development, having a sound banking system is vital. Together with strengthening financial supervision capacity, there is a pressing need to improve risk management, apply international auditing and accounting standards, recapitalize commercial banks, and enhance human resources capacity. While strengthening rigid conformity to BASEL I, a gradual shift from capital adequacy to risk management-based BASEL II is also needed. Avoiding NPL in coming years is largely dependent on how lending controls and SOE reform progress.

Having a more balanced financial system should be a long-term objective. This contributes not only to enhancing efficient resource allocation and to mitigating financial risks, but also to an effective engagement of Viet Nam in regional financial integration. The key is to lay down all fundamental conditions for the sound development of a capital market. This requires the establishment and/or strengthening of financial institutions, a secondary government bond market, financial regulations, credit rating companies, judicial systems, accounting and disclosure standards, and clearing and settlement arrangements. Development of the securities market also depends on the process of equitization of large SOEs in which their management capacity and business efficiency can be significantly improved. This relates also to the question of how the SCIC can be transparent and competent to fulfill its mandate, and how it can avoid the conflict of interest problem. Currently, it is also important for Viet Nam to properly regulate stock market-related credit to discourage insider trading, and to enhance information disclosure and transparency and the professionalism of individual investors.

Macroeconomic Policy Responses to the Present Macroeconomic Instability

Obviously, the macroeconomic policy option becomes more complex now due to the presence of serious policy inconsistencies (high inflation, high VND nominal interest rates, weakening USD with rather low interest rate, and high pressure on nominal appreciation). In this context, any policy measure response can have an undesirable side effect (Appendix C), and a combination of various macroeconomic policies could be a better, though not perfect option.

To begin with, a strong commitment to stabilizing the economy should be the focal point in combating high inflation. Macroeconomic stability is a prerequisite for sustaining economic growth. In that sense, stabilization is consistent with the goal of achieving relatively high economic growth. There may be, however, a short-run trade-off between the two. The key risk is that the Government would go for high growth over price stability. Current experience has shown that much concern about a slowdown in economic growth can make policies conducted more inconsistently and in the end, this can slightly change expectations of sustaining high inflation.

As money supply growth was very high over the last four years, and this is associated with inflation, tightening monetary policy is necessary. But it is far from sufficient. Not only is it unsustainable as the ER is kept stable, but also strong monetary policy measures could create a liquidity problem for the whole banking system per se.

A more flexible ER policy needs to be an option. Greater ER flexibility can reduce pressure on monetary intervention and sterilization. More importantly, in the context of a weakening USD, it could significantly constrain the import of international inflation. At first, however, the widening band of ER fluctuation could lead to nominal ER appreciation and hence, encourage short-term speculative activities. But it is not always the case. Rather, it is meant to introduce two-way risks and thereby discourage speculative capital inflows, if the SBV can manipulate policy appropriately, especially when inflation is under control. In principle, a good choice for an exchange rate regime needs to be consistent with sustainable international competitiveness in the exchange rate and have room for exchange rate fluctuations to free up (within limits) domestic monetary policy.

A natural question to be asked then is, is there room for nominal appreciation without posing any serious threat to export competitiveness? To measure the price competitiveness of goods, the real effective exchange rate (REER) is usually used . Despite a relatively high inflation rate, the price competitiveness of Vietnamese exports seems to remain as the REER has depreciated compared to the equilibrium level (Figure 20). This is attributed to the depreciation of the USD compared to currencies of Viet Nam's main trading partners, and to the peg of the VND to the USD.

Figure 10. Evolution of the Real and Nominal Effective Exchange Rate
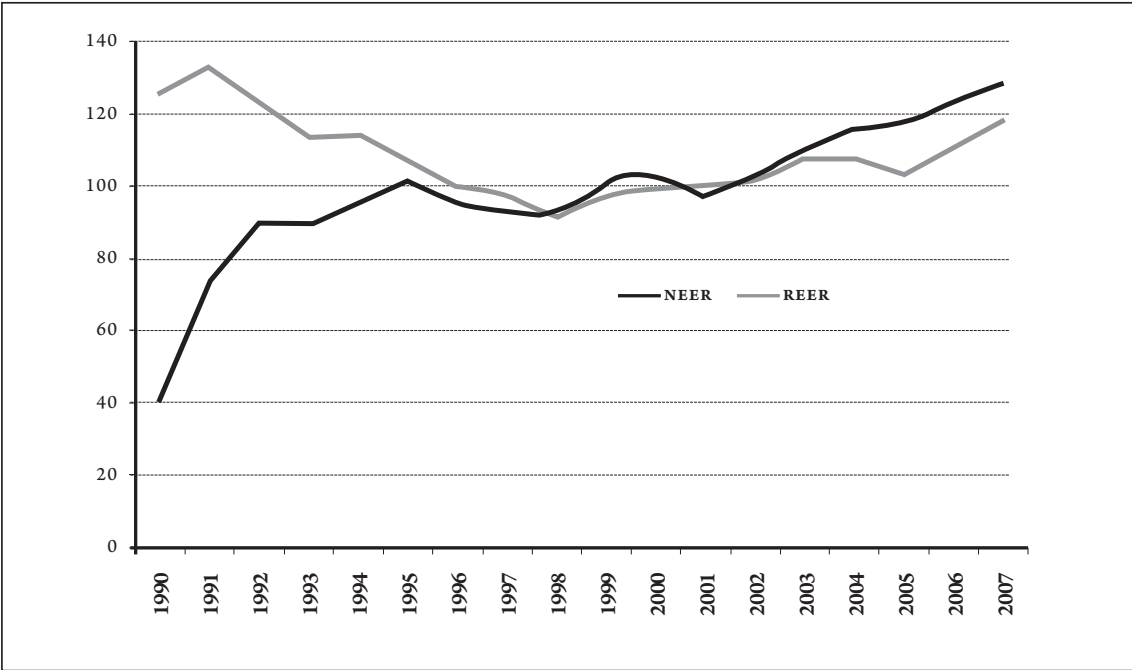
Note: The calculation is based on IMF's International Financial Statistics (exchange rates and CPI), GSO's trade statistics (trade weights). The base year is 2000. Nineteen largest

trading partners, accounting for 85.65% of Viet Nam's total trade from 2000–2007, were included in partner weights. An upward trend means real depreciation.

Sources: Cited from Dang (2008).

It can be said that permission by the Prime Minister on 3 March 2008 for the SBV to widen the trading band of VND/USD to ± 2.0% should be seen as a positive move in making ER more flexible.

Fiscal tightening is another good complementary policy option for some reasons. It may embody inflationary pressure. It can also lessen pressure on real exchange rate appreciation (by limiting increases in the relative price of non-tradable goods) and interest rate hikes. Fiscal policy, however, has several limitations as a response to capital inflows. It requires longer terms for legal approval and action. Moreover, it often has little fiscal flexibility to begin with, especially when there is a lack of political will and determination. For Viet Nam, fiscal tightening can be seen as an opportunity for the Government to make budget expenditures more transparent and to decisively cut back on inefficient public investment projects.

The choice of the scope and scale of policy mix is hardly to be right as asymmetry is inherent in the financial sector and there is a lack of reliable financial information. Therefore, policy manipulation should avoid policy shocks in order to test the market for necessary adjustments.

As policy inconsistencies still exist, which lead to various risky and speculative financial activities, rigorous and prudential screening and supervision based on updated information analysis is definitely necessary. The same work on projects financed by Government investment bonds through lending should also be undertaken. Effective enforcement of new anti-corruption laws to eliminate corruption and prevent the waste of public funds is an integral part of this endeavor.

It is worth noting that policies for the relaxation of capital flows are under consideration by the Government. The impact of this measure depends on whether there is sufficient pent-up demand for foreign assets. If not, making it easier to repatriate funds may even lead to additional net capital inflows. Experience has also shown that financial trouble can follow an inappropriate sequencing of financial and KA liberalization. Therefore, consideration of further liberalization of capital flows, if any, needs to focus first on the relaxation of some conditions for FDI outflows and a possible increase in the proportion of foreign equity investors in manufacturing and some services sectors.

In short, measures to sustain economic growth and sound financial development while mitigating the possible financial risks in Viet Nam are critically dependent upon both longer term reform processes and the implementation of necessary macroeconomic policies. This paper therefore recommends a broad reform package that aims to: (i) tackle persisting bottlenecks in the economy (weaknesses in economic institutions, the infrastructure and human resources); (ii) modernize the SBV; and (iii) strengthen risk management in the banking sector and financial supervision systems. The focus is also on capital market development based on the improvement of its fundamentals and the reform of large SOEs. In particular, this paper suggests the essence of having a firm commitment to combating high inflation and a combination of tightened monetary policy with a more flexible exchange rate policy and tightened fiscal policy. The scope and scale of the macro-policy mix should avoid policy shocks in order to test the market for necessary adjustments. With the evident policy inconsistencies, prudential screening and monitoring should be strengthened to prevent speculative financial activities.

Appendix A. Role of the Non-state and FIE Sectors in Industry (1998 and 2006)

	1998				2006			
	% of total industrial output	By sector (% of a specific industry output)			% of total indus-trial output	By sector (% of a specific industry output)		
	Total	FDI	SOE	Non-state		FDI	SOE	Non-state
Total	**100.00**	**34.68**	**43.38**	**21.94**	**100.00**	**37.16**	**34.32**	**28.51**
Mining industry	**14.57**	**83.74**	**12.56**	**3.69**	**9.11**	**71.82**	**20.42**	**7.76**
Coal mining	1.21	0.74	97.81	1.45	1.44	1.86	96.47	1.67
Petroleum and natural gas	12.20	99.76	0.24	0.00	6.50	99.88	0.12	0.00
Metal ores	0.11	2.72	73.65	23.63	0.16	3.07	45.94	50.99
Stone and other mining	1.04	1.84	50.82	47.35	1.01	1.40	38.88	59.72
Manufacturing	**79.23**	**25.34**	**47.61**	**27.05**	**84.91**	**35.87**	**31.45**	**32.68**
Food products and beverages	22.37	21.73	46.02	32.24	20.95	26.51	31.53	41.96

Tobacco products	2.84	0.50	99.12	0.38	2.57	1.83	97.37	0.80
Textiles	4.97	21.03	54.30	24.67	4.71	30.01	40.94	29.05
Apparel wear	3.09	23.29	33.26	43.45	3.72	38.11	22.59	39.30
Tanning and leather dressing, leather products	4.58	45.25	29.63	25.11	4.58	59.26	12.70	28.04
Wood and wood products	1.88	9.36	20.67	69.97	1.87	18.54	11.80	69.66
Paper and paper products	2.06	12.75	52.23	35.02	2.06	17.18	32.79	50.03
Publishing and recorded media	1.19	1.83	89.49	8.68	0.93	3.24	86.82	9.94
Coke, refined petroleum products	0.06	0.00	0.00	100.00	0.12	43.65	0.00	56.35
Chemical and chemical products	5.74	27.35	62.73	9.92	5.32	41.95	40.58	17.47
Rubber and plastic products	3.22	22.01	34.15	43.84	4.70	29.51	24.79	45.71
Non-metallic mineral products	8.76	19.04	59.73	21.24	9.13	22.83	50.42	26.75
Basic metal	2.96	44.62	44.13	11.25	3.27	30.35	41.38	28.28
Fabricated metal products, except machinery and equipment	2.98	28.45	15.42	56.13	3.75	31.15	11.68	57.17
Machinery and equipment	1.28	23.42	58.72	17.86	1.54	52.23	24.13	23.64
Office, accounting and computing	1.01	98.51	0.00	1.49	0.56	96.15	0.00	3.85
Electrical machinery and apparatus	1.74	33.79	52.10	14.10	2.76	45.69	38.89	15.43
Radio and communications equipment and apparatus	2.37	81.36	17.27	1.37	2.26	78.52	11.80	9.68
Medical, precision, and optical instruments, watches, clocks	0.23	71.39	20.72	7.88	0.20	85.20	6.86	7.94
Motor vehicles	1.09	70.57	15.71	13.73	2.56	82.33	12.21	5.46
Other transport equipment	2.71	69.34	18.68	11.98	3.99	66.89	15.18	17.93
Furniture	2.01	26.75	7.90	65.35	3.26	40.66	5.24	54.11
Recycle	0.08	0.00	0.00	100.00	0.07	1.46	0.00	98.54
Electricity, gas and water supply	**6.20**	**0.36**	**99.53**	**0.11**	**5.98**	**2.79**	**96.25**	**0.96**
Electricity and gas	5.63	0.17	99.79	0.03	5.59	2.73	96.41	0.86
Water	0.58	2.19	96.97	0.83	0.39	3.75	93.82	2.43

Note: The choice of the year of 1998 is not only due to data availability, but because this is the year before the 1999-Enterprise Law was approved.

Source: GSO (Various issues) and authors' estimates.

Appendix B. Balance of Payments of Viet Nam (1990–2007)

USD million	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
1. Trade balance	**-41**	**-2345**	**-2775**	**-1247**	**-989**	**972**	**377**	**481**	**-1054**	**-2581**	**-3854**	**-2439**	**-2776**	**-10360**
Exports (FOB)	1731	5198	7255	9185	9361	11540	14448	15027	16706	20149	26485	32447	39826	48561
Imports (FOB)	1772	7543	10030	10432	10350	10568	14072	14546	17760	22730	30339	34886	42602	58921
Imports (CIF)											31969	36761	44891	62682
2. Services	**55**	**159**	**-61**	**-623**	**-530**	**-547**	**-550**	**-572**	**-749**	**-778**	**61**	**-219**	**-8**	**-894**
Exports	55	2074	2243	2530	2616	2493	2702	2810	2948	3272	3867	4176	5100	6030
Imports	0	1915	2304	3153	3146	3040	3252	3382	3697	4050	3806	4395	5108	6924
Adjusted for F&I												1500	1832	3009
3. Investment income	**-411**	**-236**	**-384**	**-543**	**-677**	**-429**	**-451**	**-477**	**-721**	**-811**	**-891**	**-1219**	**-1429**	**-2168**
Receipts	28	96	140	136	127	142	331	318	167	125	188	364	668	1093
Payments	439	332	524	679	804	571	782	795	888	936	1079	1583	2097	3261
Of which														
Scheduled Interest	237	262	340	379	303	371	462	345	288	286		443	541	626
payments														
(Actual payments)	53	128	281	348	246	276	328	345	288	286		443	541	626
4. Transfer (net)	**138**	**290**	**1200**	**885**	**1122**	**1181**	**1732**	**1250**	**1921**	**2239**	**3093**	**3380**	**4049**	**6430**
Private sector	0	140	1050	710	950	1050	1585	1100	1767	2100	2919	3150	3800	6180
Government sector	138	150	150	175	172	131	147	150	154	139	174	230	249	250

A. Current Account	-259	-2132	-2020	-1528	-1074	1177	1108	682	-603	-1931	-1591	-497	-164	**-6992**
(Excluding private transfer)											-4510	-3647	-3964	-13172
B. Capital account	121	2360	2624	1944	1129	509	-754	220	1980	2533	2753	3087	3088	**18771**
5. Foreign direct investment	120	1956	2395	2220	1671	1412	1298	1300	1400	1450	1610	1889	2315	**6600**
FDI in Viet Nam												1954	2400	6700
Viet Nam FDI abroad												65	85	100
6. Medium and Long-term Loans	-47	93	37	356	228	2	65	139	-51	457	1162	921	1025	**2043**
Disbursements	233	433	772	1145	952	1036	1348	958	1049	1540	2047	2031	2260	3480
Scheduled Amortization	280	340	735	789	724	1034	1283	819	1100	1083	885	1110	1235	1437
(Actual payments)	166	272	508	639	544	582	979	668	990	1083	885	1110	1235	1437
7. Short-Term Loan	48	311	224	-520	-233	-118	-29	-22	7	26	-54	46	-30	**91**
Disbursements	338	1381	1747	1006	478	239	333	370	377	418	1001	1046	1070	902
Scheduled Amortization	290	1070	1523	1526	711	357	362	392	370	392	1055	1000	1100	811
(Actual payments)	290	1092	1523	1526	711	357	362	392	370	392	1055	1000	1100	811
8. Portfolio Investments											-	865	1313	**7414**
9. Currencies and deposits	-4	-51	-32	-112	-537	-787	-2088	-1197	624	1372	35	-634	-1535	**2623**
C. Errors and omissions	-142	-628	-628	-280	-278	-917	-676	-862	-1020	777	-279	-459	1398	**-1611**
D. Overall balance	142	177	-24	137	-224	769	-322	40	357	2151	883	2131	4322	**10168**
E. Financing	-142	-177	24	-137	224	-769	322	-40	-357	-2151	-883	-2131	-4322	**-10168**
10. Change in NFA, incr	-156	-357	-262	-318	-13	-1317	-116	-191	-467	-2151	-883	-2131	-4322	**-10168**

	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Change in NFA (-;incr)	-156	-448	-440	-277	30	-1285	-90	-253	-519	-2097	-810	-2076	-4289	-10143
Use of IMF credit	0	91	178	-41	-43	-32	-26	62	52	-54	-73	-55	-33	-25
Purchases	0	91	178	0	0	0	0	106	106	0	0	0	0	0
Repurchases	0	0		41	43	32	26	44	54	54	73	55	33	25
11. Change in arrears and rescheduling	**298**	**180**	**286**	**181**	**237**	**548**	**438**	**151**	**110**			**0**	**0**	**0**
Change in arrears							0	0	0			0	0	0
Rescheduling							438	151	110			0	0	0
% of GDP	**1990**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
1. Trade balance	-0.68	-11.17	-11.10	-4.62	-3.66	3.35	1.22	1.46	-3.01	-6.45	-8.56	-4.60	-4.55	-14.59
4. Transfer (net)	2.30	1.38	4.80	3.28	4.16	4.07	5.59	3.79	5.49	5.60	6.87	6.38	6.64	9.06
Private sector	0.00	0.67	4.20	2.63	3.52	3.62	5.11	3.33	5.05	5.25	6.49	5.94	6.23	8.70
A. CA balance	-4.32	-10.15	-8.08	-5.66	-3.98	4.06	3.57	2.07	-1.72	-4.83	-3.54	-0.94	-0.27	-9.85
B. KA balance	2.02	11.24	10.50	7.20	4.18	1.76	-2.43	0.67	5.66	6.33	6.12	5.82	5.06	26.44
5. FDI (net)	2.00	9.31	9.58	8.22	6.19	4.87	4.19	3.94	4.00	3.63	3.58	3.56	3.80	9.30
6. M-L term Loan (net)	-0.78	0.44	0.15	1.32	0.84	0.01	0.21	0.42	-0.15	1.14	2.58	1.74	1.68	2.88
7. ST Loan (net)	0.80	1.48	0.90	-1.93	-0.86	-0.41	-0.09	-0.07	0.02	0.07	-0.12	0.09	-0.05	0.13
8. Portfolio Investments	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.63	2.15	10.44
C. Errors and omissions	-0.07	-0.24	-2.51	-1.04	-1.03	-3.16	-2.18	-2.61	-2.91	1.94	-0.62	-0.87	2.29	-2.27

Appendix C. Policy Responses to Capital Inflows and Their Effects

Policy measures	Effects and effectiveness
Sterilization (for defending ER stability) <u>Instruments</u>: reserve requirements, sterilization	- Using a higher reserve requirement raises the cost of financial intermediation and distorts resource allocations. Sterilization through open market operation (OMO) often leads to increased interest rates inducing further unintended capital inflows and causes significant quasi-fiscal costs. - In either case, sterilization can be self-defeating by raising the level of macroeconomic policy inconsistencies and encouraging further capital inflows. Greater sterilization effectiveness means more limited sustainability. - It may create a liquidity problem if maturity mismatch is present. - Real (effective) ER can be eroded as inflation goes up.
Greater ER flexibility/appreciation-<u>Instruments</u>: widening the band for ER to fluctuate; making ER fluctuation, etc.	- Greater exchange rate flexibility can reduce pressure on monetary intervention and sterilization. - It does not always mean nominal exchange rate appreciation. Rather, it is meant to introduce two-way risks and thereby discourage speculative capital inflows. This usually involves, in the context of a de facto peg or a tightly managed float, introducing a wider band of fluctuation. - Expectations of ER appreciation could encourage inflows of short-term speculative capital, while discouraging some inflows by longer-term investors.
Fiscal tightening <u>Instruments</u>: Narrowing budget deficits by increasing revenues and/or reducing current and investment expenditures	- Fiscal tightening can contain inflationary pressure and prevent a real appreciation of the currency. In addition, fiscal tightening could also reduce pressure on the real exchange rate (by limiting the increase in the relative price of non-tradable goods) and the increase of interest rate.
Liberalization of capital outflows <u>Instruments</u>: Relaxation of FDI and portfolio investment outflows, and overseas lending conditions	- The impact of this measure depends on whether there is a sufficient pent-up demand for foreign assets. If not, making it easier to repatriate funds may even lead to additional net capital inflows.
Capital inflows controls <u>Instruments</u>: e.g. Tobin tax	- Their effectiveness is mixed. As such a policy is applied, investors' confidence could collapse and the development of a capital market would be seriously damaged.
Further trade liberalization <u>Instruments</u>: tariff reduction and the like	- It can have some effects on downward pressure on inflation. But further trade liberalization could encourage more imports. Over time, however, it may improve export competitiveness by reducing the price of imported inputs and may not contribute much to reducing net imports. - It may also encourage further capital inflows by showing a signal of authorities' commitment to a liberal and open international economic policy regime.

Source: A summary by the authors.

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ECONOMIC GROWTH AND FOREIGN DIRECT INVESTMENT IN VIETNAM: AN EMPIRICAL ANALYSIS

Nguyen Phi Lan

Abstract

The linkages of foreign direct investment (FDI) to economic growth have been an issue of intense argument for a long time. Although this debate has provided rich insights into the relationship between FDI and growth in developing countries, there is very little empirical analysis of the issue in Vietnam compared to other developing countries, especially in applying a simultaneous equation model to test the relationship between FDI and economic growth. Our findings show that FDI and economic growth are important determinants of each other in Vietnam. Moreover, these findings emphasize that the impact of FDI on provincial economic growth is positive only when Vietnamese provinces have a certain threshold of financial development, human capital stock, research and development, and technology.

1. Introduction

Foreign Direct Investment (FDI) inflows into Vietnam since 1988 have been regarded as a very impressive phenomenon of the economic transition from a centrally planned economy to a market oriented economy (Kokko et al., 2003). Since the reform policy known as Doi Moi was implemented in 1986, annual FDI inflows into Vietnam have increased dramatically from USD 0.32 billion in 1988 to nearly USD 4.0 billion in 2005, with an annual growth rate of 28 percent (GSO, 2006). During this period, FDI inflows have played a very important role, not only in providing investment capital but also in stimulating export activities, as well as introducing new labour and management skills, transferring technologies and generating job opportunities.

FDI inflows not only into Vietnam but also into many other developing countries take advantage of the comparative advantage of these countries with respect to cheap labour and natural resources. As a result of FDI inflows, many developing countries, especially Asian newly industrializing countries (NICs), have experienced great advances in their economic development.

However theoretically as well as practically, there are still inconclusive arguments for and against the role of FDI inflows in enhancing economic growth in a country. Whether FDI inflows are beneficial or not to economic growth, and what governments should do to attract and use FDI inflows effectively, are still a matter of considerable debate.

The central question of the paper is whether a two-way linkage between FDI and economic growth in Vietnam exists. Thus, this paper seeks to analyze FDI inflows into Vietnam and to investigate their effect on provincial economic growth. An analysis of FDI and its effect on provincial economic growth is important to help Vietnam enjoy further economic development. The paper is organized as follows. introduction is presented in Section 1. Section 2 reviews the literature. Section 3 presents the empirical specification. Data and econometric technique are illustrated in Section 4. In the next section, we discuss and analysis estimation results. Finally, Section 6 concludes.

2. Literature review

In the endogenous growth theories, Lucas (1988, 1990), Romer (1986, 1987) and Mankiw (1992) amended the exogenous growth model, especially the Solow growth model, by including the growth driving factors of human capital as well as physical capital to explain the presence of FDI in developing countries. Based on their models that are viewed as the endogenous growth models, the effect of FDI on economic growth can be through technology diffusion. Technology diffusion plays a central role in promoting economic growth. The theories highlight the dependence of the long run economic growth rate on the state of domestic technology relative to that of the rest of the world. Technology diffusion can take place through a variety of channels that involve in the transmission of ideas and new technology. One of the channels is through for developing country to access advanced technologies. FDI by multinational corporations is viewed as a major channel for the access to advanced technologies by developing countries. MNCs with advanced technologies are a substantial part of the world's R&D investment. Findlay (1978) illustrates that FDI increases the rate of technological progress in the host country through a "contagion" effect from the more advanced technology, management practices, etc. used by the foreign firms. Be-

sides, FDI can contribute significantly to human capital such as managerial skills and research and development (R&D). MNCs can have a positive impact on human capital in host countries through the training courses they provide to their subsidiaries' local workers. The training courses influence most levels of employees from those with simple skills to those presenting advanced technical and managerial skills. Research and development activities financed by MNCs also contribute to human capital in host countries and thus enable their economies to grow in the long term (Blomstrom and Kokko 1998; Balasubramanyam et al. 1996). On the other hand, the Eclectic Theory of FDI, which was developed by Dunning (1988), provides an alternative tool to analyze the relationship between FDI and economic growth. Based on location advantages, many empirical studies have found that economic growth is an important determinant of FDI. Chakrabarti (2001) pointed out that higher economic growth results in greater FDI inflows as it is a measure of the attractiveness of the host countries. Moore (1993) argued that as economic growth rises, FDI inflows into host countries tend to be encouraged.

Recently, empirical studies have used the endogenous growth models to investigate the impact of FDI on economic growth in host developing countries at the macro-level. In an empirical study, Borensztein et al. (1998) examine the influence of FDI on economic growth in 69 developing countries over two periods, 1970-1979 and 1980-1989. In the endogenous growth model in which economic growth is determined by FDI, human capital, government expenditure, domestic investment, inflation rate, and institutions, they use two stage least squares (2SLS) estimator to deal with endogeneity problems and found that FDI inflows positively influence economic growth. In addition, they also point out that the relationship between FDI and domestic investment in these countries was complementary.

De Mello (1999) estimated the impact of FDI on capital accumulation, and output and total factor productivity growth in a recipient economy. By using time series and panel data evidence of a sample of OECD and non-OECD countries over the period 1970-1990, de Mello indicated that FDI boost economic growth in the long run through technological progress and knowledge spillovers. However, de Mello emphasized that FDI led growth depends on the degree of complementarity and substitution between FDI and domestic investment.

By using a panel data for 18 countries in Latin America over the period 1970-1999, Bengoa and Sancher-Robles (2003) pointed out that the impact of FDI on economic growth are positive only when host countries had adequate human capital, economic stability, and liberalized markets. Similarly, using a sample of 84 countries, Wang and Wong (2004) indicated that FDI promotes economic

growth only when host countries have an adequate level of human capital. Alfaro et al. (2002), using cross country data for the period 1975-1995, showed that FDI plays an important role in contributing to economic growth. However, countries with well-developed financial markets gain significantly from FDI. This means that countries with better financial systems can exploit FDI more efficiently. As a result, FDI can contribute more to economic growth in these countries. This finding is supported by Hermes and Lensink (2003) using a panel data of 67 developing countries for the period 1970-1995 and by Aghion et al. (2006) using a sample of 118 countries over the period from 1960 to 2000. Moreover, they also emphasize that less developed countries should first reform their domestic financial system before liberalizing the capital account to allow for enlarged FDI inflows. As a result, an increase in FDI is important to enhance economic growth in these countries.

Tsai (1994) employed a simultaneous system of equations to test a two-way linkages between FDI and economic growth for 62 countries in the period of 1975-1978 and for 51 countries in the period of 1983-1986. He found that two-way linkages are existed between FDI and growth in the 1980s. In an empirical study, Berthelemy and Demurger (2000) used a simultaneous equation model estimation based on a sample of 24 Chinese provinces from 1985 to 1996 to test the relationship between foreign direct investment and economic growth. They found that FDI inflows played an important role in promoting provincial economic growth in China over the period 1985-1996. Moreover, they stressed the importance of the potential for future growth in foreign investment decisions. Bende-Nabende et al. (2001) also investigated whether FDI caused economic growth of the ASEAN-5 economies over the period 1970-1996, and, if that was so, whether economic growth had a significant effect in attracting FDI to region. Their findings showed that FDI promoted economic growth most effectively through human capital factor and through learning by doing effects, and in turn economic growth influenced FDI.

Using a panel of data for 84 countries over the period 1970-1999, Li and Liu (2005) applied single equation and simultaneous equation system to examine the endogenous relationship between FDI and economic growth and found that endogeneity between FDI and economic growth does not exist for the whole sample period. Only from the mid-1980s, FDI and economic growth become significantly complementary to each othered and form an increasing endogenous relationship. Moreover, they showed that FDI not only directly promotes economic growth by itself but also indirectly does so via its interaction terms. In their paper, Li and Liu illustrated that there is a strong positive interaction effect of FDI with human capital and a strong negative interaction effect of FDI with

the technology gap on economic growth in developing countries. The empirical result from the paper also confirms that human capital and technology-absorptive ability are very important for FDI to positively promote economic growth in developing countries.

Although these studies provide evidence of the effect of FDI on economic growth in both developed and developing countries like Vietnam, there have been few quantitative studies considering the role of FDI in promoting regional economic growth, especially provincial economic growth. Moreover, the two-way linkage between FDI and economic growth in which FDI promotes economic growth and in turn economic growth is viewed as a tool to attract more FDI is limited. Thus, the study fills in the literature review by measuring the two-way linkage between FDI and economic growth in Vietnamese provinces. In addition, the study also investigates whether the impact of FDI on provincial economic growth are positive only when Vietnam had adequate human capital, technology, and liberalized markets.

3. Empirical specification

In an empirical study implemented by Hendry (2000), economic growth and FDI have been found to depend on many factors. The endogenous growth theory and the eclectic theory of FDI present assistance for the empirical specification that captures the linkage between economic growth and its determinants and FDI and its determinants. However, the determinants of economic growth and FDI possibly vary from country to country and from region to region. Based on the endogenous growth theory and the FDI location theory as well as empirical studies, the section summarizes the determinants of economic growth and FDI.

3.1. Determinants of Economic Growth

Theoretically and practically, FDI can accumulate capital and bring advanced technology, and advanced managerial and labour skills which affect positively on the economy. Recent empirical growth studies have provided investigations of these determinants of economic growth.

Human capital: In endogenous growth theory, human capital has been recognized as an essential determinant of economic growth. Mankiw et al. (1992), Barro and Sala-i-Martin (2004), and Benhabib and Spiegel (1994) have long stressed the importance of human capital to growth in both developed and developing countries. Benhabib and Spiegel (1994) pointed out that human capital is a factor affecting productivity growth, as suggested by endogenous

growth theory. The authors used the school enrollment as a proxy for human capital.

Learning by doing: Another determinant of economic growth is learning by doing. Arrow (1962), Romer (1986), and Stokey (1991) emphasized the importance of learning by doing in promoting economic growth in the long term. In their endogenous growth models, Grossman and Helpman (1990) emphasized that learning by doing can have a positive effect on growth during economic transition, as well as in the long term. Bende-Nabende et al. (2001) found that technological learning by doing can stimulate economic growth in the ASEAN-5 economies in the period 1970-1996. In their research, they used annual manufacturing value added as a percentage ratio of GDP to be a proxy for learning by doing.

Exports: The endogenous growth theory pioneered by Romer (1986) and Lucas (1988) has provided persuasive evidence for the proposition that exports affect positively growth in a country. Grossman and Helpman (1991), and Barro and Sala-i-Martin (2004) argued that a more open trade regime to the rest of the world leads to a greater ability to absorb technological progress and export goods that stimulates economic growth. Exports mostly are measured as the ratio of exports over GDP in recent empirical studies. Grossman and Helpman (1990), and Rodrik (1992) have pointed out that exports can potentially create growth-accelerating forces.

Macroeconomic stability: Macroeconomic stability is one important determinant of economic growth. In researches by Tobin (1965), Stockman (1981), Friedman (1977), Sidrauski (1967), Gomme (1993), and Fischer (1993) the inflation rate was used as an indicator of macroeconomic stability. Another macroeconomic stability factor is the real exchange rate. Real exchange rate volatility is defined as an indicator for poor macroeconomic policies that lead to real exchange rate misalignment and influence growth (Husain et al., 2005; Kamin and Rogers, 2000). Thus, the effect of the real exchange rate on economic growth is negative.

Financial development: Barro (1991) pointed out that financial development has a significant positive impact on economic growth. King and Levine (1993) found that higher levels of domestic investment are positively related to faster economic growth. Hermes and Lensink (2003) argued that private investment influences growth through the level of technology, especially which related to upgrading existing or adopting new technologies, based either on a demonstration effect, a competition effect, or a linkage effect. Thus, an economy needs to develop its domestic financial system.

Public investment: Most public investment in developing countries could negatively influence economic growth. Durham (2004) argued that public investment is financed by increasing taxes; it could further raise distortions in the economy and increase input costs. This leads to a negative impact on expected output growth. However, public investment can also positively affect output growth by investing more in infrastructure and human capital. Blankenau and Simpson (2004) showed that governments play an essential role in human capital accumulation by providing funds for formal schooling. Public education expenditures directly affect human capital accumulation and consequently influence long-term growth. Thus, a positive effect of public investment on economic growth is expected.

Other determinants: Recent studies implemented by Sachs (2003), and Presbitero (2005) stated that geography plays a direct and essential role in promoting economic growth through many channels including human health, agricultural productivity, physical location, and proximity and ownership of natural resources. Presbitero (2005) argued that geographical conditions, especially climate and natural endowment, could directly influence the level of current income through the availability of natural resources as well as enabling to access international trade and commercial routes. On the other hand, geography also influences the disease ecology such as malaria and other tropical diseases, which hamper social and economic growth in different ways.

3.2. Determinants of FDI

Market size: market size is one of the most important determinants of explaining the location of FDI. Market size is defined as the level of development of the economy, usually measured by per capita GDP. Moreover, the perception by MNCs of market size is more closely correlated to the growth rate of the market. Empirical studies have examined both income and economic growth and find that higher income can attract more FDI inflows into host countries by increasing the market size and purchasing power in such countries. Kravis and Lipsey (1982) demonstrated a positive influence of market size in host nations on the location decision of U.S. MNCs in the 1960s. Based on the cross-sectional data of 135 countries for the year 1994, Chakrakarti (2001) found that the market size of a host country, measured by GDP per capita, had the strong explanatory power determining its FDI inflows.

Infrastructure development: Clearly, the better the infrastructure in the host country, the more attractive it is to the MNCs. In fact, foreign investors seek host countries which have the international-standard infrastructure facilities to invest in because efficient infrastructure helps them reduce transaction costs. In

empirical studies, an infrastructure variable proxied by expenditure on road transport (Hill and Munday, 1992), per capita usage of energy (Mudambi, 1995), telephones per thousand population (Asiedu, 2002), railway transport (Bengoa and Sanchez-Robles, 2003), and a general transportation/urbanization index (Glickman and Woodward, 1988), has been found to have a positive and significant coefficient on FDI.

Labour market: The level of the attractiveness of developing countries in attracting FDI depends on the labour market of the host countries in terms of labour cost, availability, and productivity. The economists emphasize the role of cheap labour in determining the location of FDI because it is in line with developing countries' comparative advantage. Moore (1993) and Lucas (1993) suggested that as host country labour costs rise, FDI inflows into host countries tend to be discouraged. In contrast, the more labour that is available in the host countries, the more attractive it is to the foreign investors. The empirical studies implemented by Biswas (2002), and Brainard (1997) find that high labour costs of host countries lower FDI inflows into such countries.

The level of openness: Some economists argue that the level of openness that will attract more FDI depends on the nature of FDI. If it is a market-seeking investment where horizontal FDI is undertaken to get behind trade barriers, a decrease in the level of openness (more trade restrictions) will increase horizontal FDI. However, vertical FDI that is viewed as a non-market-seeking investment may prefer to locate in more open economies (less trade barriers). Balasubramanyam and Salisu (1991), Jackson and Markowski (1995), and Chakrabarti (2001), by using a variable proxied by export volume to estimate its impact of openness on FDI inflows into the host countries, prove that after such countries open their door to the outside world, the FDI inflows have not stoped growing. They have found a positive impact of exports on FDI.

Other determinants: The role of the government in the host country is an important determinant of the location decision for FDI by MNCs. The government's role is defined as maintaining the economic and political stability, promoting investment, developing infrastructure and human capital, and creating a liberalized and competitive economic environment through its macroeconomic tools such as monetary and fiscal policies. In fact, government policies in terms of tax incentives and trade policies play an important role in attracting more FDI into host countries. Some governments try to attract FDI by giving special tax incentives or land rent at cheap prices. Thus, the impact of fiscal incentives on FDI should be positive.

Based on the above discussion on theoretical and empirical studies of the

economic growth and FDI, a system of equations is formed in which the economic growth rate (g) is determined by FDI, government expenditure (SI), the ratio of exports to GDP (Xg), human capital (HC), financial development (DIg), the growth rate of labour (LA), learning by doing (LD), and the real exchange rate (RER). The FDI is determined by the economic growth rate (g), market size denoted by GDP per capita (Y), domestic investment (DI), exports (X), labour cost (WA), the skill of labour (SKILL), infrastructure (TEL), and the real exchange rate (RER). Thus, the system of equations can be written as follows:

$$g_{it} = \alpha_0 + \alpha_1 FDI_{it} + \alpha_2 SI_{it} + \alpha_3 Xg_{it} + \alpha_4 HC_{it} + \alpha_5 DIg_{it} + \alpha_6 LA_{it} + \alpha_7 LD_{it} + \alpha_8 RER_{it} + \varepsilon_{it} \quad (1)$$

$$FDI_{it} = \beta_0 + \beta_1 g_{it} + \beta_2 Y_{it} + \beta_3 DI_{it} + \beta_4 X_{it} + \beta_5 SKILL_{it} + \beta_6 WA_{it} + \beta_7 TEL_{it} + \beta_8 RER_{it} + \varepsilon_{it} \quad (2)$$

In which i denotes province, t denotes time period (years from 1996-2005).

The expected signs of the coefficients are illustrated in table 1. The dependent variables are in the top row and the independent variables are in the first column.

4. Data and econometric techniques

4.1. Data

This analysis is based on an annual dataset for 61 provinces of Vietnam over the period 1996-2005. Most of the data are collected from the General Statistics Office (GSO), the Ministry of Planning and Investment (MPI), the Ministry of Labour-Invalids and Social Affairs (MLISA), and the Ministry of Industry (MOI). Unfortunately, the data for provinces on relevant variables for the period 1986-1995 is not available. Thus, the study only examines the linkage of FDI to economic growth over the period 1996-2005. Table 2 shows the definition of each variable in the system of equations.

4.2. Econometric Techniques

As mentioned above, in many empirical studies on the relationship between FDI and economic growth, such one-way linkage between FDI and economic is not enough and meaningful. This occurs if economic growth is determined by FDI and FDI is in turn determined by economic growth. In short, there is a two-way linkage between FDI and economic growth; it is better to use a simultaneous equation model to investigate the two-way linkage between FDI and economic growth. For simultaneous equations models consisting of two equations, estimates from ordinary least squares (OLS) methods are biased and even inconsistent (Green, 2000; Gujarati, 2003).

Table 1. The expected direction of the relationship between the dependent and independent variables

	Dependent Variables	
	g	FDI
g	n.a	+
FDI	+	n.a
SI	+/-	n.a
Xg	+	n.a
HC	+	n.a
Dig	+	n.a
LA	+	n.a
LD	+	n.a
RER	-	+
Y	n.a	+
DI	n.a	+
X	n.a	+
SKILL	n.a	+
WA	n.a	-
TEL	n.a	+

Note: + and – represent results that are expected to be positively and negatively statistically significant respectively. n.a.: not applicable.

Therefore, there are three statistical techniques for a pooled time series and cross-sectional dataset: two stage least squares (2SLS), three stage least squares (3SLS), and the generalized method of moments (GMM) to test the causal relationship between economic growth and FDI. However, we decided to report the results we obtained using the GMM model for several reasons. First of all, while the parameter estimates remained similar in magnitude and sign, the GMM estimation results in the paper are generally found to be statistically more robust. Second, the GMM method provides consistent and efficient estimates in the presence of arbitrary heteroskedasticity (Greene, 1997). Moreover, most of the diagnostic tests we discuss in the paper can be cast in a GMM framework.

In the paper, we examines the key issue underlying the estimated relationships between FDI and economic growth. This analysis is based on a panel dataset for 61 provinces of Vietnam over the period 1996-2005. The results for the relationship analysis will be discussed in the next section.

After completing model estimations, we performed some statistical tests to make sure that the developed models are robust. First, given the simultaneous equations model, a J statistic of Hansen test is performed to test the over-identification in GMM. Thus, a null hypothesis of correct model specification and valid over-identifying restrictions is tested. In the simultaneous equations, we use instrumental variables including SI, Xg, HC, Dig, LA, LD, RER, Y, DI, X, WA, SKILL, TEL, and RER.

Second, a Durbin-Wu-Hausman test is performed to test the endogeneity. A null hypothesis is rejected, suggesting that OLS estimates might be biased and inconsistent and OLS is not the appropriated technique to be used in the study. Moreover, it also suggests that the endogenous variable's effect on the estimates is meaningful, and instrumental variables techniques are required.

The third test was for homoscedasticity, a Pagan-Hall statistic test for heteroskedasticity can be used. A null hypothesis of homoscedasticity is rejected, suggesting that the GMM technique is consistent and efficient in the presence of arbitrary heteroskedasticity. After implementing most of the diagnostic tests (see Tables of 3, 4, 5, and 6), the GMM technique is consistent and unbiased in the study.

5. Estimation result and analysis

The results are shown in Tables 3 and 4. The results reflect that FDI is an important determinant of the provincial economic growth in Vietnam. The estimated coefficient of the FDI in column (1) of Table 3 is significant at the 1 percent level in the GMM. It also indicates that, other things remaining constant, one thousand of Vietnamese dong (VND) increase in FDI per capita in Vietnam would bring about a 0.000054 percent increase in the provincial economic growth.

Other important determinants of economic growth in Vietnam are exports, government expenditure, financial development, the growth of labour, learning by doing, human capital, and real exchange rate. The ratio of exports to GDP is significant at the 1 percent level in the GMM estimate. The growth of labour force is significant at the 1 percent level. The estimated coefficient of government expenditure in equation (1) is not statistically significant in the GMM estimate.

Table 2. Variable Definitions and Data Sources

Abbreviations	Variable definition	SOURCE
G	Provincial economic growth rate (annual %)	GSO
Y	GDP per capita (expressed in thousands of VND at constant prices)	GSO
FDI	FDI per capita (expressed in thousands of VND at constant prices)	MPI
SI	The ratio of annual government expenditure to GDP	GSO
X	Exports of goods and services per capita (expressed in thousands of VND at constant prices)	GSO
XG	Ratio of exports to GDP	
HC	Number of University and College students per thousand persons	GSO
DIG	The ratio of gross domestic investment to GDP	GSO
DI	Gross domestic investment per capita (expressed in thousands of VND at constant prices)	GSO
TEL	Telephones per thousand persons	GSO
LD	Learning by doing (annual manufacturing value added as a percentage ratio of GDP is used as a proxy)	GSO
RER	Real exchange rate	MOI
SKIL	The percentage of skilled labours in the total labour force	
WA	Monthly average wage of employee (expressed in thousands of VND at constant prices)	GSO
LA	The growth rate of labour (annual %)	MLISA
DUMM	Dummy=1 if cities and provinces in the key economic regions	MLISA
Y	=0 otherwise	MLISA
		Own calculation

The estimated coefficient of learning by doing on the economic growth in Vietnam for the period 1996-2005 is statistically significant at 1 percent level, and its sign is consistent with expectations. Vietnam's significant results for learning by doing probably reflect the assembly-type of production activities it specializes in. In addition, Vietnamese labour force is benefiting from knowledge spillovers at work, improving its productivity, and hence stimulating economic growth.

The estimated coefficient of real exchange rate has an expected negative sign, and it is significant at the 1 percent level in the GMM estimate. The coefficients of human capital and financial development on the economic growth in Vietnam over the period 1996-2005 are statistically significant at the 5 percent level and their signs are positive in the GMM estimation.

Table 4 shows that the estimated coefficient of the economic growth in FDI equation is statistically significant at the 5 percent level in GMM estimate. Its sign is positive and consistent with the expectation. The estimated coefficient on economic growth indicates that, other things remaining constant, a 1 percent increase in economic growth would raise FDI per capita by VND 993,000. It seems that higher economic growth in Vietnam indeed reflects a good signal about the Vietnamese economy to foreign investors. It also shows an increasingly larger market size for investment in Vietnam. GDP per capita, which is used as a measure of market size, has a positive and significant coefficient at the 1 percent level in the GMM estimation. The estimated coefficient of domestic investment is positive and statistically significant at the 1 percent level, implying that the linkage between FDI and domestic investment is complementary. The coefficient of exports is consistent with the expectation and statistically significant at the 1 percent level in the GMM estimation. The skill of the labour force is an important determinant of FDI in Vietnam. The estimated coefficient of skilled labour on FDI is positive and statistically significant at the 1 percent level in the GMM estimation. The negative coefficient of the labour cost is significant at the 1 percent level, reflecting that higher labour costs in Vietnam are associated with lower FDI inflows. The estimated impact of infrastructure on FDI is positive and statistically significant at the 1 percent level in the GMM estimation. A depreciation of real exchange rate in Vietnam tends to raise FDI inflows into Vietnam as the estimated coefficient of real exchange rate is positive and statistically significant at the 1 percent level in the GMM estimation.

The geographical distribution of FDI in Vietnam is characterized by its concentration in the key economic cities and provinces in the South such as Ho Chi Minh City, Dong Nai, Binh Duong, and Baria Vung Tau, and in the North such as Hanoi, Hai Duong, Vinh Phuc, Hai Phong, and Quang Ninh. Thus, we extended the model for the period 1996-2005 by introducing a dummy variable for provinces in the key regions including Red River Delta and South East where have the highest inflows of FDI. Table 2 shows the definition of the variable. It is expected that cities and provinces in the key economic regions with better infrastructure, skilled workers, and higher income tend to attract more FDI and grow faster. Table 3 and 4 show the results. The regional dummy variable has a positive sign in both the economic growth and FDI equations. In the economic

Table 3. Econometric Results of equation (1) for the period 1996-2005

Economic growth equation (1)	(1)	(2)
FDI (FDI)	0.000054 (4.80)*	0.000049 (3.99)*
Exports (Xg)	0.243119 (1.95)**	0.245129 (1.92)**
Government Expenditure (SI)	0.068351 (0.29)	0.417532 (0.41)
Financial Development (Dig)	1.256011 (2.93)*	1.184253 (2.71)*
Labour Growth (LA)	0.157515 (2.58)*	0.408601 (2.88)*
Learning by Doing (LD)	0.018336 (3.05)*	0.017551 (3.08)*
Human Capital (HC)	0.038917 (2.64)*	0.037175 (2.58)*
Real Exchange Rate (RER)	-0.094108 (-4.27)*	-0.136351 (-4.82)*
Regional Dummy (DUMMY)		0.391238 (1.13)
Constant	18.706020 (6.34)*	19.005950 (6.46)*
Hansen test (p-value)	0.15	0.29
Durbin-Wu-Hausman test (p-value)	0.00	0.05
Pagan-Hall test (p-value)	0.01	0.02
Observations	563	563

Notes: (i) Robust t-statistics in parentheses; (ii) *** significant at 10%, ** significant at 5%, and * significant at 1%

growth equation, it is not significant in the GMM estimation. In the FDI equation, the variable is very significant at the 1 percent level in the GMM estimation. All other coefficients of both economic growth and FDI equations tend to follow a similar magnitude, sign, and significance level in this specification. The results show that cities and provinces in the key economic regions such as Red River Delta and South East where have better infrastructure and skilled employees, higher growth, and larger market size attract more FDI inflows.

Recent empirical studies argue that impacts of FDI on economic growth depend on the existence of adequate absorptive capacity in the host countries. Thus, Table 5 illustrates the impacts of FDI on provincial economic growth in Vietnam via absorptive capability. As can be seen in Table 5, the estimated coefficient of the interaction between FDI and Human capital is positive and statistically significant at the 5 percent level but the coefficient of FDI in column (1) of Table 5 is negative and not statistically significant. This reflects that the impacts of FDI on provincial economic growth in Vietnam are positive only when Vietnamese provinces have a certain threshold of human capital. Similarly, the estimated coefficient of the interaction between FDI and financial development in column (2) of Table 5 is negative and statistically significant at the 5 percent level. The negative coefficient implies that a certain level of financial market development is an important prerequisite for FDI to have a positive effect on provincial growth.

Further Analysis of the Relationship between FDI, Economic Growth, Technology Gap, and Research and Development (R&D)

The endogenous growth theories also point out that expenditure on research and development and technology gap in the host countries affect importantly the capability to absorb the externalities from FDI. Thus, we further investigate the effect of the role of R&D, which is used as one alternative indicator of human capital, and technology gap on provincial economic growth in Vietnam as well as their effects on FDI via the absorptive capacity. In equation (1), we add two variables of R&D, and technology gap. R&D variable used in equation (1) is the ratio of investment in R&D to GDP, and technology gap variable is the percentage difference between the average growth of foreign sector and that of province in Vietnam. We expect the coefficient of R&D variable is positive and its technology gap variable is negative.

Column (1) of Table 6 indicates that the coefficient of R&D is positive and statistically significant at the 10 percent level. This means that investment in R&D contributes positively to provincial economic growth in Vietnam in the period 1996-2005. Besides, the estimated coefficient of technology gap is negative

and significant at the 1 percent level. The result confirms that provinces with lower technology gap will grow faster in terms of technology. We also investigate the effects of FDI on economic growth via absorptive capability. We find that the estimated coefficient of the interaction between FDI and R&D is negative and statistically significant at the 5 percent level. It again confirms that a certain level of investment in R&D is an important prerequisite for FDI to have a positive effect on economic growth. The coefficient of the interaction between FDI and technology gap is negative and statistically significant at the 1 percent level. This proves that the impact of FDI on provincial economic growth is positive only when Vietnamese provinces have a certain threshold of technology.

Table 4. Econometric Results of equation (2) for the period 1996-2005

FDI equation (2)	(1)	(2)
Economic Growth (g)	992.8359	802.3072
	(2.73)*	(2.34)**
Market Size (Y)	1.451904	1.460676
	(11.32)*	(12.53)*
Domestic Investment (DI)	0.050031	0.052338
	(5.71)*	(6.64)*
Exports (X)	0.934665	0.934665
	(7.00)*	(7.47)*
The Skill of Labour (SKILL)	141.1244	120.3292
	(2.70)*	(2.44)**
Labour Cost (WA)	-5.460528	-4.867383
	(-4.64)*	(-4.41)*
Infrastructure (TEL)	49.79898	47.9732
	(6.62)*	(4.90)*
Real Exchange Rate (RER)	161.6789	145.9019
	(3.05)*	(3.05)*
Regional Dummy (DUMMY)		1179.619
		(3.05)*
Constant	-34870.23	-31513.77
	(-3.86)*	(-3.83)*
Hansen test (p-value)	0.13	0.12
Durbin-Wu-Hausman test (p-value)	0.00	0.00
Pagan-Hall test (p-value)	0.01	0.01
Observations	543	543

Notes: (i) Robust t-statistics in parentheses; (ii) *** significant at 10%, ** significant at 5%, and * significant at 1%

Table 5. Impact of FDI on Provincial Economic Growth in Vietnam via Absorptive Capacity

Economic growth equation (1)	(1)	(2)
FDI (FDI)	-0.000089	0.000084
	(-1.83)	(4.53)*
Exports (Xg)	0.264740	0.334157
	(2.16)**	(2.22)**
Government Expenditure (SI)	-0.390307	-0.569683
	(-0.69)	(-0.57)
Financial Development (Dig)	1.419888	1.747579
	(3.30)*	(3.89)*
Labour Growth (LA)	0.165762	0.167893
	(2.69)*	(2.73)*
Learning by Doing (LD)	0.020171	0.018908
	(3.42)*	(3.01)*
Human Capital (HC)	0.028890	0.036969
	(1.90)**	(2.50)*
Real Exchange Rate (RER)	-0.096025	-0.094292
	(-4.39)*	(-4.30)*
FDI*Human Capital	0.000004	
	(2.25)**	
FDI*Financial Development		-0.000059
		(-2.22)**
Constant	19.19335	18.59838
	(6.54)*	(6.34)*
Hansen test (p-value)	0.21	0.34
Durbin-Wu-Hausman test (p-value)	0.01	0.00
Pagan-Hall test (p-value)	0.00	0.01
Observations	563	563

Notes: (i) Robust t-statistics in parentheses; (ii) *** significant at 10%, ** significant at 5%, and * significant at 1%

6. Conclusion

In conclusion, the paper sought to examine the relationship between FDI and economic growth in Vietnam by using a simultaneous system of equations for a panel dataset of 61 Vietnamese provinces over period 1996-2005. The empirical results provide a clear answer to the question as to whether a two-way linkage between FDI and economic growth in Vietnam exists. Based on the statistical evidence, this paper has demonstrated that FDI and economic growth are important determinants of each other in Vietnam. The results also have various implications for both Vietnamese central and local governments seeking to attract FDI.

First, FDI has a positive and statistically significant impact on provincial economic growth in Vietnam over period 1996-2005, and provincial economic growth in Vietnam is viewed as an important factor to lure FDI inflows into Vietnamese provinces. This stresses the importance of the potential for future growth in the decision of foreign investors to commit funds to Vietnam. Second, the relationship between exports and FDI is complementary. The finding is consistent with the fact that FDI in Vietnam is mainly concentrated on export-oriented manufacturing activities. Third, the results provide new evidence on the role of skilled workers and infrastructure in attracting FDI inflows into Vietnam. Thus, a successful FDI policy has to coincide with an increase in GDP, human capital accumulation, and infrastructure through investing more in the transportation and telecommunication systems, enhancing the quality of education, and facilitating the implementation of projects. Fourth, the finding shows that human capital and investment on R&D are important determinants of provincial economic growth in Vietnam. The result for human capital also emphasizes that human capital can contribute to economic growth by facilitating the adoption of foreign technologies in Vietnam. Fifth, the significant impact of exports on economic growth is positive and statistically significant in the GMM estimation. This implies that the integration of Vietnam into the region has brought in benefits such as stimulating trade flows between Vietnam and its trade partners. Finally, FDI inflows into Vietnam only influence positively provincial economic growth only when Vietnam has certain thresholds of human capital, investment in R&D, technology, and financial development.

Through the analyses of the impact of FDI on economic growth in Vietnam, we can see the success of the Vietnamese government in promulgating the Law on Foreign Investment since 1987. Under the Doi Moi period, FDI has contributed significantly to the high rate of economic growth in Vietnam. Moreover, Vietnamese provinces also gained benefits from FDI in order to stimulate their economic growth. Clearly, whichever route of analysis is taken, there is still much work to be done. However, we believe the piece of research has laid some important foundations.

Table 6. Economic Growth and FDI: Using Research and Development and Technology Gap

Economic growth equation (1)	(1)	(2)	(3)
FDI (FDI)	0.000028	0.000053	-0.000006
	(2.81)*	(3.19)*	(-0.05)
Exports (Xg)	0.139887	0.148923	0.133530
	(1.28)	(1.25)	(1.23)
Government Expenditure (SI)	-1.592068	-1.628443	-1.574779
	(-1.99)**	(-2.04)**	(-2.00)**
Financial Development (Dig)	0.957675	1.033599	0.999145
	(2.42)*	(2.66)*	(2.62)*
Labour Growth (LA)	0.124454	0.120881	0.127988
	(2.31)**	(2.25)**	(2.43)*
Learning by Doing (LD)	0.018639	0.018457	0.021126
	(3.73)*	(3.27)*	(4.47)*
Research and Development (R&D)	0.153391	0.167511	0.169995
	(1.64)***	(1.83)***	(1.86)***
Technology Gap	-2.178576	-2.210997	-1.442873
	(-3.83)*	(-4.00)*	(-2.70)*
Real Exchange Rate (RER)	-0.064482	-0.063214	-0.056075
	(-3.65)*	(-3.25)*	(-3.23)*
FDI*R&D		-0.000025	
		(-2.01)**	
FDI*Technology Gap			-0.000225
			(-4.07)*
Constant	17.05742	16.87612	15.74285
	(7.33)*	(7.21)*	(6.88)*
Hansen test (p-value)	0.19	0.19	0.25
Durbin-Wu-Hausman test (p-value)	0.00	0.01	0.00
Pagan-Hall test (p-value)	0.04	0.00	0.00
Observations	563	563	563

Notes: (i) Robust t-statistics in parentheses; (ii) *** significant at 10%, ** significant at 5%, and * significant at 1%

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ON THE EMPIRICS OF EFFECTIVENESS OF OFFICIAL DEVELOPMENT ASSISTANCE (ODA) IN GROWTH IN VIET NAM

Hoang Van Phuong

Abstract

This paper explores a new angle on effectiveness of ODA in growth of the Vietnam economy of Vietnam by employing growth accounting framework to calculate the contribution of ODA in economic growth in the period of 1993-2006. This paper is structured as follows: part I will highlight some major developments and statistics of ODA up to date; part II will present empirical estimation of the contribution of ODA in the growth accounting framework; part III will present major findings and concluding remarks.

1. ODA in Social and Economic Development Plan (SEDP)

1.1 Objective

ODA effectiveness has long been an interested topic for the government and donors alike. While many qualitative reports on ODA effectiveness have been produced by donors and the government of Vietnam, none have figured out the quantitative effectiveness of ODA on the economy of Vietnam. Therefore, this article will make an exploration to calculate the empirical contribution of ODA on growth in Vietnam in the period of 1993-2006. Findings will serve as background for policy makers, donors in making ODA strategy for Vietnam.

1.2 Data Update

ODA plays a significant role in the social and economic development strategy of the government of Vietnam. According to the socio-economic targets set out in the Five-Year Plan 2006-2010, to ensure an economic growth rate of 7.5-8% annually, a total amount of US$140 billion[1], or equivalent to 40% of GDP should be mobilized, in which US$11 billion is sourced from ODA[2].

During the period of 1993-2005, US$32.5 billion was committed, US$ 22.6 billion was signed, and US$15.9 billion was disbursed[3]. ODA accounts for 16% of central government outlays (as high as 24.3 percent in 1999 and as low as 16 percent in 2002), and an average 11% of national investment[4]. These indicators distinguish Vietnam from other borrowing countries in the way that ODA is important for the country's development, but Vietnam is not dependent on ODA: some even speculate that Vietnam may do well without ODA at the moment.

2. Estimation of contribution of ODA on growth from 1993 to 2006

This part will calculate the contribution of ODA on growth in Vietnam since the time Vietnam implemented its reform program in 1986 by applying growth accounting framework that follows two steps: (1) the contribution of capital input on growth will be calculated; (2) the contribution of capital then will be decomposed into various sources such as contribution of aid, contribution of domestic investment, and contribution of TFP. The decomposed contributions of various sources of capital will represent the contribution of foreign aid to growth directly.

1. Theoretical Framework of Growth Accounting

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[1] The main external financial resources for Vietnam are foreign aid (ODA), foreign direct investment (FDI), a growing level of foreign indirect investment (FII) and remittances of overseas Vietnamese. While FDI and other inflows are implemented by foreign investors and private firms and only invested in the profitable sectors, aid inflows are the assistance of developed countries or international organizations and allocated to public and infrastructure investment, aiming at building a foundation for sustainable development, and paving ways for private investment.

[2] SEDP 2006-2010

[3] Strategic Framework for Official Development Assistance Mobilization and Utilization 2006-2010

[4] World Development Indicators CD-Rom, 2006

Growth accounting framework was first presented by Solow (1957), then Kendrick (1961), Denison (1962), and Jorgenson and Griliches (1967). The theoretical framework of growth accounting for Vietnam during the period from 1986 to 2007 in this paper is referred to Barro and Sala-i-Martin (Growth, 2004, chapter 10) as follows:

Assume that an economy follows a production function as $Y = F(T, K, L)$ (1) in which Y is aggregate output or gross domestic product, T is the level of technology, K is capital stock and L is labor stock. It is well understood that there are various kinds of labor (primary education attainment, technical education attainment, university education attainment) and various kinds of capital (long-lived, short-lived).

Taking log of (1) and then taking the first order derivatives with respect to time of both sides results:

$$\frac{\dot{Y}}{Y} = \left(\frac{F_T T}{Y}\right)\left(\frac{\dot{T}}{T}\right) + \left(\frac{F_K K}{Y}\right)\left(\frac{\dot{K}}{K}\right) + \left(\frac{F_L L}{Y}\right)\left(\frac{\dot{L}}{L}\right) \qquad (2)$$

where are the factor (social) marginal products and $g = \left(\frac{F_T T}{Y}\right)\left(\frac{\dot{T}}{T}\right)$

is the growth contributed by technological progress or the so-called Total Factor Productivity (TFP). The equation (2) literally implies that the growth rate of GDP can be decomposed into three components of factor inputs: capital, labor and technology. In particular, it implies that the decomposition is a weighted average of the growth rates of the three inputs, where the weights are given by the relative contributions of each of the factors to GDP or the social marginal products times the amount of input divided by GDP.

From equation (2), it is clear that if are known, the weights of contributions of capital and labor on growth can be determined. In fact, in practice, researchers have found some ways to determine empirically based on data of factor prices such as (the rental price of capital) and (the wage rate), while the contribution of the growth rate of technological progress can be estimated indirectly by the following equation

$$g = \left(\frac{\dot{Y}}{Y}\right) - \left(\frac{F_K K}{Y}\right)\left(\frac{\dot{K}}{K}\right) - \left(\frac{F_L L}{Y}\right)\left(\frac{\dot{L}}{L}\right) \qquad (3)$$

Furthermore, once are determined, then the fraction of GDP is paid for capital $s_K = \frac{F_K K}{Y}$ is and the fraction of GDP is paid for labor is,

$s_L = \frac{F_L K}{Y}$ thus (2) can be rewritten as

$$\frac{\dot{Y}}{Y} = g + s_K \left(\frac{\dot{K}}{K} \right) + s_L \left(\frac{\dot{L}}{L} \right) \quad (4)$$

In addition, if only labor and capital are only the two factor inputs involved in the production process, then this condition must be held: $s_K + s_L = 1$, thus (4) can be rewritten as

$$\frac{\dot{Y}}{Y} = g + s_K \left(\frac{\dot{K}}{K} \right) + (1 - s_K) \left(\frac{\dot{L}}{L} \right) \quad (5)$$

2.2 Application of Growth Accounting Framework

To estimate capital stock, we assign an arbitrary guess of the initial capital stock $K(0)$ and then the Perpetual Inventory Method is used to estimate the accumulated capital stock in the subsequent years. It is undoubted that the accumulated capital stock is sensitive during the first few years due to the arbitrary guess of the initial capital stock $K(0)$, however, it will be depreciated off and the estimated capital stocks will be more accurate.

The capital stock together with labor and growth rate of GDP will be used to estimate the TFP growth rate for each year based on formula (5).

The next step is to decompose the capital stock into various sources and the numerical contributions of various capital sources will also be calculated.

2.3 Data

The dataset for the growth accounting exercise in this study is drawn from various sources: (1) Asian Development Bank Key Indicators 2005, (2) World Development Indicators 2004, (3) Statistical Year Book of GSO

Variables and Data Sources for Growth Accounting

Variable	Source
GDP growth at 1994 constant prices	ADB 2006, WDI 2006
Labor Input as employment number	ADB 2006, WDI 2006
Gross Fixed Capital Formation	ADB 2006, WDI 2006
Deprecation Rate	Assumed an arbitrary number of 0.06
Foreign Aid Disbursement	Ministry of Planning and Investment of Vietnam, ADB

2.4 Estimation Results and Discussion

Assumptions

- The annual depreciation rate is 0.06. This rate is applied by the Government of Vietnam for 27 economic sectors, and is also in line with other studies

- For sensitive analysis, the share of labor in the production function is assumed to take values of 0.5, 0.6, and 0.7 [5]

- For the purpose of initial capital stock estimation, the ratio of initial capital-output to what is assumed an ad-hoc level of 2:1 [6]

The first step is to estimate the capital stock (the initial capital stock is assumed to take an arbitrary value such that K/Y(0)=2) then the PIM method is used to estimate the capital stock in the subsequent years. The series of estimated capital stock for the economy of Vietnam is presented in Table 4 (the last column).

Second, based on a set of assumptions on various indicators and available dataset of the economy of Vietnam, the growth accounting for Vietnam during the period from 1986 to 2006 is carried out by using the growth accounting formula $GY = g + s_k GK + (1 - s_L)GL$; in which GY is the growth rate of GDP, g is the growth rate of labor, GK is the growth rate of capital stock. The results in Table 5 show a number of significant results: (1) since the implementation of the reform program, Vietnam has maintained a high growth rate, despite the minimal impacts of the Asian financial crisis in 1997, the averaged growth rate for the whole period of 1986-2006 is amounting to 7%; (2) the growth rate of labor is stable for the whole period at about 2%; (3) the growth rate of capital stock was small during the beginning of the transition period since 1986, but it has maintained a stable growth rate at around 11% during the later years; (4) the growth rate of Total Factor Productivity (TFP) was high prior to 1997, then went down to negative levels and then is slowly recovering but it is still lower than the period before 1997. It can be observed that the high growth rate of output before 1997 was due to high growth rate of TFP, while that of output after 1997 was mainly due to high levels of capital accumulation or high levels of investment.

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[5] For the industrial countries, the share of labor is usually assumed to take the value of 0.7 for various studies of growth accounting for industrial countries

[6] In fact, it is very difficult to estimate the capital stock of an economy and currently there is no universal method of estimation. It is clear that the initial level of capital stock will be drained off due to depreciation and the investment data becomes more and more important and the longer the time span, the more accurate the capital stock.

Furthermore, the contributions of labor, capital and TFP to the growth of output is estimated, also based on the growth accounting formula, as $GY = g + s_K GK + (1 - s_L)GL$. Thus the specific formulas to estimate the contributions of labor, capital and TFP on growth of output are $g/GY, s_K/GK, s_L GL$ respectively. The estimation results are presented in Table 5. As can be seen, for the whole period from 1987 to 2006, the contribution of labor to growth is stable at 20 percent; the contribution of TFP was high at the beginning of the implementation of the reform program and low from 1998; while the contribution of capital stock to growth has accounted for more than half of the growth since 1996. It is clear again that the growth rate of the economy of Vietnam has been mainly due to the accumulation of capital stock through the high rate of investment since 1997.

Finally, the last step is to decompose the contribution of ODA to the growth rate of output. The data on ODA is sourced from the database released from the Ministry of Planning and Investment (MPI). The original data of annual ODA inflows in $US billion is converted to VND billion at 1994 constant prices, then the PIM Perpetual Inventory Method: $K(t+1) = (1-\delta)K(t) + I(t+1)$ is applied to estimate the stock of ODA over the studied period 1993-2006. For ODA capital stock, the deprecation rate is also assumed to take the value of 0.06.

Table 7 shows the contribution of ODA to the growth rate of output as well as the proportion of foreign aid stock in total capital, and the ODA inflow as a proportion of total gross domestic investment over the studied period. As can be seen, ODA has played an increasingly important role in capital stock accumulation as well as in gross domestic investment and growth of output: ODA accounted for a minimal contribution of 0.73 percent on growth of output in 1993, reaching 10 percent on growth on output in 1999, and then stabilizing at around 8 percent until 2006; the contribution of ODA to gross domestic investment and as a proportion of capital stock has been significant for the whole period, averaging 15 percent and 11 percent respectively.

It is also observed that the contribution of ODA to growth is sensitive to the assumption of the share of labor in the production function; however, this sensitivity is quite minimal. As can be seen in table 5, the averaged contributions of ODA stock on growth of output for the period of 1993-2006 with the assumption of share of labor of 0.5, 0.6 and 0.7 are 8.7 percent, 6.5 percent, and 4.9 percent respectively.

3. Discussion and Issues

3.1 The reliability of Growth Accounting Framework

There is unsettled debate in the literature about the reliability of growth accounting framework in general and of the TFP in particular. In fact, the growth accounting exercise above merely takes into account only the change in quantity of factor inputs rather than quality of factor inputs, due to unavailability of data. As pointed out by Jorgenson and Griliches (1967) and Jorgenson, Gollop, and Fraumeni (1987), the accuracy of the estimation of growth accounting framework can be improved if the factor inputs can be disaggregated by quality classes; this will result in more practical technological progress or the Solow residual. For example, labor input can be disaggregated into n vectors that contain the level of education attainments, age, sex, and region (technical training, university, or no education, male, rural, urban) as $GL = \sum S_{Lit} GL_{it}; \sum S_{Lit} = 1$ where GL is the growth rate of labor, is the growth rate of sub-category of labor, and is the share of subcategory of labor. This formula suggests that if the quality of labor input is improving over time, but the estimation of labor input fails to capture such quality, improvement will lead to overestimation of TFP.

The same treatment is also applied for capital input, since there are various categories of capital such as short lived capital (machinery) and long lived capital (buildings), which have different rate of returns. Failure to capture the change in the structure of capital input will lead to inaccurate estimation in growth accounting and TFP.

For the case of Vietnam, it is evident that the country has experienced a significant improvement in education as well as in the structure of capital over the studied period from 1986 to 2006. However, due to lack of data for various kinds of labor input and capital input, it is impossible to capture for the dynamics over time. Therefore, it is expected that the estimated TFP contains a portion of labor input quality improvement and the change of the structure of capital input rather than true TFP. Further estimation should be carried out if more dataset becomes available.

3.2 The contribution of ODA to Growth

The estimated results based on the growth accounting framework have shown that ODA has played a significant role in contributing to the growth of output with an averaged contribution of 6.5 percent for the period from 1993 to 2006. In addition, the majority of ODA inflows into Vietnam during the studied period have been allocated for the establishment of a foundation for long run and sustainable economic development in sectors such as education, infrastruc-

ture development, and health care, among others[7]. It is worthwhile to note that the estimated contribution of foreign aid to growth of output only reflects short-run contributions on capital accumulation and growth, while the long run contributions and spillover effects are still neglected and they are also very difficult capture empirically. Therefore, it is expected that the total contribution of ODA to growth of output far outweighs the estimated one.

3. Orientation for ODA

Vietnam is now among the highest ODA recipients in the developing world (UNDP, 2005). However, it is clear that this important financial resource will not last long due to the following reasons: (1) the major donors such as Japan, IBRD, ADB are facing financial constraints in recent years, (2) demand for ODA

Table 1. Aid Commitment, Signed Agreement and Disbursement in Vietnam 1993-2007 (Unit: $US Billion)

Year	Commitment	Signed Agreement	Disbursement	Disbursement Rate
1993	1.81	0.57	0.413	0.23
1994	1.94	2.02	0.725	0.37
1995	2.26	1.44	0.737	0.33
1996	2.43	1.59	0.9	0.37
1997	2.4	1.7	1	0.42
1998	2.2	2	1.242	0.56
1999	2.1	1.41	1.35	0.64
2000	2.4	1.75	1.65	0.69
2001	2.4	2.12	1.5	0.63
2002	2.4	1.78	1.55	0.65
2003	2.5	1.86	1.41	0.56
2004	2.83	2.1	1.8	0.64
2005	2.9	2.3	1.8	0.62
2006	3.2	2.7	2.2	0.69
2007*	4.45		2.2	0.69

Source: Ministry of Planning and Investment, 2006, (*) estimation for 2007

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[7] For details, see Overview of ODA in Vietnam, 2004, UNDP Vietnam

is still high and enormous in other developing countries, (3) the economy of Vietnam has achieved significant milestones during the last 20 years and will continue to do so in the coming years. Therefore, it is very important for Vietnam to prepare to make a transition from concessional to non-concessional and sovereign loans and to diversify its external financial sources in the direction of FDI, government bonds, company bonds, and portfolio investments. Policies should be designed and implemented to sustain stable macroeconomic environment and establish an institutional framework with enhanced transparency in the public, corporate and financial sectors.

Table 2. Distribution of ODA (2001 - 2005)(Unit: $US million)

Sectors	Total Aid Signed Agreement Value	Loans	Grants	Share
Agriculture and rural development in association with poverty reduction	1,607	1,300	308	16.0 %
Industrial and Power sectors	1,582	1,536	46	15.8 %
Transportation - Post & Telecommunication	2,541	2,445	96	25.4 %
Science, Technology and Environment	1,005	726	280	10.0 %
Health care – Education – Social areas	1,063	484	579	10.6 %
Other Sectors	2,219	1,805	414	22.2%
Total	10,018 (*)	8,295	1,722	100.0 %

Source: Ministry of Planning and Investment

Table 3. Average Terms of New Commitments of New Loans in Vietnam 1990-2005

New Loans Terms	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Interest (% p.a.)	5.7	3.1	1.7	2	2.7	3.3	2.5	3.2	2.4	2.3	1.4	1	1.3	1.9	1.6	1.8
Maturity (years)	9.6	12.7	24.4	30.5	26.3	26.3	29.6	27.1	29.1	34	36.1	38.7	35	28	31	32
Grace period (years)	4.2	5.7	8.2	8.2	7.8	7.9	8.6	7.6	8.2	9.1	9.6	9.7	9.4	7.7	8.2	8.7

Source: ADB Key Indicator 2005

Table 4. Basic Statistics for Growth Accounting of Vietnam 1986-2006

Year	Y (Billion VND 1994)	GY	L(employed, Million People)	GL	I (Billion VND) 1994	K (K/Y=2)
1986	109189	2.79	27	1.35	6005.4	218378
1987	113154	3.58	28.5	1.37	8486.55	212521.29
1988	119960	5.14	28.5	1.58	12955.68	210491.13
1989	125571	7.36	28.9	1.4	14063.95	211371.48
1990	131968	5.1	29.4	1.73	16582.89	214012.61
1991	139634	5.96	30.1	2.38	21043.31	219984.96
1992	151782	8.65	30.9	2.66	26774.56	230694.79
1993	164043	8.07	31.6	2.27	39789.12	250134.95
1994	178534	8.84	32.3	2.22	45483	277762.91
1995	195567	9.54	33	2.26	53085.18	310381.23
1996	213833	9.34	33.8	2.21	60093.27	348347.58
1997	231264	8.15	34.5	2.17	65446.75	390216.73
1998	244596	5.76	35.2	2.14	71055.04	435054.62
1999	256272	4.77	36	2.11	70807.33	479882.53
2000	273666	6.79	37.6	4.51	81032.27	527009.37
2001	292535	6.89	38.4	2.13	91191.27	581500.58
2002	313247	7.04	39.5	2.86	104062.3	644237.35
2003	336243	7.3	40.5	2.53	113724.8	714476.68
2004	362093	7.7	41.6	2.72	128374.7	792657.82
2005	392871	8.5	42.2	2.68	144183.6	881377.49
2006	424301	8.2	43.8	2.73	159112.7	980143.01

Source: ADB Key Indicators 2005, World Development Indicators 2004, Vietnam Statistical Year Book (various issues), and Author's calculation

(*) estimation for 2006

Table 5. Growth Accounting in Vietnam (1987-2006)

Scenario 1: capital-output ratio=2; share of labor=0.6
Scenario 2: capital-output ratio=2; share of labor=0.5
Scenario 3: capital-output ratio=2; share of labor=0.7

Year	K/Y=2; Share of Labor=0.5				K/Y=2; Share of Labor=0.6				K/Y=2; Share of Labor=0.7			
	GY	GL	GTFP	GK	GY	GL	GTFP	GK	GY	GL	GTFP	GK
1986	2.79	1.35	n/a!	n/a	2.79	1.35	n/a	n/a	2.79	1.35	n/a	n/a
1987	3.58	1.37	4.24	-2.68	3.58	1.37	3.83	-2.68	3.58	1.37	3.43	-2.68
1988	5.14	1.58	4.82	-0.96	5.14	1.58	4.57	-0.96	5.14	1.58	4.32	-0.96
1989	7.36	1.4	6.45	0.42	7.36	1.4	6.36	0.42	7.36	1.4	6.26	0.42
1990	5.1	1.73	3.61	1.25	5.1	1.73	3.56	1.25	5.1	1.73	3.51	1.25
1991	5.96	2.38	3.38	2.79	5.96	2.38	3.42	2.79	5.96	2.38	3.46	2.79
1992	8.65	2.66	4.88	4.87	8.65	2.66	5.1	4.87	8.65	2.66	5.33	4.87
1993	8.07	2.27	2.73	8.43	8.07	2.27	3.34	8.43	8.07	2.27	3.96	8.43
1994	8.84	2.22	2.21	11.05	8.84	2.22	3.09	11.05	8.84	2.22	3.97	11.05
1995	9.54	2.26	2.54	11.74	9.54	2.26	3.49	11.74	9.54	2.26	4.43	11.74
1996	9.34	2.21	2.12	12.23	9.34	2.21	3.12	12.23	9.34	2.21	4.12	12.23
1997	8.15	2.17	1.06	12.02	8.15	2.17	2.04	12.02	8.15	2.17	3.03	12.02
1998	5.76	2.14	-1.05	11.49	5.76	2.14	-0.12	11.49	5.76	2.14	0.82	11.49
1999	4.77	2.11	-1.43	10.3	4.77	2.11	-0.61	10.3	4.77	2.11	0.21	10.3
2000	6.79	4.51	-0.38	9.82	6.79	4.51	0.15	9.82	6.79	4.51	0.68	9.82
2001	6.89	2.13	0.66	10.34	6.89	2.13	1.48	10.34	6.89	2.13	2.3	10.34
2002	7.04	2.86	0.22	10.79	7.04	2.86	1.01	10.79	7.04	2.86	1.8	10.79
2003	7.3	2.53	0.62	10.9	7.3	2.53	1.46	10.9	7.3	2.53	2.3	10.9
2004	7.7	2.72	0.86	10.94	7.7	2.72	1.68	10.94	7.7	2.72	2.5	10.94
2005	8.5	2.68	1.56	11.19	8.5	2.68	2.41	11.19	8.5	2.68	3.27	11.19
2006*	8	2.73	1.03	11.21	8	2.73	1.88	11.21	8	2.73	2.73	11.21
Average	6.91	2.28	2.01	7.91	6.91	2.28	2.56	7.91	6.91	2.28	3.12	7.91

Source: Author's calculations, (*) estimation for 2006

Table 6. Contributions (%) of Capital, Labor and TFP
on Growth in Vietnam 1986-2006

Scenario 1: capital-output ratio=2; share of labor=0.5
Scenario 2: capital-output ratio=2; share of labor=0.6
Scenario 3: capital-output ratio=2; share of labor=0.7

	K/Y=2; Share of Labor=0.5			K/Y=2; Share of Labor=0.6			K/Y=2; Share of Labor=0.7		
Year	Kcon	Lcon	TFPcon	Kcon	Lcon	TFPcon	Kcon	Lcon	TFPcon
1986	n/a	24.2	n/a	n/a	29.04	n/a	n/a	19.36	n/a
1987	-37.42	19.12	118.31	-29.94	22.94	107	-22.5	26.8	95.7
1988	-9.3	15.38	93.92	-7.44	18.46	88.98	-5.6	21.5	84.0
1989	2.84	9.53	87.63	2.27	11.43	86.29	1.7	13.3	85.0
1990	12.25	16.96	70.79	9.8	20.35	69.85	7.3	23.7	68.9
1991	23.41	19.97	56.62	18.73	23.97	57.31	14.0	28.0	58.0
1992	28.15	15.37	56.48	22.52	18.44	59.03	16.9	21.5	61.6
1993	52.19	14.03	33.78	41.75	16.84	41.41	31.3	19.6	49.0
1994	62.48	12.53	24.99	49.98	15.04	34.98	37.5	17.5	45.0
1995	61.54	11.85	26.6	49.24	14.23	36.54	36.9	16.6	46.5
1996	65.48	11.83	22.68	52.39	14.2	33.41	39.3	16.6	44.1
1997	73.72	13.31	12.97	58.98	15.97	25.06	44.2	18.6	37.1
1998	99.67	18.6	-18.27	79.73	22.32	-2.05	59.8	26.0	14.2
1999	107.93	22.09	-30.01	86.34	26.5	-12.84	64.8	30.9	4.3
2000	72.34	33.26	-5.6	57.88	39.91	2.21	43.4	46.6	10.0
2001	74.98	15.43	9.59	59.98	18.52	21.5	45.0	21.6	33.4
2002	76.6	20.34	3.06	61.28	24.41	14.31	46.0	28.5	25.6
2003	74.26	17.24	8.5	59.41	20.69	19.9	44.6	24.1	31.3
2004	71.17	17.66	11.17	56.93	21.2	21.87	42.7	24.7	32.6
2005	65.84	15.76	18.4	52.67	18.92	28.41	39.5	22.1	38.4
2006	70.04	17.06	12.9	56.03	20.48	23.5	42.0	23.9	34.1
Average	52.41	17.22	30.72	41.93	20.66	37.83	31.4	24.1	44.9

Source: Author's calculations, (*) estimation for 2006

Table 7. Contribution of Aid on Capital Stock and Growth in Vietnam 1993-2006

Scenario 1: capital-output ratio=2; share of labor=0.5
*Scenario 2: capital-output ratio=2; share of labor=0.6*
Scenario 3: capital-output ratio=2; share of labor=0.7

($US and VND Billion, 1994 constant price)

Year	K (K/Y=2)	Aid ($US Billion)	Aid (1994 VND Billion)	Aid Stock (1994VND Billion	Aid Stock/K (%)	Aid/I (%)	Aid Contribution (%) on Growth of Output		
							Share of Labor		
1986	218378								
1987	212521						0.5	0.6	0.7
1988	210491								
1989	211371								
1990	214013								
1991	219985								
1992	230695								
1993	250135	0.413	4394.73	4394.73	1.76	0.11	0.92	0.73	0.55
1994	277763	0.725	7950.13	12081.18	4.35	17.48	2.72	2.17	1.63
1995	310381	0.737	7382.24	18738.55	6.04	13.91	3.72	2.97	2.23
1996	348348	0.9	8523.04	26137.28	7.50	14.18	4.91	3.93	2.95
1997	390217	1	9719.88	34288.92	8.79	14.85	6.48	5.18	3.89
1998	435055	1.242	12715.17	44946.75	10.33	17.89	10.3	8.24	6.18
1999	479883	1.35	13932.88	56182.83	11.71	19.68	12.64	10.11	7.58
2000	527009	1.65	17576.47	70388.33	13.36	21.69	9.66	7.73	5.80
2001	581501	1.5	16670.04	82835.07	14.25	18.28	10.68	8.54	6.41
2002	644237	1.55	17186.67	95051.63	14.75	16.52	11.3	9.04	6.78
2003	714477	1.41	15219.06	104567.59	14.64	13.38	10.87	8.69	6.52
2004	792658	1.8	18720.30	117013.84	14.76	14.58	10.51	8.4	6.30
2005	881377	1.8	18063.04	128056.05	14.53	12.53	9.57	7.65	5.74
2006	980143	2.2	21685.65	142058.34	14.49	13.63	10.15	8.12	6.09
Average	434792	1.306	13552.81	66910.08	10.80	14.91	8.17	6.54	4.90

Source: Author's calculations, (*) estimation for 2006

Figure 2. Contribution of Foreign Aid as Percentage on Growth of Output in Vietnam 1993-2006#
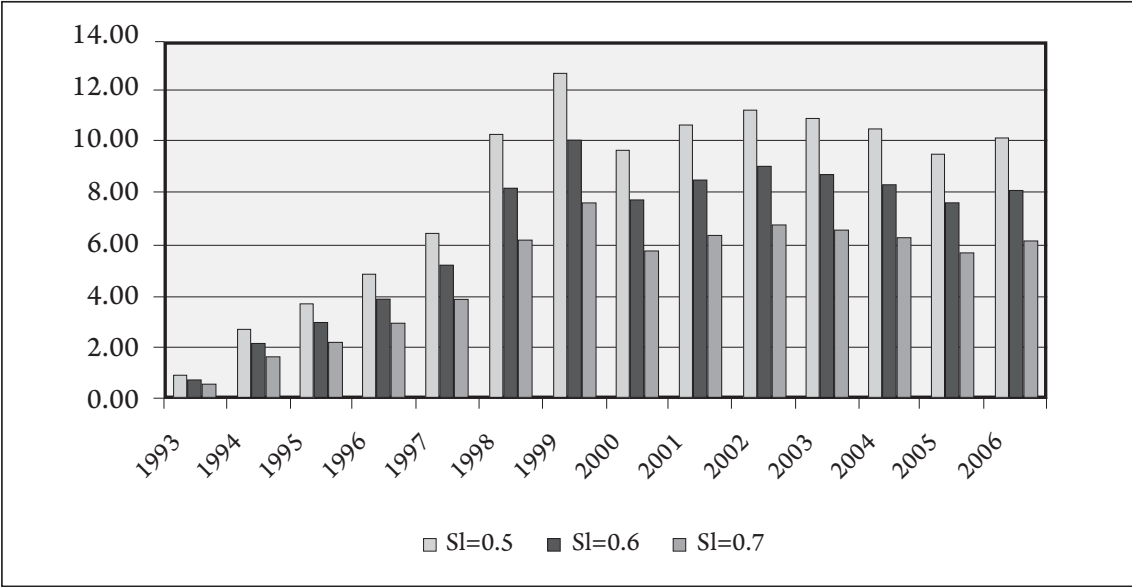
This estimation shows that aid is one of contributors to growth of output, among labor, capital, and TFP

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THE ROADMAP FOR ODA MOBILIZATION AND UTILIZATION IN VIETNAM

Le Quoc Hoi

Abstract

Since the reconnection with international financing institutions in 1993, Vietnam has attracted a large amount of ODA and ODA has significantly contributed to infrastructure construction, poverty reduction, institutional reform, economic growth and socio-economic development. However, improving the efficiency of ODA use is attracting attention not only from beneficiaries and management institutions, but also from donors and policy makers. This paper examines the situation of ODA mobilization and utilization in the period of 1993-2007 and provides roadmap and policy measures to enhance the effectiveness of ODA in Vietnam.

1. Current situation of ODA mobilization and utilization

Vietnam has become an attractive destination for ODA on social and economic as well as political and strategic grounds since 1993. Figure 1 indicates that the flow of ODA is trending upward, but it is not always growing. The decline in commitments in 1997 and 1998 was a reflection of the Asian financial crisis. During 1993-2007, Vietnam achieved significant results in ODA mobilization and utilization. A total of 37 billion USD was pledged to Vietnam by international donors, accounting for around 2% of global ODA. Of these pledges, 22.6 billion USD was translated into formal agreements. On average, Vietnam has attracted 2.5 billion USD per year.

Figure 1. Commitments and Disbursements of ODA 1993-2007
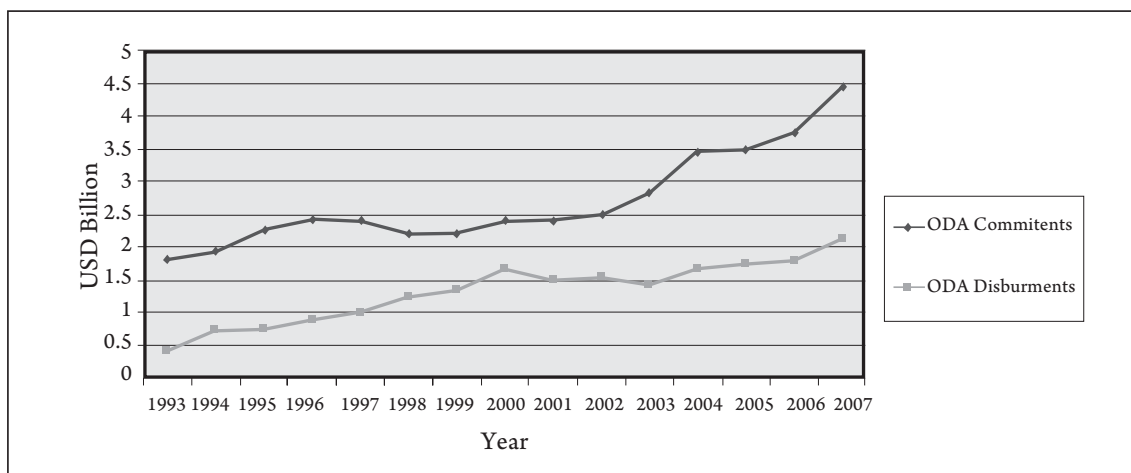
Source: MPI

As illustrated in figure 1, ODA disbursements increased more than four times between 1993 and 2007. Most of the long-term increase in disbursements is accounted for by loans rather than grants. Almost half (49%) of the loans affected by international treaties have interest rates lower than 1% per annum and a maturity of at least 30 years, of which 10 years is a grace period. Another third of the loans have a rate of interest between 1% and 2.5% per annum (MPI, 2007). Moreover, the large share of loans in ODA should be considered in the context of Vietnam's limited external indebtedness. The country's total convertible currency debt was 37% of GDP in 2007 (MPI, 2007), so it would appear that there is no imminent danger of a debt crisis in Vietnam.

With the upward trend in the amount of ODA, Vietnam has undertaken multiple relations with international donors. Up to now, 28 bilateral donors and 12 multilateral donors have provided ODA to Vietnam. Besides, more than 350 NGOs operating in Vietnam also provided an average grant of 100 million USD per year. Among the donors, 3 largest donors are Japan, WB and ADB, accounting for more than 70% of ODA commitments from 1996 to 2006, of which Japan accounted for more than 40%.

Table 1. ODA Commitments of top 10 donors from 1993 to 2006

Donor	ODA Commitments (million USD)	(%)
Japan	8.469,73	42,9
WB	5.329,82	26,61
ADB	2.900,97	14,49
France	912,26	4,56
Germany	597,35	2,98
Denmark	549,48	2,74
Sweden	412,83	2,06
China	301,08	1,50
Australia	282,32	1,41
EU	269,83	1,35

Source: MPI

ODA has been dominated by capital investment projects (41%), but with a substantial volume of technical assistance (23%) and free-standing assistance (20%). Only 13% of disbursements in 2005 were for programme aid and balance of payment support (see Figure 2).

Figure 2. ODA Disbursement by Type – 2005
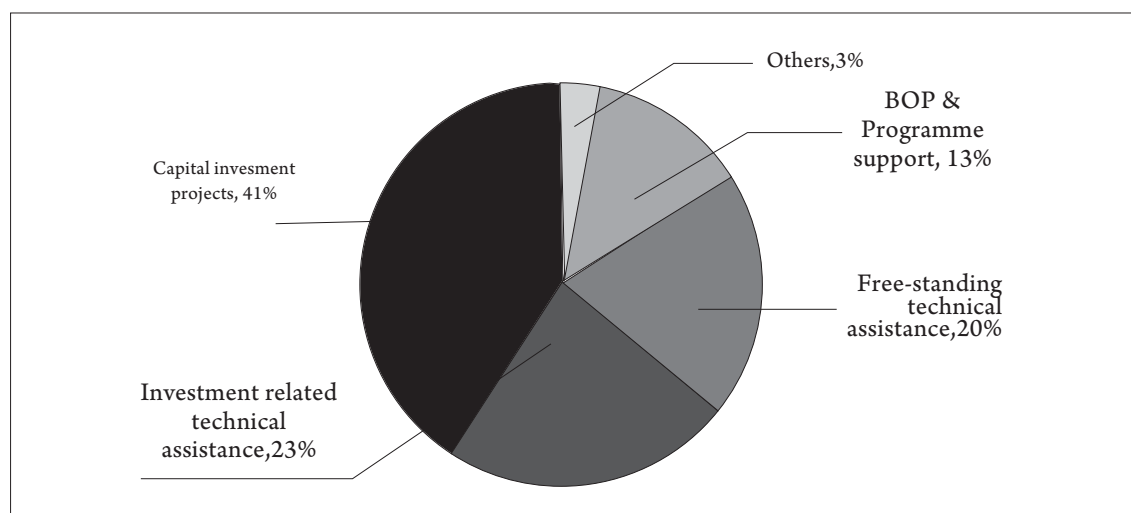
Source: MPI

ODA funds have mostly been allocated in accordance with the priority that the government places on economic sectors. The predominance of project ODA is commensurate with the sectoral focus shown in Figure 3. Transportation, telecommunication, energy and industries, with their scope for large infrastructure projects, are the largest sectors (42%), followed by agriculture, natural resources and rural development (21%), and with much less ODA allocated to education, training, health care, environment and technology (12%). All the other sectors received about 18% of disbursed ODA.

In terms of regional structure of ODA, the North Central region, the South Central Coast and the main economic region of the Central account for the largest share in total ODA (31.22%), followed by the South East region and the main economic region of the South (30.86%). ODA in the Central Highlands and the Mekong Delta account for small proportion of total ODA, with 3.7% and 7.44% respectively. The North Central region and the South Central Coast had the highest ODA per capita (52.46 USD), followed by the North Mountain region (33.98 USD), the South East region (25.4 USD), and the Central Highlands (21.89 USD). Two regions with the lowest ODA per capita are the Mekong Delta (11.19 USD) and the Red River Delta (18.42 USD).
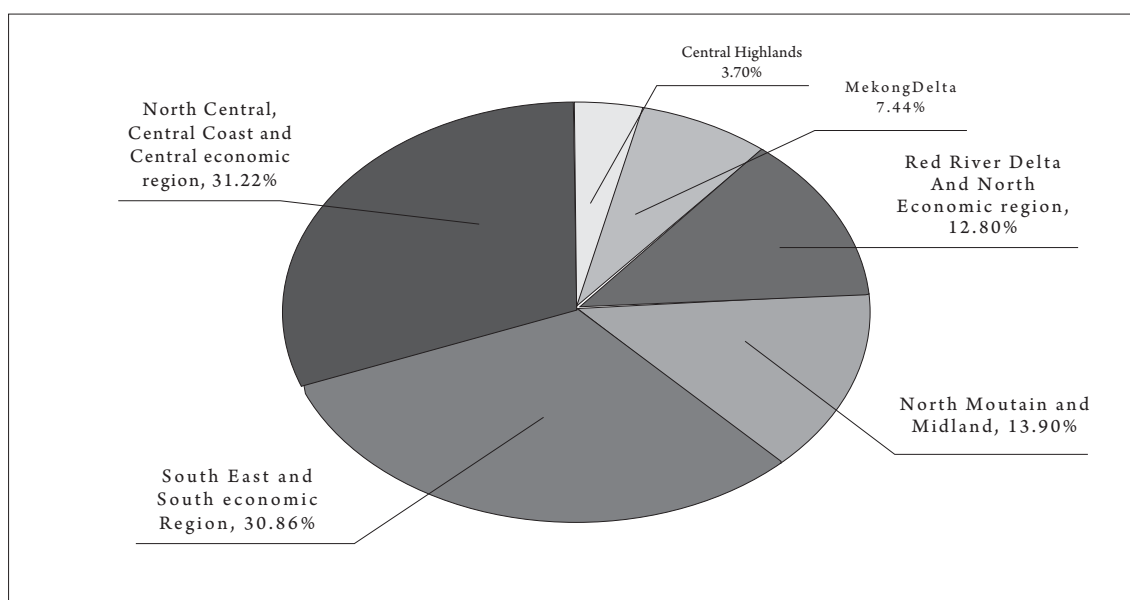
Figure 3. Sectoral Composition of ODA Disbursements, 2001-2005
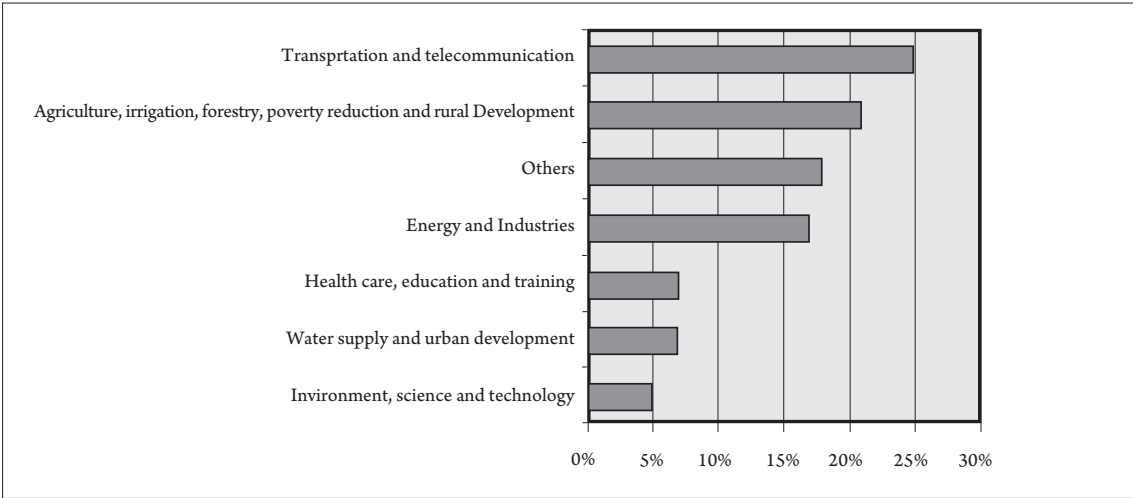
Source: MPI

ODA has provided a significant investment source for social-economic development. In the 2001-2005 period, ODA accounted for about 11.2% of total investments and 17% of total government budgets. Thanks to ODA funds, development has been made in many aspects of the economy. Infrastructure of Vietnam has been improved in terms of quantity and quality, creating favorable

Figure 4. ODA commitments by region, 2001-2005

Central Highlands 3.70%

MekongDelta 7.44%

North Central, Central Coast and Central economic region, 31.22%

Red River Delta And North Economic region, 12.80%

North Moutain and Midland, 13.90%

South East and South economic Region, 30.86%

Source: MPI

Table 2. ODA disbursement in total invetsment

Unit: million USD

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
GDP	24654	26791	27186	28674	31132	32473	35028	39530	45436	52893	60877
Total investment	7920	9257	8820	9404	10657	11503	13085	15417	18479	21627	24937
ODA disbursement	900	1000	1242	1350	1650	1500	1528	1422	1650	1752	1785
ODA disbursement / total investment (%)	11.3	10.8	14.1	14.3	15.4	13.0	11.6	9.2	8.9	8.1	7.2
ODA disbursement / GDP (%)	3.65	3.73	4.56	4.58	4.55	4.61	4.36	3.59	3.63	3.31	3.0

Source: Author calculates using data from MPI and GSO

conditions for improving the effectiveness of domestic investment and FDI attraction. Moreover, ODA has also contributed to poverty reduction, human resources development, transfer of technical, managerial and institutional experiences, and institutional capacity.

One question that needs to be answered is: why has Vietnam attracted so much ODA in recent years? There are several main answers to this question. First, Vietnam has had stable political conditions and comprehensive social and economic reform which led Vietnam to become one of the aid community's favorite countries. Second, Vietnam has benefited from its impressive track record

of rapid growth and poverty reduction at a time when aid doctrines focus more explicitly on poverty reduction and there is more willingness to concentrate aid on those countries that seem to use it well. Third, the active integration into the global and regional economy, the dynamism of the economic and administrative reform process, and the Vietnamese government's willingness to engage with donors have reinforced donor enthusiasm.

From recipient perspectives, ODA is considered as a real resource if it is effectively combined with other domestic resources in order to achieve national targets in certain periods. From donor perspectives, ODA becomes a real aid if it is transferred to recipients to create directly or indirectly conditions for development. From both perspectives on ODA and its impacts, it can be stated that ODA in Vietnam has been a real aid in the renovation (Đoi moi) process. However, besides the success in ODA mobilization and utilization, there are still many issues that Vietnam has to solve in order to use this important resource more effectively in the future.

2. Current issues of ODA

The efficiency of ODA use

Improving the efficiency of ODA use is one of the most important issues that Vietnam has to address. One of the main reasons of the inefficiency of ODA is that awareness and understanding about the nature of ODA have not always been accurate and complete in the process of mobilization and utilization. Perceptions are made that ODA grant is free and the burden for repayment of ODA loans is with the government. This incorrect perception has led to inefficiency in the implementation of ODA projects and programs. In fact, although most ODA is in the form of concessional foreign loans with low interest rates, long payment periods and grace periods, ODA is not free and therefore using ODA is a trade-off. If ODA is not used effectively, the burden for ODA repayment will be increased. On the other hand, the combination of ODA funds and other investments is still weak, which therefore reduces the efficiency of ODA utilization.

Slow disbursement

The rate of ODA disbursement is still slow. From 1993 to 2006, ODA disbursement is 15.9 billions USD, accounting for only 42.9% of total ODA agreements (37 billion USD). As shown in Figure 1, on average the ODA disbursement rate has been about 50% in recent years. The low disbursement rate has been combined with the slow speech of disbursement, and has meet

about 70-80% of the requirement of planed ODA disbursement. There has been a difference in ODA disbursement among donors and the type of project. ODA projects related technical assistance often had high disbursement rate. Slow disbursement is mainly in construction projects due to the time consuming for preparation activities such as land compensation, emigration or resettlement.

The average rate of ODA disbursement in Vietnam is also lower than the disbursement rate of other ASEAN countries (see Table 3). ODA as a proportion of GDP in Vietnam ranges from 3.5% to 4.5%, lower than some countries with the same economic development[1]. Vietnam needs to exert more effort to push up the disbursement rate because in comparison with the increasing total commitments each year, the result is far from the expectation. As forecasted by some ADB experts, if Vietnam improved its ODA disbursement rate, the country's growth rate of GDP would be raised from the current 8-8.4% to close to 9% and the country might achieve middle-income status by 2009, earlier than its target of 2010.

There are several reasons to explain why ODA program and project implementation was delayed. First, very often it took a long time for ODA projects and programs to get off the ground. About 50% of ODA sources in Vietnam go to infrastructure projects, which need more time to be implemented and even take three or five years longer to finish than projects in other sectors, thus also leading to slow disbursement. Other developing countries, for example those in Africa, used only one-third of ODA for infrastructure projects and had higher disbursement rate. Second, the ability of Vietnamese personnel to manage

Table 3. The rate of ODA disbursement in Vietnam and other ASEAN countries[2] 2001-2005

Donors	The average rate of ODA disbursement in other ASEAN countries	The average rate of ODA disbursement in Vietnam
WB	18 % per year	15 % per year
ADB	20 % per year	18 % per year
Japan (JBIC)	15 % per year	9.3 % per year

Source: MPI

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[1] See Vietnam Economic Times (2006)

[2] ASEAN countries in this table include Thailand, Malaysia, Indonesia and Philippine.

ODA projects and programs, particularly when it came to local government involvement, was disappointing. Third, existing investment and construction, bidding, management and ODA utilization laws are inconsistent and are inconsistently interpreted. Furthermore, the difference in manner between Vietnamese personnel and international donor implementation of projects was oftentimes great and this hindered project implementation. At a recent Vietnam Donors' Consultative Group Meeting (2007), Vietnam's donors said that ODA disbursement would improve markedly if there was some harmony in the way the Vietnamese government and international donors chose to function.

ODA management, monitoring and evaluation

ODA management has been undertaken by a supervising mechanism from both the Vietnamese side and donor side. However, due to the non-transparency and conditions, management organizations did not have full making decision. In fact, management organizations mainly focus on how to attract as much as ODA with easy conditions, but the implementation, management and evaluation of project efficiency are confided to investors with project management committee on behalf. Besides, investors and project management committee lack experience and evaluation capacity in ODA implementation. Therefore, ODA monitoring is mainly on report of progress and disbursement situation to serve leaders and donors.

Institutional arrangements and human capacity

Institutional arrangements and human capacity for the management and implementation of ODA are still weak and have not yet met the requirements for improved ODA effectiveness. The recent leakage and corruption in PMU 18 and in big projects of Petrolimex are examples of the weak ODA management and monitoring. According to a survey by CIEM and JICA (2003), most participants in the ODA delivery process expressed the view that internal Vietnamese procedures for project appraisal and approval of new projects were complicated and generally not harmonized with donors' practices. A government decree aimed at redressing this problem was seen by many as having so far been insufficiently implemented. A remaining challenge is to ensure transparency and accountability of aid management on the Vietnamese side.

Decentralization

Decentralized organizational structures for the management and utilization of ODA have been implemented and have achieved significant improvements, such as the expansion of ODA beneficiaries and the respect of leadership and ownership of local governments. However, the decentralization of ODA has not

met the requirements of the reform in public resources management. Decentralized policy in ODA management and utilization is not consistent between the central and local governments. Limited capacity of the local government staff in project management and language skills is a factor hindering the ODA decentralization and the effectiveness of many ODA projects. Poor coordination between the central government and the local government, between the government and donors leads to delays in various steps of project design and implementation. This is the kind of situation that can easily lead to waste and inefficiencies. In order to improve ODA effectiveness, a greater investment in capacity building in local administration and management will be necessary.

Repayment

Repayment prospect of ODA is an issue that Vietnam needs to be concerned with from now on. In Vietnam, the focus of ODA mobilization has been mainly on attracting as much ODA with easy conditions as possible, but the aspect of repayment resources and capacity has not been paid much attention. According to data from MPI, the total debt of Vietnam is currently around 22 billions USD and accounts for 37% of GDP. With the safe level of 40% of GDP advised by IMF, the remaining loan capacity of Vietnam is not much. Therefore, Vietnam needs to consider the source of repayment, and the effective use of ODA becomes more important for ODA repayment.

Table 4. Total convertible debt of Vietnam

	2000	2001	2002	2003	2004	2005	2006
Total debt (billion USD)	11.8	11.9	11.8	13.3	16.7	18.9	22.2
As % GDP	39	37.4	34	34	36.8	35.8	36.6

Source: MPI

The use of ODA with the regional, sectoral and national development approach

The use of ODA is still not fully consistent with the regional development approach with large infrastructure as core. Since infrastructure development was one of the top priorities in the Vietnamese development plan, the largest amount of ODA has been allocated in this area. However, many of the approved ODA are behind schedule and have not been completed yet due to various causes. Given the fact that domestic private participation in the infrastructure sector has been negligible, ODA should not only focus more extensively on infrastructure, but

should also be based on long term economic strategy, especially regional and national development strategy.

3. The roadmap for future ODA mobilization and utilization

In the 2008-2010 period, the direction for ODA is to continue utilizing funds with attention made to ODA effectiveness and payment capacity. The focus of this period is to accelerate the disbursement of signed ODA projects and programs in order to put their outputs into operation and enhance ODA effectiveness. In order to ensure aid effectiveness, ODA projects and programs should be utilized based on the national, local and sector socio-development plans. Beneficiaries should also mainstream ODA projects and programs in their socio-economic plans. The following priorities in ODA utilization should be given for ODA projects and programs in this period: agriculture and rural development; economic infrastructure development toward a standardized and modern approach; social infrastructure development; environment and natural resources protection; institutional capacity and human resources development; and technology transfer, research and development capacity building. In addition, Vietnam will need to prepare effective and high quality projects that continue after 2010.

In the coming years, the demand for infrastructure development will still be large to support the continuous increase in expected industry production. In addition, the internal rates of return from road, bridge and power generating projects have been so high that further allocation of funds into this area is justified. The Vietnamese government has the objective of having the industry sector absorb a larger portion of the labour force and of decreasing the ratio of population in the agricultural sector significantly. According to this economic structural change, a strategic approach to ODA is necessary. On the one hand, the infrastructure development, especially transportation, telecommunication and electric power sectors, is assigned one of the top priorities. Therefore, Vietnam should continue to use and attract ODA to these sectors. On the other hand, ODA should be allocated to prioritized areas, especially poor and difficult areas. The priority use of ODA in infrastructure and prioritized areas is necessary to maintain sustainable economic growth and to reduce poverty.

See Vietnam Economic Times (2006)

Vietnam is moving to commercial loans after 2010. According to international practices, a developing country classified as having middle-income status (GDP per capita of over 1,000 USD) receives less preferential ODA funding sources. By 2010, GDP per capita of Vietnam is planned to reach 1,050 USD. When that time arrives, donors will likely wish to raise the ODA amount they would wish to loan to Vietnam. In the meantime, Vietnam needs to make better use of the ODA loan capital it is now receiving. On the other hand, as Vietnam becomes a country in which more people are living with medium level incomes, new problems arise. In fact, in some countries such as the Philippines or Sri Lanka no improvements were seen after medium income levels were attained. Therefore, Vietnam should not follow in their footsteps. Instead, Vietnam needs to follow through with its own strategic framework, particularly regarding mobilization and utilization reforms. Capacity building for future needs is also of paramount importance, particularly institutional and human capacity.

When Vietnam becomes a middle-income economy, the proportion of concessional ODA will be reduced, and ODA with conditions closer to commercial loans will become more common. Therefore, it is necessary to build an active plan for reducing ODA loans after 2010. In addition, the experience of using commercial loans needs to be examined in order to prepare for effective mobilization and utilization of these sources of funds after 2010. To utilize those sources of funds, appropriate directions for using ODA are necessary. In particular, while ODA loans with concessional conditions should primarily be used for construction of national socio-economic infrastructure, ODA loans with less favorable conditions should be utilized for sectors and areas with high financial returns and sustainable debt capacity.

As the structure of ODA will be changed and ODA can be delivered through a variety of modalities, the use of a particular modality should be based on the specific requirements of the development challenge to ensure aid effectiveness. Moreover, Vietnam will need to promote the application of new aid modalities such as approaches based on program, sector and budget support. These new modalities will strengthen government ownership, reduce transaction costs, enhance harmonization between government and donors, and accelerate disbursement of ODA projects.

4. Policy measures

The rationale for a continuation of ODA to Vietnam remains strong. In order to use this important resource more effectively in the future, Vietnam should implement the following policy measures.

First, *enhance the awareness and understanding on the nature of ODA*. ODA should be considered as a catalyst, rather than a substitute for domestic resources for development at all levels of beneficiaries. It is also important to improve ownership in the mobilization and utilization of ODA to serve social-economic development of the nation, sectors and localities and to encourage effective use of ODA.

Second, *use ODA selectively*. It is important that ODA is used selectively and in appropriate combination with other investment resources. In fact, the major policy debates are no longer on whether or not to allow ODA, but how to maximize the benefits of ODA for the country. Therefore, the quality of ODA mobilization is more important than the quantity of ODA. This means that using ODA needs to take into consideration socio-economic factors and carefully assess benefits from transfer of capital resources, knowledge, technology, management skills and international experience.

Third, *speed up ODA disbursement*. The demand to increase the speed of ODA implementation is the responsibility of both the Vietnamese government and donor community. From the Vietnamese side, the government should simplify ODA rules and procedures. From the donor side, harmonization and simplification of aid procedures with the Vietnamese government are also needed to ensure effective implementation progress. As said by WB country director Ajay Chhibber at the Vietnam Consultative Group Meeting (2007) "It is also common for the donor community to look at Vietnamese system and not always insist on using their own system for project implementation".

Fourth, *maximize the effectiveness and widespread impacts of ODA*. The mobilization and utilization of ODA must be based on benefit-cost analysis of projects and programs to ensure that these projects and programs have high effectiveness and maximum widespread impacts which contribute to economic development. It is important that ODA should not be to spread too thinly, resulting in an unsustainable foreign debt burden for the country. The effectiveness of ODA must be put in relation with economic growth and sustainable development. Moreover, national, sector and regional social-economic development strategies and master plans must be taken into account in order to enhance the effectiveness of ODA.

Fifth, *extend the beneficiaries of ODA to private sectors for projects and programs that serve public interests*. The broad participation of beneficiaries is an important way to ensure that the right interventions are selected, that ODA funds are used in an accountable, transparent and effective manner, and that the waste, leakages and corruption are prevented.

Sixth, *build an appropriate plan for ODA decentralization*. The decentralization in ODA management and utilization is an inevitable and common trend in the world and in Vietnam as well. The point is that Vietnam should consider which level of ODA decentralization is suitable and which ODA projects are decentralized. From this perspective, experiences of ODA decentralization, which has been carried out, need to be examined. A criteria system for ODA decentralization which includes the duration and costs of projects, the capacity of ODA management and the effectiveness of projects, also needs to be developed.

Seventh, *strengthen the monitoring and management of ODA*. This includes: (i) ensuring the consistency, clarity, simplicity and transparency of the legal system on ODA management and utilization, (ii) reinforcing the government's anti-corruption efforts, (iii) accelerating administrative reforms and the effectiveness of state administration, (iv) enhancing professional training and retraining for project management officers, (v) improving financial policies for ODA which include implementing foreign debt management strategy and ensuring clear and transparent tax policies for ODA projects and programs; (vi) strengthening the management of ODA according to the Law on state budgets.

Eighth, *build plans to reduce ODA loans with short payment period and strict conditions*. Experiences from some Asian countries such as ASEAN and China show that the quantity of ODA mobilization necessary in a certain period depends on the level of economic development in that period. ODA is likely to decrease in ASEAN in both quantity and in per capita terms. Vietnam should begin to study plans and strategies to reduce ODA gradually, especially ODA with conditions, while attracting other foreign investments such as FDI. In doing so, Vietnam not only maintains an increase in total investments, but also improves the efficiency of all types of investments, including ODA.

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EQUITIZATION IN VIETNAM: CORPORATE GOVERNANCE PERSPECTIVE

Quach Manh Hao

Abstract

This paper reviews related literature on the firm and its corporate governance with a view towards making recommendations on the ex-post equitization process in Vietnam. The paper argues that creating sound corporate governance practices is now becoming a more and more important issue alongside with equitization process. The state (through its SCIC) must consider itself as a large investor to make the equitization process achieve its overall goal of enhancing firm efficiency.

1. Introduction

Vietnam aims at achieving most of the State Owned Enterprises (SOEs) being equitized by 2010. The pilot scheme was launched in 1992 based on a resolution of the tenth session of the Eighth National Assembly and the Prime Minister Decision 202-CT on equitization programs on 8 June 1992. The decision allows small - medium size and profitable but not strategic SOEs to be equitized. The decisions also regulates that the employees of the equitized firms should have the first right to buy the shares. The pilot scheme was very cautious, with only 5 SOEs were equitized during 1992-1996 (see Truong et al, 2006).

On a notable move, in 1994, the government established 18 general corporations and 64 special corporations which were large conglomerates incorporating SOEs operating in various strategic industries and areas. These general and special corporations consisted of around 2,000 of the 6,300 SOEs at the end of 1994 and accounted for about half of the SOE sector's employment (see Sjo-

holm, 2006).

The pilot scheme was extended in 1996, with the issuance of the Decree 28-CP in May 1996 to end the pilot stage and open the new stage for equitization. The decree maintained general principles of the pilot program and allowed the transformation of all small - medium size and non-strategic SOEs into joint-stock firms. This decree required SOEs' controlling agencies (ministries, people's committees and state corporations) to select enterprises for equitization. However, the process was also slow, with only 25 firms added to the list of equitized firms (Truong et al 2006) from 1996 to 1998, of which there were 18 SOEs being equitized as late as in early 1998 (MPDF, 1998).

The speed of equitization however has been accelerated since the opening of the Vietnam Stock Exchange in Ho Chi Minh City in 2000. As of February 2008, there were around 4,000 firms having being equitized, in which 3,400 had been equitized since 2000. Most of them however were small and medium size. Some of large SOEs were scheduled to be equitized in 2007 but the process was seen slower for some reasons, including the gradualism by the government resulting from concerns with the oversupply in the stock market.

As planned previously, there would be around 1,500 SOEs being equitized from 2007 to 2010, in which most of the subsidiaries of general corporations should be equitized in 2008. By the year 2010, there would be 554 SOEs left, including 26 general and special corporations; 178 enterprises in the field of defense, national security; and some other essential subsidiary SOEs. However, the 2007 saw only 2-3 big names (e.g. Bao Viet Insurance, Vietcombank) out of 20 being equitized as initial planning, meaning that now most of them are planned to be implemented in the next two years.

On the exchanges, the number of listed firms is now around 250 with a total market capitalization of around 30-40% of the GDP. This is a significant increase if we know that by the end of 2006, the capitalization was estimated at only 20% of the GDP. The increasing number of listed firms and the proportion of capitalization on one hand shows a greater public attention to the equitization process and equity market, on the other hand indicates that Vienam has experiencing a bubble emergence which requires appropriate sterilized intervention and improved legislative infrastructure.

At this very recent time, debates on equitization in Vietnam have focused on the analysis of whether or not the equitization process should be initiated as planning. Especially, the continuous correction in 2007 and early 2008 has brought the government into a situation where they have to make a hard choice: to ensure commitment on equitization plan or to sell the state assets at the so-called

"cheap" prices. We are not proposing a discussion on what is "cheap", but remind that the example of VCB offering is still alive, indicating that it's not easy to manipulate the market forces.

The equitization process in Vietnam is now in its final stage but the road ahead is not easy to go. It's because the general economic conditions are not in a good shape, if not being worse, for big name public offerings. The government is suffering an increasing high inflation while the whole economy is exposing to liquidity crisis. In the meantime, there has not been a well coordinated effort between fiscal policies and monetary policies. Monetary tightening policies seem not to be the right tools because they do not solve the roots of inflation: inefficient public investments and especially the overinvestment and diversification by large SOEs. As a result, "we see pressures on banks for liquidity, pressures on households for high inflation and pressures on businesses for working capital, but we may not get the air out of the asset bubble"[1]. All of these clearly are a difficulty test for the government's commitment.

Neither this paper aims at adding any views on the equitization process with respect to the planning commitments, as many others do, nor on the "whys and hows" of the equitization process. Instead, this paper looks at the ex-post equitization issues as keys to ensure the success of equitization. The ex-post equitization here however is implied at firm level, but some implications may be drawn at policy maker level. Our view is simple that, when a firm is equitized, it enters into a new lifecycle, and thus, finding the right mechanism for it to operate in a new lifecycle is more important than bringing it into. The paper proposes that equitization is not sufficient for achieving efficiency. It requires improved corporate governance practices alongside with.

The paper is organized as follows. The next section discusses the firm and its efficiency, which argues that the firm can attain efficiency through market mechanism. It then discusses the role of equity market as the source of success for equitization process. Specifically, it supposes that the key issue to the firm is its corporate governance, and the equity market would help enforce corporate governance practices. The corporate governance section analyzes the sources of conflicts of interest within the firm and suggests the possible solutions to those conflicts. The conclusion section then summarizes the key points of the paper.

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[1] Jonathan Pincus, chief economist at UNDP Vietnam, Financial Times on 3 Mar 2008.

2. The firm and its efficiency

It's commonly argued that the overall goal of equitization is to create efficiency at firm level. Although the term efficiency is used broadly, we simply imply that the best economic performance by the firm. In Vietnam, the SOEs do not face disciplinary effects of the market and the threat of takeover. Besides, the owners often fail to discipline the firm, partly because most decisions are based on negotiations, and objectives are rightly defined. As a result, SOEs are normally seen less efficient than other firms. Recent studies show the growing role of private and FDI sectors in term of contribution to GDP in Vietnam, while the SOEs sector still dominates the economy[2].

The lack of managerial incentives and no effective monitoring are the reasons for the old-fashion of SOEs. From our point of views, managerial incentives are weak if managers are appointed on the basis of political decisions rather than of professional capacity and if salaries and job security are not related to economic performance. These, unfortunately, are the common practices in most of SOEs. Besides, the objectives of SOEs are often defined by politicians, and in many case, have multiple objectives which cause performance hard to be monitored, if monitoring indeed exists. Furthermore, for big SOEs such as general and special corporations, they almost do not face any competition and have enough market power to set their own prices, and thus their performance tells nothing about efficiency[3].

Equitization in general and of the SOEs in particular therefore is expected to increase the firm efficiency, creating a new face for the economy. Indeed, there have been several reports on the improved performance by the equitized firms. The report by Enterprise Innovation Unit (Ban Doi moi Doanh nghiep) affirms that equitization process has positively affected the equitized firms' performance in terms of managerial efforts and capacity. According to this report, 96% of the equitized firms reported increased effort by managers; 88% reported increased working capacity as performance based bonus was applied. These results however are based on the reportings from the equitized firms and really need further verification.

A recent study by Truong et al (2006) may provide a good reference for the effectiveness of the equitization process in Vietnam. This study estimates the impact of equitization on the firm performance in Vietnam by comparing the pre- and post-equitization financial and operating performance of 121 former SOEs.

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[2] Report by Vietnam Program, Kennedy School of Government, Harvard University, 2008.

[3] The case of EVN can be an example.

They indeed find significant increases in profitability, sales revenues, efficiency and employee income, which are associated with equitization event. Their study also emphasizes that firm size, residual state ownership, corporate governance and stock market listing are key determinants of performance improvements

Given these positive results, it's necessary to note that the improved efficiency is not automatically created through the equitization process itself, but through the market mechanism. The common view is that equitization brings firms to the public, enabling efficiency to be achieved through increased monitoring. Failing to understand this will cause serious failure in achieving the overall goal. Our intuition is that, firm ownership restructuring is the necessary condition for enhancing efficiency, but the sufficient condition is the managerial enforcement. These two conditions are practiced and testified in the equity market. Hence, in our views, the equity market plays an important role which decides how efficiency can be achieved.

3. The equity market

Basically, an equity market serves for at least three key functions: (i) financing firms' investments, (ii) improving firms' corporate governance and performance; and (iii) signaling information regarding issuers to public investors through stock prices. It's documented in Greenwald and Stiglitz (1998) that, by issuing equity, firms do not have to face the burden of financial obligation (like with debts) in the state of recession, and thus this enables long term investment and growth. This can be seen as a risk sharing mechanism between the firm and the investors. Levine (2000) adds that, liquid market would also encouraging investors to put more money in equities than in debts.

The role of equity market in developing countries is also seen from the lack of alternative financing options. Due to asymmetric information problem and limited collateral, firms normally find it difficult to raise funds through debt markets, such and bank loans and bonds, and thus they rely largely on equity as the only source of finance. Hence, from the investor's point of view, with equity investments, they can claim unlimited gains while risk is limited to the initial investments. The equity market is also helps venture capitalist through IPO process.

Levine (2000) also argues that well functioning equity markets may help to strengthen accounting, auditing and disclosure system that are applicable to issuing firms and thus stimulate standardization of information. Stiglizt (1985) adds another view on this, arguing that the availability of information to investors at large would lead to the emergence of a large number of information producing

firms, which sells their information at reasonable cost and thus reduce the cost of information for the investors as a whole.

Furthermore, the equity markets provide an alternative tool for corporate governance through the use of shareholders' monitoring devices as well as market for corporate control where badly managed firms can be bought, replaced the management and make capital gains (Allen and Gale, 2000). The urge for a market based monitoring system is critically important as we observed the collapse of Asian financial market in 1997, which was based mainly on relationship monitoring system (Shirai, 2004).

Given the above findings, it's clear that developing a sound equity market is a condition for the success of equitization. The role of financing firms' investments can be achieved only if the equity market creates enough liquidity and reduces policy risks. In the case of Vietnam, such conditions as the T+3 settlements have been seen as constraints to liquidity, which increase risks to investors, especially under chaotic conditions. Besides, there is no framework for the unlisted - equitized firms, causing serious concerns over the liquidity. The equity market can also improve the corporate governance of the firms if there is a framework for monitoring and disclosure. Perhaps individual investors may not have enough incentives, but the listed firms should be regulated to provide information about performance for the shareholders in time. Such information as the updated financial statements, firm profiles should be posted and updated on the website of the stock exchanges, at least. The role of signaling can be achieved if the first two roles are strengthened. If more information is available to the public, investors may act appropriately. If their actions can be implemented as quickly as they expect, information could eventually result in the correction in prices. Only then, the changes in prices could signal the performance, or the efficiency, of the listed firms in an appropriate way. Otherwise, we would see a stock market with no fundamental effect and insider trading would cause serious concerns with the investors' confidence and fall of the stock market as consequences. Perhaps, a Chinese lesson can be learnt in this case.

4. Chinese lesson

A good lesson learnt from the equitization in China can be seen from an empirical study by Shirai (2004). Briefly, equitization process of SOEs in China started in early 1990s with an initial focus on small SOEs. Since 1998, the process continued with increasing larger firms and with increasing speed. In 1996, there was around 114,000 SOEs, in 2003, this figure was around 34,000 (Garnaut et al., 2005). The state ownership in the overall economy declined from around 41 per-

cent in 1998 to around 34 percent in 2003 (Garnaut et al., 2005). By 2005, there were around 1,400 large SOEs listed and their market capitalization amounted to about 40 percent of GDP (Garnaut et al, 2005).

One of the notable features of ownership structure in China is that individuals can own only one-third of the publicly listed form SOEs. The two-thirds remained owned by the state or the institutions which are also state-owned. The shares of the SOEs are also classified into different groups, in which A-shares are owned and traded only by Chinese while B-shares listed in Shanghai and Shenzen are owned and traded only by foreigners. Oversea listings, including H-shares in Hong Kong and N-shares in New York are also restricted to foreign investors. With this classification, it's hard to measure the performance of the equitized firms (Megginson and Netter 2001).

The empirical findings do not favour the success of the equitization in China. Shirai (2004) finds that, the equity market in China has contributed little to financing firms' investment, while there was a significant positive impact of loan finance. These results imply that the issuers increasingly use newly raised funds from the equity markets for nonproductive purposes, such as repaying debt, purchasing other firms, supplementing working capital, etc. In addition, public investors hold stocks for only short-term gains, making stock prices volatile and equity an unstable source of external finance for investment.

Shirai (2004) also finds that firms whose state ownership is in the range of 41-60% tend to produce lower profitability, probably due to asset stripping by managers or officials in charge of them. These results indicate that the government urgently needs to introduce measures to cease such practices before promoting further privatization. This finding is crucial because it shows the effect of the large state ownership in the firms. Besides, Shirai suggests that the performance of B-share and H-share firms was inferior to that of the A-share firms. This can be understood as the result of reported accounting manipulation practices frequently performed in the A-share market and the inability of foreign investors to monitor the firms in the absence of well-defined minority shareholders' rights.

More interestingly, Shirai shows that public listing has not helped firms to improve their performance. This could imply that the role of corporate governance indeed should be strengthened. The solution is that the government should allow more firms to be listed in the domestic exchanges, which increase competitive, transparently-managed firms and encourage existing listed firms to improve their corporate governance, which would in turn encourage investors to holder the stock longer. Given the above findings, we suppose that to ensure the success of equitization, we need to improve the corporate governance.

5. Corporate governance

It can be argued that, the nature of equitization process is changing the corporate governance. However, the role of corporate governance is not only at the time of change, but also ex-post. In other words, equitization process restructures the firm ownership, but the corporate governance will control the new structure in the way that increases firm's efficiency. Corporate governance however is not as simple as the firm's charter or regulation - it's all about how to control the conflicts of interest among parties within the firm. Hence, the firm owners should, at the first stage, identify the potential conflicts of interest within their firm. Our discussion below follows a framework by McColgan (2001).

The conflicts

The conflicts in the firm are subjects of corporate governance. Conflicts are understood to derive from the existence of asymmetric information between parties in a firm, say shareholders, debtors and managers. In the seminal framework by Jensen and Meckling (1976), they discuss these conflicts of interest as the theory of the firm, in the sense that it is what a firm should do to get developed. The conflicts of interest eventually incur costs, which ultimately reduce the firm efficiency. These costs are mentioned largely in the literature as agency costs or agency problems.

Jensen and Meckling (1976) define agency relationship as that one party (principal) engages another party (agent) to perform some service on their behalf. By doing so, the principal delegates some of the authority to its agent. However, because there is no perfect contracting for every possible action of the agent, while these actions affect both the agent's and principal's welfare, agency problem arises. The standard agency problem is supposed by Jensen and Meckling (1976) who observe that managers bear all the cost of failing to pursue their goals but capture only a small portion of benefits. They suggest that the problem could be decreased if the managerial incentives increase.

Jensen and Meckling (1976) summarize agency cost as the sum of monitoring cost, bonding cost and residual loss. Monitoring costs are the expenditures paid by principal to measure, observe and control an agent's behaviors. They can be the audit costs, compensation packages or the cost of firing managers. These costs are eventually borne by managers because their compensation will be adjusted to cover these costs (Fama and Jensen, 1983). Bonding costs are the expenditures that managers spend on constructing a system to ensure that they behave on the shareholders' benefits. These can be the additional information disclosures to shareholders. Notably, these can be seen benefit to both parties:

shareholders and managers, and thus they are additional costs to shareholders. The residual cost is the difference between the expected outcome and the actual outcome. Normally, this is acknowledged because the cost of enforcing the principal – agent contract would outweigh benefit from it.

Although the work by Jensen and Meckling is basic, it gives us some intuition on the equitization process. First, it indicates why SOEs in generally is less effective than the other sectors. That is because when managers work for themselves, they have more incentives to do the best things for the firm. But, with the SOEs structure, managers are allocated and thus they do not have enough incentives. Second, with the firms being equitized, and with the existence of equity market, agency cost could be reduced as it can be captured and monitored by the market. In other words, equitization creates chance for improving efficiency through reducing agency cost. However, we should note that the level of state ownership may decide how effective the market monitoring could be, especially if the SCIC – a state representative in most of the equitized SOEs - is not been seen active as a large shareholder.

The nature of conflicts

The nature of conflicts of interest within a firm is explained from different perspectives in the literature. Jensen and Meckling (1976) see the moral – hazard conflict in their model which assumes managers initially owning a firm but they then start consuming private perquisites rather than investing in NPV projects as their ownership stake in the company declines. Shleifer and Vishny (1989) add that, instead of not investing, managers may pursue projects that best suit their personal skills, to maximize their benefits (e.g. high remuneration, high cost of firing) rather than of the shareholders. The moral – hazard framework also suggests that the managerial effort also decreases as managers own smaller stake in the company and thus have less incentives to work at best effort. Rosenstein and Wyatt (1994) confirm this phenomenon by showing the negative market reaction to announcement of a firm's directors as an outsider to another board. The moral hazard is seen to be high in large companies because the complexity and difficulty in contracting managers (Jensen 1993).

While the moral hazard framework emphasizes on the managerial effort and the issue of under-investment as the cause of conflicts, the earnings retention approach see the problem of over-investment. Brennan (1995) argues that the grandiose visions and cash distributions are of more concern. Empirical studies show that, the director remuneration increases with firm size, giving managers with direct incentive to size growth, rather than shareholder returns (Jensen and Murphy, 1990; Conyon and Murphy, 2000). Specifically, mangers prefer to re-

tain earnings, which help increasing size, while shareholders prefer high levels of cash distributions, e.g. dividends (Jensen, 1986).

Furthermore, increasing with the firm size is the tendency of more diversification for job security purpose (Jensen, 1986). This clearly is not of investors' interest as they already hold diversified portfolios. Lang and Stulz (1994) confirm this by showing that returns to shareholders in more diversified firms are significantly lower than in less diversified, and moreover, firm value decreases when firms become more diversified. Besides, earnings retention ultimately reduces external funding and thus reduces external monitoring power, which benefits the managers (Easterbrook, 1984).

The conflicts between shareholders and management can be arisen from the timing of cash flows, which normally are discussed in the literature as the short-sighted perspective. Managers are assumed to be concerned more with the cash flows during the employment term, while shareholders are concerned with all future cash flows. This problem is especially seen as top executives approach their retirement or have made plan to leave the firm. For example, Dechow and Sloan (1996) show that the R&D expenditure as top executives approach their retirement tend to decline, simply because R&D expenditures reduce the management compensation in the short term.

It is also well documented that risk aversion is a source of conflicts between shareholders and managers. Because managers devote most of their human capital to the firm, and their income depends on the firm's performance, they are risk averse and tend to make diversified investments to minimize the risk associated with the firm's performance (Jensen, 1986). The risk aversion is also seen from the capital structure policy, that managers prefer equity to debt financing because debts increase the probability of bankruptcy and defaults (Brennan, 1995). Besides, empirical evidence from Demsetz and Lehn (1985) suggests that high risk firm is more related to those with low firm's ownership by managers. This indicates that risk – aversion is dependent on the level of firm ownership by managers.

Given the above findings from the literature, we see almost all potential for all of the above agency problems in Vietnam. As mentioned, in many cases, managers are allocated on the basis of political decisions. Besides, the common ownership structure shows the larger portion to the State, while the active monitoring bodies including strategic partners, employees, managers and public investors hold the smaller part. Thus, there are reasons to believe that managers may lack managerial effort which may cause under-investment. More seriously, there is increasing managerial effort of transforming the state assets into private assets

during the equitization process, which sees several manipulated offerings. It's also observed that many listed firms in the year 2007 announced new equity issuance and paid dividends by shares. This obviously is a signal of over-investment with a firm-size growth vision, which improves managerial benefits but ultimately reduces those of shareholders.

Besides, many listed firms have not focused on their core operations, but have expanded to other sectors, making them being hybrid and more diversified. Increasing firm size and being more diversified is clearly what the investors do not expect. On one hand, they hold diversified portfolios already (this is especially true with the State – SCIC) and thus further diversification may result in low return. On the other hand, increasing size and more diversification means that investors may find it hard to monitor the firm's performance, further encouraging managers to act on their own benefits. All of these clearly require appropriate actions to control for agency costs, alongside with the equitization process. Especially, the SCIC, the largest shareholder in most of the equitized SOEs, should be more active in agency controlling. If this body is not, it's hard to believe that smaller shareholders will find enough incentives to monitor the firms. The next section will briefly discuss the use of agency cost controls that are largely discussed in the literature.

6. Agency cost controls

Managerial labor market

Fama (1980) supposes that a managerial labor market would help to control the agency problem. He argues that corporate managers will be compensated in accordance with the market's perception of how well they are aligned with shareholders' interests based on previous performance with other firms. The Fama's hypothesis can be understood as that market can normally observe the managerial preferences with respect to firm size (earnings retention), their age and the amount of time they are likely to spend on the firm, and their preferences for diversification, then revise the wage to resolve any problem with these preferences. However, Fama accepts that due to market imperfections, it's not always that managers are rewarded for the level of alignment they achieve with the interests of shareholders. Jensen and Murphy (1990) also suggest that equilibrium in the managerial labor market is likely to prevent large penalties for poor performance.

The role of managerial labor market is supported by large amount of empirical evidence. Most of the studies are consistent that poor managers will lose their jobs. Gilson (1989) finds that external labor market use evidence on past

performance in defining the job opportunities and compensation levels for firm executives. Kaplan and Reishus (1990) also find that managers in firms that have cut dividends are less likely to receive roles as outside directors in other firms as they are perceived as poor managers. However, some evidence suggests that the market is only effective in disciplining the poorest performance managers (Jensen and Murphy, 1990; Kaplan and Reishus, 1990).

In Vietnam, the market for managerial labor is just at the beginning, if exists. Some of the big SOEs have announced plans to recruit CEOs on market basis, but the results have not been known. Perhaps, the current salary and compensation package is the most constraint for the development of managerial labor market. What we do think we can do is to change the philosophy of managerial labor: it's the labor goods rather than the human beings. If we don't improve this market, we lack one of the effective mechanisms for improving efficiency.

Corporate boards

The role of corporate boards on agency cost controls has been well studied in the literature. Fama and Jensen (1983) suppose that an effective board must separate the decision management and the decision control. To attain this, the corporate board should be composed largely of independently directors holding managerial positions in other firms. Outside directors are able to separate the above functions and exercise the decision control since reputational concerns and equity stakes give them sufficient incentives to do so.

This phenomenon is supported by some of the empirical evidence. For example, Rosenstein and Wyatt (1990) find that a firm's stock price rises significantly upon the announcement of an outside director to a firm's board. They also find that, the greatest increase arise in the sub-sample of smaller firms while insignificant increases for the sample of larger firms. This could be due to the asymmetric information problem and the fewer existing outside board members in smaller firms. The evidence however is subjected to cautious comments that the finding simply reflects the correction of a disequilibrium within the individual firm (Hermalin and Weisbach, 1991), and thus should not be understood as that continuous appointment of outside directors would increase the stock prices.

It is argued that CEO tends to dominate the board nomination process and will choose directors most in line with their own preferences. Core, Holthausen and Larcker (1999) find that CEO compensation is an increasing function of board size, the percentage of outside directors appointed by the CEO, and the percentage of directors serving on three or more boards. Jensen (1993) argues that corporate board becomes less effective when the size increases and. Yermack

(1996) and Eisenberg, Sundgren and Wells (1998) find empirical confirmation of this, where they document an inverse relationship between board size and corporate value for large and small companies respectively.

Although this tool to agency problem is somewhat familiar in Vietnam, the practice of appointing outside directors to the board of an outstanding firm in Vietnam is still a nominal process. In many cases, the outside directors are chosen by the CEO of the outstanding firm, and thus their role of decision control is limited. Alternatively, outside directors are normally from the cross-holding firms, and thus they lack monitoring incentives. Furthermore, most of the outside directors do not really understand the firm's business and thus they cannot make appropriate decision controls. All of these make the "outside directors on the board" not an effective tool, although the approach is appropriate.

Financial policy issues

Financial policies toward capital structure could be also an effective for agency controls. However, in Vietnam, issuing debts is not a common practice. Specifically, issuing debts is constrained by both the internal and external factors. The market for debt issuance is non-existent while access to bank loans is not easy. In the meantime, managers find it easier and more incentive to issue equity. The danger is that, too much equity would lead to the risk of lacking external monitoring and thus increasing the cost to shareholders.

Jensen and Meckling (1976) argue that the existence of debt reduces the proportion of equity and therefore enables higher levels of insider ownership. Jensen (1986) also argues that the existence of debt in the firm's capital structure acts as a bonding mechanism for company managers. By issuing debt, rather than paying dividends, managers contractually bind themselves to pay out future cash flows in a way unachievable through dividends. Easterbrook (1984) argues that external capital market monitoring brought to companies by debt financing forces managers in value maximizing strategies, rather than personal utility maximization. From the social point of view, Brennan (1995b) argues that the role of a firm's capital structure should be to ensure its socially optimal liquidation.

However, how much debt is sufficient is a question on the other side. The optimal capital structure should be where the marginal costs of debt equal its marginal benefits. This is the point where the value of the firm is maximized. Nevertheless, issuing debt beyond optimal levels will increase its risk and reduce the value of the company. Stulz (1990) argues that, while debt may reduce the risk of over-investment, there will always be a danger that it could lead to under-investment due to the costs of raising new finance. Another solution to

reduce the agency cost is dividend payment. However, because paying dividend is not a legal commitment as compared with debt payment, so the use of it is less efficient (Jensen, 1986).

Clearly, an appropriate use of debts is a tool for improving efficiency within the firm. However, in the year 2007, many of the listed firms in Vietnam have issued new equity to the market, instead of using debt finance. This on one hand is a signal of over-valuation, on the other hand shows the over investment problem. The correction of the market following the trend of new equity issuances is the worst market reaction that we have seen in the history of the equity market. We understand that the choice of debt or equity is entirely of the firm, but if monitoring devices are enhanced, e.g. information disclosures are enforced, then investors would have had an apparent pictures on the firms, avoiding surprising collapses.

Large shareholdings

Another solution to agency problem can be the use of block shareholders and institutional investors. This is because normally individual do not have skills, time and interest to monitor the managerial incentives, or otherwise, they do not have sufficient incentives to monitor the firm's management due to small ownership and free-rider problem, so they do not have enough pressure on the firm management board. The CEO may also tend to be more willing to bear bonding cost to block shareholders and institutional investors. Large ownership by outside investors represents a large threat control to firm management and provides pressure for internal governance systems to operate more efficiently. Mikkelson and Ruback (1985) report significantly positive market reactions to block purchases, but that these disappear quickly unless the acquirer initiates some form of corporate restructuring. McConnell and Servaes (1990) find a positive relationship between institutional ownership and corporate value.

However, the use of block shareholders may also lead to negative effect on the firm value. Shleifer and Vishny (1997) argue that firms holding large blocks of shares in other firms may pursue their own interests at the expense other shareholders. This may include trying to acquire the firm for their own value-destroying diversification purposes. Similarly, Denis (2001) contends that whilst block shareholders seek to increase firm value, they may also attempt to enjoy benefits not available to other shareholders. In addition, Holmstrom and Tirole (1993) find that such blocks can reduce the liquidity of a stock and the supply of company information to the market.

Although there are clearly advantages and disadvantages of block shareh

olding and institutional investors, we do believe that the use of them is necessary. However, block shareholding does not work in Vietnam, while the role of institutional investors is limited. This is because the shares held by the public are normally too small for them to have any incentives to monitor the management's activities. In the meantime, institutional investors are in most cases financial institutions, holding diversified portfolios already and thus preventing them from monitoring individual firms. The other reason is that most of the firms are cross-holdings, so they may find hard to monitor each others.

Takeovers

Poor performance should be in pressure of takeovers. However, the current situation does not support this tool. It's because that firms are controlled by the States, while the managers are normally allocated on political basis. Takeovers may occur in relation to the earnings retention conflict between shareholders and management. Jensen (1986) argues that takeovers occur in response to breakdowns of internal control systems in firms with substantial free cash flows and organizational policies which are wasting resources. Takeovers threat works in two different ways: first, managers who fear of losing jobs may react by investing these free cash flows in more efficient investment projects; second, successful takeover targets realize substantial wealth increases, indicating a potential for improved performance which the previous management had failed to utilize (Jensen and Ruback, 1983).

Martin and McConnell (1991) identify two motives for takeover: efficiency gains and disciplining poorly performing management. They find the performance of disciplinary targets, where top management depart following the takeover, was no worse than the market average, but worse than their industry average. Non-disciplinary targets perform as well as their industry average. They find that CEO turnover in target firms increases following a takeover. This is consistent with the takeover market discipling managers who fail to maximize shareholder wealth.

Managerial Remuneration

Remuneration package is an important factor affecting the conflict of in terests between shareholders and managers. Basically, high levels of remuneration would result in high performance (Jensen and Meckling, 1976). Remuneration package can take three standard forms: basic salary, performance based bonuses and stock option schemes. While the salary is a basic tool and determined through managerial labor market mechanism, it's arguable that this tool works only with the poorest performance managers (Jensen and Murphy

1990). This would imply that basic salary alone is insufficient for agency cost control.

A generally used tool is the bonus system, which relies on accounting measures of performance. Banker, Lee and Potter (1996) support the use of it by showing that the sales of the firms in their study indeed improve after the introduction of the performance based bonus system. However, there are also some concerns with the manipulation issues and the short-sighted incentives relating to the performance based bonus (Healy, 1985; Jensen and Murphy, 1990). Moreover, bonuses related to the earnings might lead to firm size preferences, which eventually damage the shareholder's benefits. Thus, designing a bonus system is not an easy task as said.

The use of stock option is one the most effective tools in reducing agency cost as it is seen as a substitution for managerial ownership. These options give managers the right to buy stocks at a fixed price at given times in the future. The higher the value of the firm, the higher the the value of the options and the profit managers can make upon exercising them.

While the salary may have increased in recently years in the equitized SOEs, the bonus system and especially the stock option has not been used. Perhaps, we need to change the approach which focuses not only on the level of pay, but also the structure of it. Baker, Jensen and Murphy (1988) argue that the level of pay determines where managers work, but the structure of the compensation contract determines how hard they work. Effective compensation contracts should provide management with sufficient incentive to make value maximizing decisions at the lowest possible cost to shareholders.

Managerial share ownership

Giving managers some ownership of the firm is a direct tool to manage the agency cost (Jensen and Meckling, 1976). Benston (1985) confirms this hypothesis, finding a significantly positive relationship between shareholder's wealth and changes in value of managerial ownership. This is because managers are tied close to shareholders' gain and loss. For example, Hull and Mazachek (2001) find a positive market reaction following a new equity issuance to high level of managerial ownership. This is because market percepts that managers in high managerial ownership firms have less incentives to issue overvalued equity as they are likely to suffer from price falls.

However, inside ownership may lead to the problem of managerial entrenchment, in which managers gain too much voting power within the firm and are able to pursue their own interest at the expense of outside shareholders (Fama

and Jensen, 1983). In the meantime, it's hard to remove managers where they own a large portion of the firm. Bethel et al. (1998) and Weisbach (1988) find an inverse relationship between disciplinary events and managerial share holdings. This indicates that powerful managers are difficult to discipline even when they are poor performers. The example of FPT with their diversification strategies could be an example of managerial entrenchment.

7. Conclusion

Although there are too many things untouched relating to the equitization process, we have analyzed some of the points, which from our point of views, are important for the success of equitization process. We have proposed that, equitization process itself does not create higher firm value, or efficiency, but the corporate governance through market mechanism does. Hence, we suggest that, the corporate governance practices should be enhanced, together with equitization process, and they – the corporate governance practices - are indeed the ex-post equitization concerns as well.

In some of our specific arguments, we have presented that the equity market plays an important role in the economy, especially in the developing economies. Its roles include financing firms' investments, enhancing corporate governance and making information more available and transparent to the public. However, the level of importance depends very much on how the corporate governance is strengthened, or in other words, how equity market is interactive to the corporate governance practices. The Chinese lesson is somewhat meaningful to Vietnam as it indicates that the equity market does not help financing the firms' investments, implying the non-productive uses of equity issuance and that the listing does not increases the firms' efficiency. These all findings are due to the lack of corporate governance practices that should help the equity market work well in the first instance.

The paper also suggests that Vietnam has been facing almost all aspects of agency problems, which are the subjects of corporate governance. They are the moral hazard conflicts where managers lack managerial efforts or the over investment problem where managers act on their own benefits. Increasing firm size and diversification is also a reality in Vietnam where managers strengthen their individual positions at the cost of shareholders. Some of the agency controls have been proposed based on the literature review. Although these tools are seen from the general literature, i.e. more from developed markets, they indeed give some intuitions to the ex-post equitization in Vietnam. Among other things, we see enforcement of managerial labor market, the use of compensation structure, of

block shareholding and institutional investors, and managerial ownership are the appropriate tools that can be applied to Vietnam at this moment. Somewhere in our arguments, we do imply that the SCIC should play a more active role in controlling agency problem.

In short, this paper adds a theoretical approach to the equitization process in Vietnam, with a focus on agency problem and the role of corporate governance. Further empirical research may explore the role of equity market and the performance of the equitized firms as a background for further recommendations on the equitization. Alternatively, research may also focus directly on the comparison of performance between firms with and without corporate governance practices. Only then, we may have a comprehensive picture of the role and importance of equity market, as well as of the corporate governance in attaining the overall goal of efficiency – which basically is defined as the supreme goal of the equitization process.

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DEVELOPMENT OF CORPORATE BOND MARKET

Tran Thi Thanh Tu

Abstract

In a transition economy like Vietnam, fund demand for development is increasing year by year. By the beginning of the Doi moi period, the total investment capital raised sharply from 2.9% of GDP in 1990 to 45.6% of GDP in 2007. The Vietnamese government has made many efforts to encourage raising this huge amount of funds. The bond market is one of the most essential mobilizing fund channels not only for national projects but also for private ones. However, in contrast with the booming of the stock market, the bond market is still under-developed, along with poor management, many policies and inherent risks should be considered. This paper points out some shortcomings in the development of the bond market as well as suggesting some policy implications towards a sustainable and strong development of this market.

1. Overview of Debt Market in Vietnam

The debt market in Vietnam consists of T-bills, Government bonds, municipal bonds, corporate bonds and certificates of deposits and other debt valuable papers. It is obvious that bonds dominate the debt market. The bond market in Vietnam is considered small in terms of size, and immature in terms of the level of standardization. This is a growing market that attracts foreign investors' interest.

At the end of the year 2007, there were around 570 government and corporate bonds listed in the market. The total value of these at par value coming to around 115,560,000 billion VND. Government bonds trading in the secondary market account for the major part of total market value. Statistics from the Vietnam Stock Exchange (VSE) from the end of 2005 to the first half year of 2008

show that they account for only around 5% in 2005, rising to nearly 50% in 2006 and in 2007, and more than 60% of the total market value in the first two Quarters of 2008. To compare with stocks, the amount of stock trading has decreased between 2005 and 2008 both in terms of value and volume. In 2005, stock trading accounts for more than 80%, but this number is only just below 30% in 2008. Although the stock market has developed faster than the bond market in terms of liquidity, the total amount of funds raised by issuing bonds is much greater than issuing stocks. This shows the importance of bonds, especially government bonds as a main funding source for investment.

Graph 1. Share of Bond and Stock trading in 2005-2008
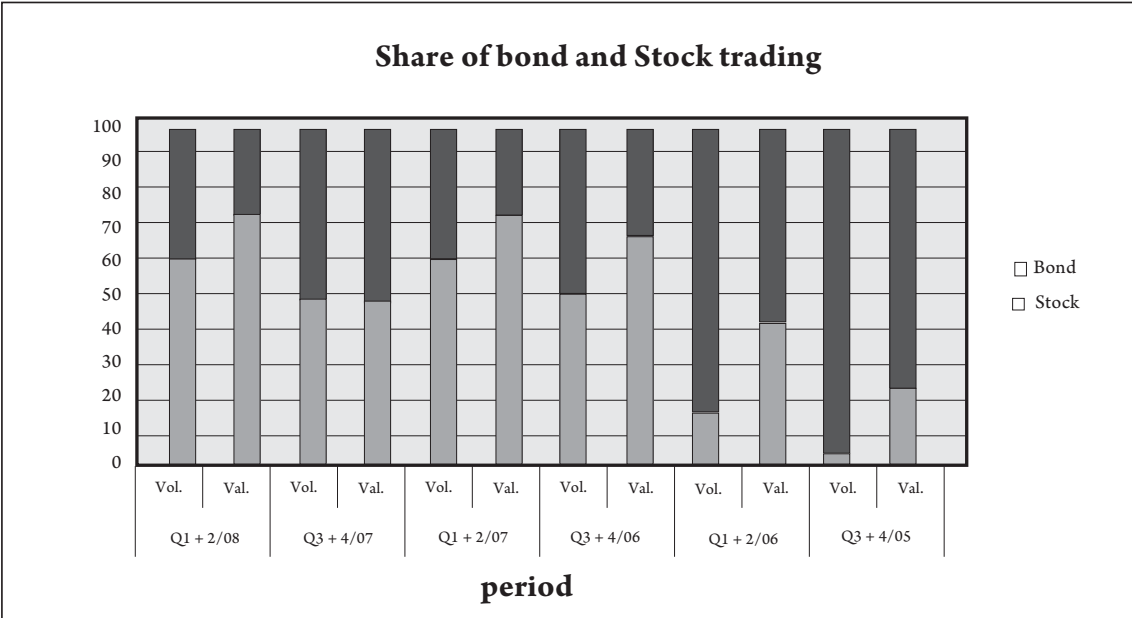
Source: www.HASTC.org.vn

Among the three types of bonds currently issued and traded in Vietnam, including Government T-bills and bonds (normally considered Government bonds in general), municipal bonds and corporate bonds, the volume of Government bonds dominates the bond market with 81% market share, with municipal bonds at 10%, and corporate bonds 9%[1]. Volumes traded of those bonds for the period 2005-2008 are illustrated in the Graph 2.

For the 5 year period 2006-2010, GDP is expected to grow at 8% - 8.5%, total required investment capital is estimated of VND 2,675,000 billion, accounting for 39.9% of GDP. The demand for bonds to be issued is therefore estimated of VND 187,250 billion[2]. Of which, Government bonds account for the largest share in terms of number and value.

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[1] As of end of Quarter III 2006, Banking and Finance Department, MOF.

[2] The 5 Year Debt Management Plan, Banking and Finance Department, MOF

Graph 2. Bond Trading Volume - Value

Bond Trading Volume - Value
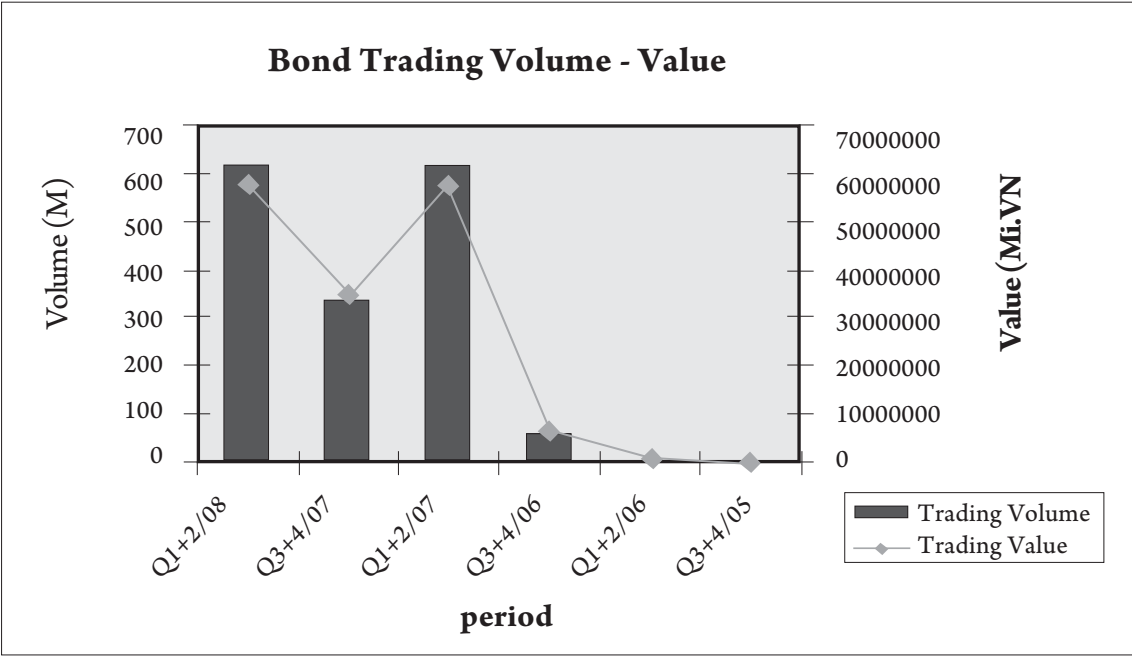
Source: www.HASTC.org.vn

Government Bonds and T-bills

T-bills in Vietnam are considered to be short-term debt papers with maturity of either 182, 273 or 364 days while Government bonds are those with a maturity of 7, 10, or 15 years. There are over 450 different types of T-bills and Government bonds currently being traded. VND 60,000 billions worth of Government bonds are issued annually by State Treasury and Vietnam Development Bank through mainly underwriting and bidding (auctioning) channels. Retail selling of Government bonds through State Treasury branches and other agents will be eliminated. The planned issue of T-bills and Government bonds all together for 2007 is VND 60,000 billion, of which T-bills account for 45%[3]. Government bonds are now issued mainly through underwriting, bidding though securities transaction centers and SBV Transaction Center.

The Government bonds and T-Bills market is mostly active in the primary market, not the secondary one. After innitially being issued, those bonds are held up to the maturity by commercial banks and larger corporations for liquidity management.

Municipal Bonds

The municipal bonds are issued by the local governments under permission of the Government. There have been so far Hanoi City, Hochiminh City and

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[3] State Treasury, Planning Department

Dongnai province that issued bonds to fund their capital expenditures. Provinces are allowed to borrow up to 30% of their total capital expenditure and need to seek approval from the Government to issue bonds. The total value of municipal bonds outstanding is VND 7,000 billion. These bonds are issued through auctioning, underwriting and agents channels. However, the liquidity for this kind of bond is very poor.

Table 1. Municipal Bonds Issuing

No	Issuer	Maturity (year)	Yield (%)	Issuing date	Listing date	Listing Volume
1	Hanoi People Committee	5	9.07	20/10/2005	28/10/2005	1,500,000
2	Hanoi People Committee	5	9.1	1/11/2005	7/11/2005	8,550,000
3	Hanoi People Committee	5	8.7	24/10/2006	3/11/2006	400,000
4	Hanoi People Committee	5	8.75	27/10/2006	6/11/2006	4,600,000

Source: www.hastc.org.vn (24 July, 2008)

Corporate Bonds

Issuers include SOEs in transition to joint stock companies or large corporations. The total value of corporate bonds outstanding is over VND 17,000 billion (in 2007). These bonds are issued through auctioning, underwriting and agents channels. However, the liquidity for this kind of bonds is very modest. This bond market will be discussed further later.

CDs and valuable papers

CDs are considered valuable paper and attract deposit insurance. CDs could be in one-year or longer term. The 90 day residual maturity restriction on trading of valuable papers is applied for Open Market operations in which SBV buys or sells valuable papers only, and not applied for forward transactions. This restriction is for short term monetary policy conduct purposes of SBV. Normally SBV makes quarterly forecasts of the liquidity in the market, and 90 days are the number of days for a quarter. SBV has no intention to lift this restriction even though they are aware of complaints about this from credit institutions. There has been so far no official banking forum or association discussing this issue.

The Ordinance on Commercial Papers approved by the National Assembly on December 24, 1999 was replaced by the Law on Transferable Instruments which was approved by the National Assembly on November 29, 2005 and came

into effect on July 1, 2006. The Law regulates commercial papers and cheques. This new law is expected to enhance the trading of commercial papers and improve their liquidity.

The debt market in Vietnam is still in its first stage of development with high potential development of Government bonds. Vietnamese Government bonds have been recently considered attractive to domestic and international investors in terms of interest rate and safety. However, the corporate bond market is a potential capital source for firms, especially in an increasingly developing financial market like Vietnam's. The main concern is how to encourage firms to use this capital effectively in their planning capital structures.

2. Main findings from corporate bonds issuing

2.1. Number of firms and volume of capital raised from bond market is still limited

Issuer

Up to now (June 2008), there are only 11 corporations issuing bonds, including: PetroVietnam, Vinashin, Electric Vietnam Corporation (EVN), Lilama, Vietnam Steel Corporation, Vilexim, Electric Construction Corporation, Song Da Corporation, Vinaconex and Vincom. In the first 6 months of 2008, due to the slowing down of the security market, no institution issues new bonds, except Vincom. Most of the issuers are the largest corporations or equitized SOEs. In fact, their fund demands are mostly huge long term and sustainable ones for targeted national projects which is difficult to borrow solely from a bank. Their worthiness are quite good to approach to any banking loan, however, because banks also have some limitations in giving loans such as a maximum loan must below 15% of bank's equity. Then, the bond market is an essential channel to raise a huge long term funds.

Outstanding

The total debt outstanding from bond issues recently increased sharply. From 300 billion VND issued by PetroVietnam in 2003, raised to 6,600 billion-VND in early 2007, especially, in 2006, the total fund is more than 8,800 billions VND, in which, EVN issued 6 series with 6,000 billion VND. The total debt outstanding from issuing bonds from 2003 to 2007 reached 17,068 billion VND. From which, EVN and Vinashin are the largest issuers, accounting for 41 percent and 36 percent respectively. The other corporations' outstanding bond debt only account for 10 percent of total funds raising. These figures are in accordance with

Table 2. Current corporate bond issuing

No	Issuer PetroVietnam	Outstanding (billion VND)	Year to maturity	Interest rate 8.5% first year, + floating
1	PetroVietnam	300	5	8.5% first year, + floating
2	Rubber Corporation	40	2	8.60%
3	Vinashin	7,103		
	Year 2004	300	2	8.20%
	Year 2005	1,000		
	Year 2006 (5 times)	2,600		
	Seri 1	500	2	9,6%/ annual
	Seri 2	300	2	9,6%/annual
	Seri 3	500	5	10%/annual
	Seri 4	1,000	10	10.5%/annual
	Seri 5	300	2	9.6/annual
	Year 2007	3,203		
	Seri 1	3,000	10	9%/annual
	Seri 2	200	2	8.95%/annual
	Seri 3	3,000	10	9.4 %/annual
4	Sông Đà Corporation	460		
	Year 2005	200	3	9.3%/annual
	Year 2006	260	5	First year 10.5%/annual, then floating
5	EVN	6,200		
	Year 2005	200	5	First year 8.8%/annual, then floating
	Year 2006			
	Seri 1	350	5	9.6%/annual, floating+ 1.2%
	Seri 2	1,150	5	9.6%/ annual
	Seri 3	500	5	9.6%/annual then floating
	Seri 4	900	5	9.5%/annual then floating
	Seri 5	600	5	9.6%/annual
	Seri 6	500	5	9.6%/annual, plus deposit interest
	Seri 7	1,000	10	9.6%/first year, then 9,95%
	Seri 8	1,000	10	fixed 9.7%/annual

6	LILAMA (2007)	1,500		
	Seri 1	500	5	9.60%/annual
	Seri 2	1,000	10	9.20%/annual
	Seri 3	500	5	8.8 %/annual
7	Vietnam Steel Corporation (2007)	400	5	9.5%/annual
8	VINACONEX (2007)	1,000	6	3%/annual + warrant
9	VN Electronic Construction Corporation	500	3	10.15 %/annual
10	Vilexim (2007)	5	3	
	Total	17,068		
11	Vincom (2008)	2,000	5	16% for the first year, then equals to deposit interest of 4 largest commercial banks + 4% at most (May 2008)

Source: MOF, 2007

the huge demand for funds of these two corporations; they are also the most attractive bonds in the market currently. Vinashin issued bonds financing shipping projects aiming at becoming the largest shipping exporter. EVN also issued bonds for investment in hydroelectric plants to meet an increasing pressure of power demand. EVN also pursued a strategy to issue international bonds in value from 300 to 500 millions USD and soon become rated under international bond rating.

Despite rapid growth, this capital is still minor in comparison with banking loans. From 2002 to 2005, credit growth reached 25% annually, but from 2006 to 2007, this growth decreased significantly, only 15% in average annually. In 2007, the credit growth increased sharply to more than 45%, in some banks this number is even more than 50%. However, this development of banking credit does not provide finance for business and production only, a large portion is spent on stock lending. The booming of the stock market in this period can be illustrated by the change of firms in raising capital, switching from banking loans to issuing shares to gain capital. (See more on 2.4).

Maturity

The bonds' maturity is long term, ranging from 2 years to 10 years. Bonds issued by EVN are 10-year-maturity. They are issued to finance the hydroelectric plants and national electric network improvements. Bonds issued by Vinaconex and Lilama will mature in 5 years. To increase the incentives for investors, Vina-

conex issues bonds with warrants to buy shares of Cam Pha cement plant at a preferable price. In the developed financial markets, bonds usually have a maturity of up to 20 to 30 years. These long term funds could never be given by banks. However, in Vietnam currently, faced with high inflation, an uncertain policy environment, and much affected by external economic conditions, which cause the uncertainty of investor's confidence to invest in an extremely long term bond.

Interest rate

The bonds' interest is paid at the end of the financial year as a coupon. Only Song Da corporation's and EVN's bonds are flexible interest rates, adjusted by Government bonds or inter-bank monetary market interest. Basically, bonds' interest rates are higher than the bid successful interest rate of Government bonds. (see Table 3)

Table 3. Bid interest rate of Government Bond

|	Qua. 3/05	Qua. 4/05	Qua. 1/06	Qua. 2/06	Qua. 3/06	Qua. 4/06	Qua. 1/07	Qua. 2/07	Qua. 1/08	Qua. 2/08
Interest rate (%/annually)	8.95	9.07	8.95	8.75	8.4	8.8	7.7	7.15	NA	11

Source: HASTC (www.hastc.org.vn)

In the period from 2005 to 2007, government bonds interest rate issued by bidding ranged from 7.15% to nearly 9%. In comparision with the saving interest rate at that time (from 7% to 8%) this is an attractive investment opportunity and safety. From early 2008, due to high inflation and the slow down of stock market, bid interest rate of Government bonds increased rapidly to more than 10%, however, this rate is much lower than the saving interest rate (approximately nearly 20%), then, the total value of Government bonds issued at this time is only more than 21,000 billion VND.

However, they are still far below the borrowing rate from banks (on average, from 12%-14% annually for long term loans). In fact, they are a nominal rate, not a real rate, in the context of higher inflation, the real interest rate trends to move below zero. This could be explaining why private investors seem to be indifferent with bond holdings. The investors are almost all institutions such as banks, insurance companies or large corporations. They hold bonds for liquidity management not for profitability.

Compared to the interest rate of Government bond in the same tenor, it could be seen that the interest rates of corporate bonds fluctuate together with

Graph 3. Borrowing and Saving Interest rate

Average Interest Rate period 2003-2009
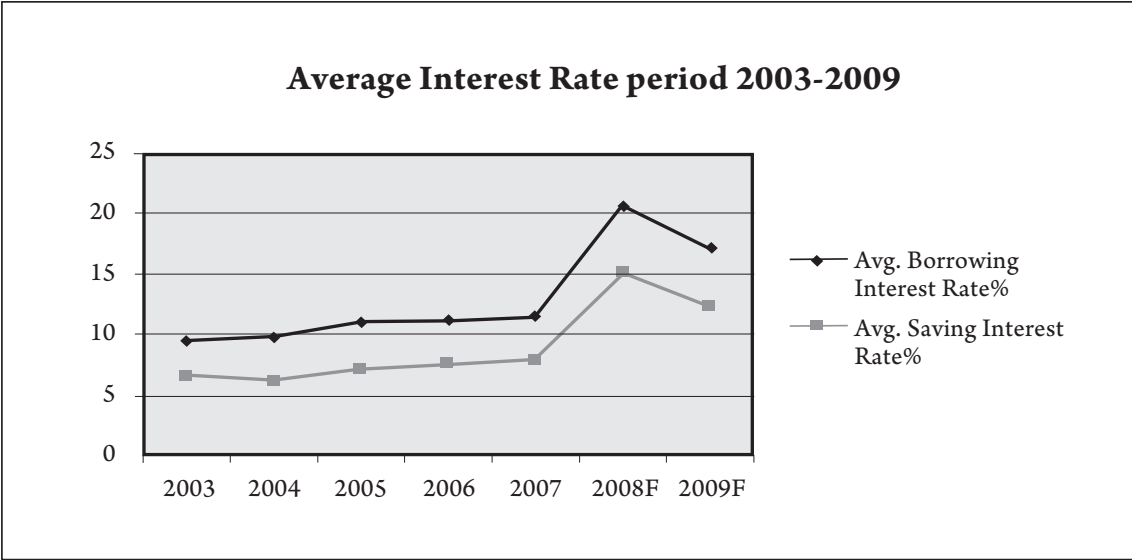
Source: Economist Intelligence Unit

the Government bond interest rates (See Table 4). The interest gap between them ranges from 2.5 percent to 3 percent, reflecting the risk difference between these bonds. The Bloomberg benchmark is the interest rate of VN Government Bonds calculated by Bloomberg based on their estimation.

In fact, depending on the time and tenor of issued bonds, could this gap really reveal the risk premium? For example, in 2005, Vinashin issued bonds with 5 year tenor, at that time, government bonds with the same maturity were being sold at 8.5%, but Vinashin bonds were not "permitted" higher than government bonds (8.4%). Then, to attract investors, Vinashin had to pay interest before rather than after interest payment, causing the real cost of raising funds to be approximately 8.9 percent.

Table 4. Interest rate of corporate and government bonds

Tenor	2 yrs	3 yrs	5 yrs	7yrs	10 yrs	15 yrs
Last trading Gov. bond	7.3	7.67	7.9	8.2	8.7	8.85
Current issuing, Gov. bond	7.2	7.35	7.86	NA	NA	8.4
BloomBerg bench mark	7.475	7.679	7.921	8.217	8.461	8.792
Corporate bonds	9.6	8.5 - 9.3	9.6 -10	NA	9.7	NA

Source: www.ssi.com.vn (Otc- 2007) and author's estimations

Besides the interest rate, the issuers have to pay a fee or commission in term of underwriting for issuing agents. Depending on issuers' credit-worthiness, this fee could be remarkable, it will mark-up the effective cost to 12 or 13 percent annually. The less credit-worthy the issuing corporation, the higher the issuing cost. This is also one of the main barriers for SME to issue bonds in Vietnam now.

Difficulty in issuing bonds in the context of increasing interest rates

From early 2008 up to now, the interest rate is changing unbelievably. Due to a shortage of liquidity in banks, as a result of tightening monetary policy, the basic interest rate which is declared by the SBV and used as the benchmark for commercial bank interest rates, raises day by day in most periods, from nearly 7.5% in January up to the highest point in June, 13%. As a consequence, the discounted rate and refinance rate that SBV applies to loans to commercial banks increase also. This increasing will lead to sharply increasing borrowing costs. Then,few firms could issue bond at that rate. In addition, the slowing down of security market in the first two quarters of 2008 make it more difficult to issue new bonds.

Underwriting

Currently, issuing agent is the most popular underwriting method. The chosen issuing agent will be in charge of providing issuing consultant services including underwriting, issuing and making coupon or principal payment. Security companies are key players in this market, besides joint-stock banks, insurance companies and auditing companies. With the advantages of information and professional staff, they are the main providers of these services. Currently, issuing consultant services are still under-developed, their revenue share of this service account for only from 5% to 10%. The security companies belonging to banks who have a national branch network will be issuing agent for commission, without this, the issuers could not sell a huge number of bonds.

Table 5. Basic interest rate regulated by SBV in the first 6 months 2008

Period	1/2/2008	19/5/2008	11/6/2008
Basic interest rate %	7.5	11	13
Discounted rate %	8.755	12	14
Refinance rate %	6	13	15

Source: SBV.gov.vn

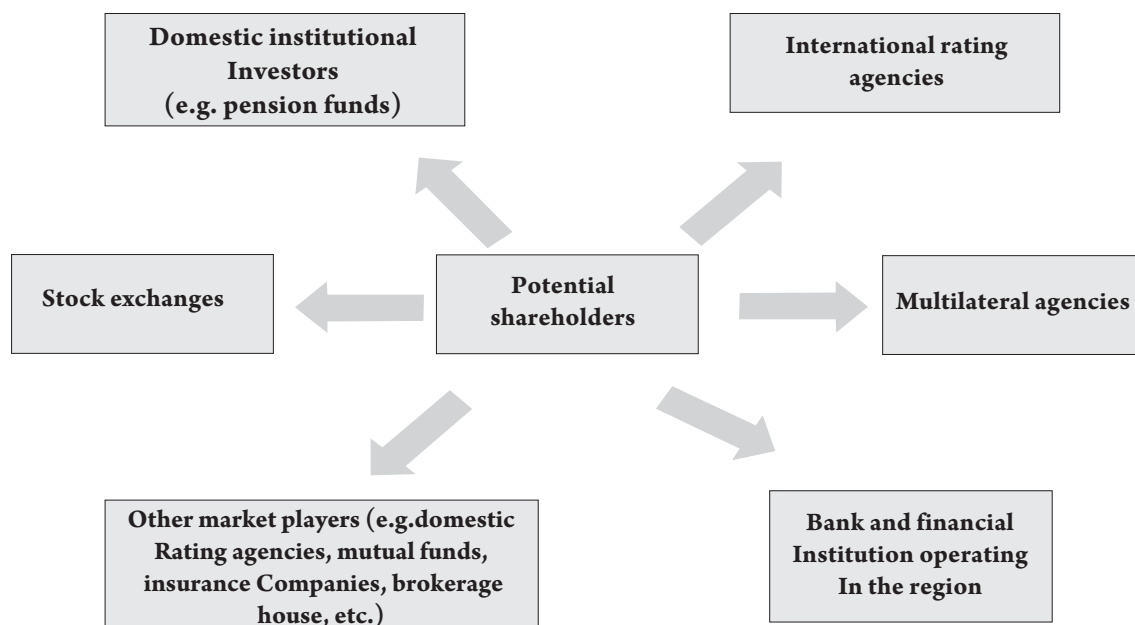## 2.2. There is no credit rating institution causing risk of insolvency

Credit rating is one of the most important things to be considered in loan approval process. This reflects obviously the borrower's financial situation, such as solvency, capital structure and profitability. Besides financial ratios, some non-financial criterion such as: management skill, business experiences, manager's capacity etc...These ratios will be rated and compared with industrial ratios. Then, all component ratings will be consolidated into an overall rating. Finally, borrowers will be ranked from A to C. AAA rating is the best borrowers, who have good solvency, high profitability and can be expandable credit. B rating should be credit rationed, closely controlled, quickly collect previous loans. C rating is the worst borrower who cannot be given any loan, collect previous loan immediately, proceed to liquidation procedures if necessary (CIC, 2007).

Credit rating in general or bond rating in particular is a crucial tool for policy maker to regulate market. Both government bonds as well as corporate bonds will be rated by regional credit rating institutions. Information relating to creditworthiness or ranking of issuers will be publicized not only in nation-wide but also regional and global network. Especially, such corporations planning to issue international bond like Vinashin and EVN will be rated by a regional credit rating institution. The model of potential shareholders credit rating institution suggested by the World Bank (Swati R.Ghosh, 2006) seems to be applicable in Vietnam. This institution will operate in the form of a shareholder company, including domestic investors, banks, insurance companies, stock exchange, multinational investment companies and international credit rating institutions (Graph 4).

However, in Vietnam, there is not any professional institution providing this service, so the standard of corporate bond ratings has not been developed. Some auditing companies have made much effort to diversify their consultant services, but, as they have a shortage of human resources, their market shares are dominated by auditing services, SOE's equitization services and evaluation services.

In December, 2007, CIC (Credit Information Center), SBV in cooperation with Dun and Bradstreet, a global leading company in providing information, published the book "Credit rating of listed companies in Vietnam stock market" to publicize the credit rating of 198 listed companies at 24th August, 2007 (excluding banks and funds). Most of the listed companies received rating B or above, only 7 companies rated CCC, accounting for 3%. This information is crucial for banks and investors, however, they are only meaningful at the time of rating, not for the whole period. If credit ratings would be done periodically, at least monthly or quarterly, they would be much more helpful for the users. Cur-

Graph 4. Potential shareholders for the regional credit rating agency

Domestic institutional Investors (e.g. pension funds)		International rating agencies
Stock exchanges	Potential shareholders	Multilateral agencies
Other market players (e.g.domestic Rating agencies, mutual funds, insurance Companies, brokerage house, etc.)		Bank and financial Institution operating In the region

Source: East Asian Finance, The Road to Robust Market, Worldbank, 2006

rently, CIC provide credit rating services only under requirements with rather high cost. So, the individual investors could not approach with this information, only when CIC published this book.

In fact, most of the issuers currently are the largest corporations in each of their industries. Their financial situations are much better than the average industry. Besides that, some issuers are underwritten by the Government, so their solvency risk is very little. However, to develop the bond market to encourage firms to issue bonds, it should be set up a standard of credit rating or bond rating should be set up. Especially, with the trend of globalization, when corporate bonds will be listed in foreign stock markets, corporate bonds should be rated under international standards[4].

2.3. Lack of market makers

The bond market makers play two roles: broker and trading bonds, then they can get profit from these functions. First, as a bond broker, the market makers could make profit from the commission that the issuers paid for them,

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[4] At present, only VCB and BIDV are rated under international credit rating standards, then their bonds' interest rates are similar with government ones. When government rates go down, corporate bonds rates will be more attractive as coupon rates are higher, under the same ranking with government ones.

and the second, as a bond trader, they could get the premium by price arbitrage. Bond price is dependent on interest rate, it will go up when interest rate go down and vice versa.

However, bond market trading is riskier than broking. To play the function of market maker, requirements are complicated and high cost: (i) holding a large amount of bonds and cash, (ii) high-tech infrastructure, (iii) high skill and professional employment. Moreover, when bond prices go down, or the risks of insolvency emerge, the market maker will lose money (Trần Đăng Khâm, 2007).

The information obtained by market makers is primary data, so they could take advantage of it, but they also could get loss when there is inside information. The market makers must buy when price goes up and sell when prices go down[5]. The potential loss shall be large in the market where the bond's price is affected heavily by the investors' psychology. Vietnam bond market is an obvious illustration. In the inefficient financial market, investors' psychology is the oriented element affecting the selling or buying decisions. It's the market makers help to balancing demand and supply forces when there is in un-biased information.

In fact, securities companies are professional traders in security market. They have advantages in broking and dealing, so they could create strong relationship between institutional and private investors, then they could increase the liquidity of trading bonds. This is one of the main concerns of policy makers, it's the low liquidity of bonds causing the under-development of this market. With the booming of the security market last year, all securities companies are attracted by the commission and fee from security dealing, they seem to not be interested in bond trading or dealing. In the near future, when the bond market is seperated from the security market, they do hope to diversify their portfolio investment to contribute to development of market makers.

2.4. Low market liquidity

This is argued as a crucial element causing under-development of bond market. Why stock market is booming while bond market is still a newly born market, only dominated by primary transactions. To have a look inside, it could be explained by some reasons. First, bond interest rate is fixed, then its price fluctuates with a small range so investors could not find high potential profit from bond investments. Therefore, the secondary transaction is not as much as stock transactions. Second, institution investors like banks and insurance companies will

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[5] Market maker must be buyers or seller when private investor have selling or trading orders, with a minimum bond batch, say 100 bonds.

hold bonds for liquidity management not for profitability management. Then, they prefer government bonds than corporate bonds. Therefore, the secondary transactions of corporation bonds is very little, most of the tradings deal with the government bonds. Especially, for the bonds of the corporations which are not listed in the stock market, the investors will hold until the due date.

At present, in HOSE (HoChiMinh Stock Exchange), there are only two corporate bonds listed including BIDV's. In HASTC (Hanoi securities trading center), there is only one. Since July, 2008 all corporate bonds and Government Bonds has beguin traded in HASTC only. The trading value and the number of listed corporations' bonds are also modest numbers (see Graph 5). The biggest share is still Vietnam Development Bank (VDB)'s bonds (45-50%), then Government bonds issued by Treasury (35-40%), the rest is municipal bonds (5-10%), corporation bonds are only below 5%.

Graph 5. The structure of bond transaction
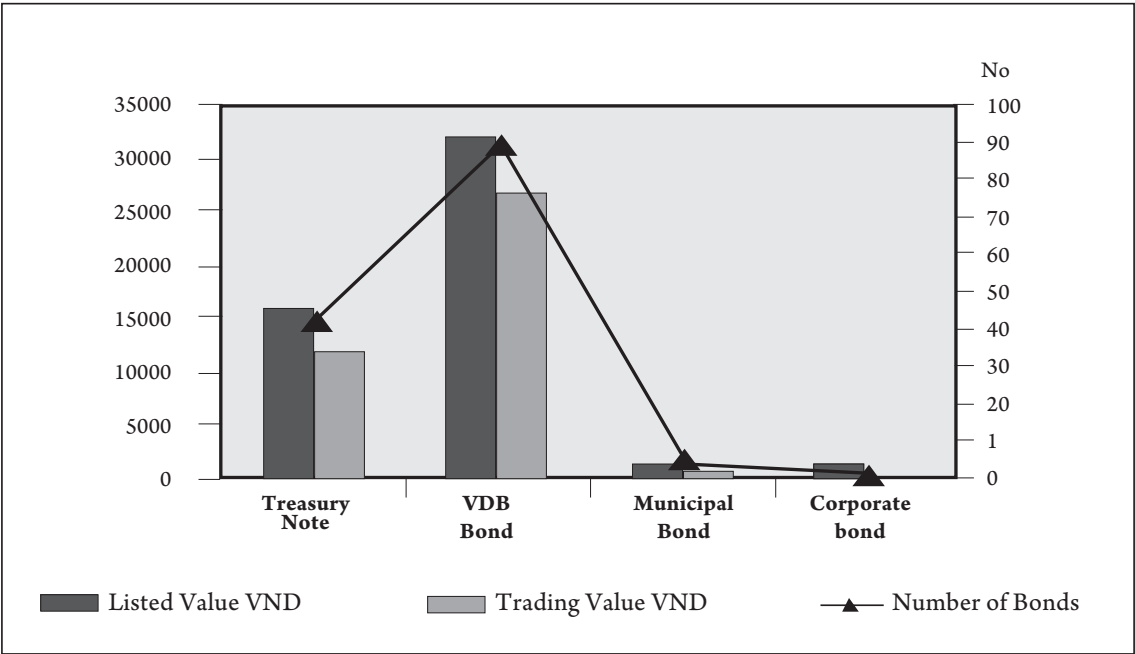
Source: www.hastc.org.vn, 12/2007

Among three types of corporate bonds traded in HASTC, in fact issued by only EVN and PVFC. PVFC is a financial company, they issued bonds mostly for providing financial services. This issuing is much different from issuing bonds of business company like EVN.

Table 5. Bond trading in HASTC

No	Issuer	Maturity (year)	Yield (%)	Issuing date	Listing date	Number of listing
1	PVFC	3	9.05	19/06/2006	12/7/2007	3,645,986
2	EVN	5	9.5	20/07/2006	16/07/2007	9,000,000
3	EVN	5	9.6	1/9/2007	24/09/2007	6,000,000

Source: www.hastc.org.vn (24 July, 2008)

The members of bond market includes commercial banks, security companies, insurance companies, investment funds, financial companies and other intermediate financial institutions. However, the most potential market makers are considered as commercial banks and securities companies. The first one are big investors in the issuing and trading bond market. They should be market makers as well as bidders or underwriters. In Vietnam, up to now, there are only Vietcombank (VCB) and IncomBank (ICB) playing as the main brokers and underwriters. The two other state-owner commercial banks are VBARD and BIDV, some joint-stock banks, and foreign banks like CitiBank, HSBC, Deutsch Bank, Standard Chartered Banks also get to start.

2.5. The low cost of issuing stocks prevent firm from issuing bonds

In the period of blooming of the stock market (2006-early 2007), it was much easier for firms to mobilize funds by issuing stocks than banking loan or issuing bonds in providing that their financial situations could be rated at B ranking. Even firms who was in the process of establishing could sell all stocks in a short of time. The popular investors were easily attracted by stocks that could be sold at a price of as 2 or 3 times as par value. Obvious, such mass issuing stocks created risks for investors. After issuing, investors could hardly check or assure that funds mobilized from issuing stocks could be invested in what area or projects that firms proposed. Some firms deposited this fund in the bank, then they used deposit interest to pay for dividend, without doing any business. It's unbelievable but is the fact. Because of additional capital (the total amount of capital by selling stocks at the price that is much higher than par value), deposit interest (calculated on this amount) is much higher than dividend paid for stock-holders (calculated on the par value). This could not happen in the efficient financial market, but it could in Vietnam. The price of stocks were pushed up over their present value or intrinsic value (PV), forced investors to face up with both business risk and financial risk in the near future when firms fail with doing investments.

On the other hand, cost of capital when issuing stocks is much lower than issuing bonds or banking loan. Even cost of debt is deductible before income tax, however, additional capital reduces the effective cost of equity, then encourage firms to issue stocks not bonds. Therefore, only if PV of stocks will be evaluated exactly, firm must rely on cost of capital to choose issuing stocks or bonds in their capital structures to maximize firm's value.

2.6. Yield curve has not been built up

Yield curve reflects the relationship between the maturity and the yield to maturity of a bond at a certain time. Yield curve is set up base on government bonds or high ranking corporate bonds which are free risk of return. Therefore, these interest rates are used as benchmark for other bonds. The gap between this benchmark and others shows the inherent risk of these bonds, the widen gap is the higher risk will be. Some certain requirements need to be considered when setting up a yield curve. First, bonds are standardized, that mean bonds should be the same in coupon and issuing conditions, and the same industry. Second, bonds are available for daily trading and listing. Third, at a certain trading day, different maturity bonds are traded, this is important requirements to draw a yield curve.

Currently, there is still no yield curve for coporate bonds in Vietnam. In fact, Vietcombank got start corporation with Reuters and HOSE (HoChiMinh Stock Exchange), but has not succeeded yet. One of the main reasons is that there are too many kinds of bonds then transactions are dispersed. On the other hand, repos and forever tradings are not separated therefore, interest rates do not match with market ones.

3. Policies implications

Improve the transparency and information disclosure in the security market

This is the first requirement for a strong efficiency of financial market. In a strong efficient market, all information are equal to every investors or market members. The information relating to financial situation of issuers are reflected exactly and fully in security price. In Viet nam, all listed companies have to publicized their financial statements periodically and they are all external audited. However, the accuracy and adequacy of these reports sometimes non-confidential. Even some firms try to have some "window dressings" some sensitivity ratios to make them better looking. These actions will make investors' evaluation is distorted. Then, hardly they can define the intrinsic value of stocks or bonds.

Therefore, a set of strict regulations on clarify and disclosure of financial situations will be issued to help investors easier in making investment decisions. All information and data disclosed publicly should be audited and supervised by authorities, especially the information relating to changes in firm management and solvency. All financial statements provided by listed companies should adopt Viet nam Accounting Standards at first and then International Accounting Standards. This requirement will help firms easily when issuing or listing in the regional or international market.

Separate bond market and stock market

Characteristics of bond and stocks transactions are much different. Bond transactions are direct negotiation not order matching tradings. The traders are also investors, so they need to negotiate directly. Trading system is always designed as a combination between negotiable trading system and inquiry information system. The trading system will not be as effective as designed if it lacks of one of these functions. Trading is only a book-entry, not providing a whole steps including analysis, investment and negotiation.

The combination of stock and bonds trading like Vietnam nowadays will prevent bond transactions from developing, decrease market's liquidity. SSC also has proposed a roadmap for separation of these two markets and chosen the most appropriated trading system: (i) from now to 2010: implication of multi-dealer system which permits only bond dealers to do broking and self-trading (ii) from 2010: introduction of inter-dealer system permit linkages between investors and bond traders, bid and ask prices are available then they can negotiate freely to determine the best price exercised[6].

In fact, the proposal of separation of bond and stock trading has been approved by the Government in June, 2008. However, due to complex and high cost of infrastructure, HASTC has not been applied this trading system yet. Besides that, the fluctuation of VN-index now makes authorities be worried and anxious after 8 years of development. Sooner or later, the separation of bond trading will be took place to improve the liquidity of this market.

Encourage the participation of private institutions in credit rating

In a strong form of efficient financial market, credit rating or bond rating is a standard for investors and issuers to evaluate bond's risk. The policy authority should encourage private institutions not only public ones in collecting and pub-

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[6] Nguyen Son, Head of Department of Market Development, SSC, Workshop in VDF in Dec 2007

licizing credit rating and bond rating. It's CIC curently having the priority to be reported by commercial banks about lending and financial situations of their borrowers. Furthermore, these information sometimes are in-creditable and out of date. The participation of private rating institutions will make this sensitive activity more objective and effective. Once privatization, all information will be equal to every investors, asymmetric information and inside transactions will be reduced, investors' confidence will be improved and reinforced.

The model of regional credit rating agency could be implicated in Vietnam, especially in the context of shortage of well-educated human resources in this area. To take advantage of technology and knowledge of the credit rating institutions in the area and worldwide will help Vietnamese ones to improve their own ability. The participation of these institutions is supported by some factors as follows: (i) the fast development of foreign direct investment (FDI) in Vietnam in the next 5 to 10 years, (ii) the prestige of these institutions in the developing finance market like Vietnam. To ensure they will operate effectively, the policy makers also need consider the following conditions: the shareholders are supported to operate independently and prestigiously; the shares must be transferred widely and the maximum holding rate is 5-10% and the balance of the shareholders' holding rate avoids the inside information and managerial conflicts. At that time, not only state-owned agencies but also companies, banks and investment funds can participate to found the credit rating institutions.

Push up the development of market makers

To be said that, commercial banks are targeted to develop as bond market makers in Vietnam besides finance and security companies. In the heated growth of stock market, those candidates were busy with stock trading for benefits or consultant services relating to SOE's IPO. They rarely find out their motivations to be a market maker. It should be issued a legal document to regulate this activity as well as create incentives for market makers. In the context of deeply slowing down of stock market in some recent months, the slowing down of bond market should to be pushed up by market makers.

In some regional markets, the model of bond club is one of the alternative of market makers. Member of bond club will be commercial banks, insurance companies and other institutional investors. They will be shared information, knowledge and experiences in bond investment. They also benefit from promoting relationship as well as an united voice in protecting member's rights when conflicts appear. In Viet nam, bond club is very primarily built up, only in the

form of an informal forum for investors, not have been approved by any local authority. Develop this model will help to enhance the foundation of specialized market makers in such a young bond market in Viet nam.

Diversify corporate bonds

At present, there are two main corporate bonds issued: (i) fixed interest rate or interest payment annually (coupon interest rate) and (ii) floating interest rate that means interest rate is flexible depending on market rate. Depends on the real fact of economy, firm will choose each of them. In a stable economy, firm should issue fixed income bonds, that will create a fix income for investors, at that time, both interest rates and bond prices are nearly fixed, the income of investors will have not impacted much on firms' business. On the other hand, when the economy facing with many chaos of macro economics factors, the investors will prefer flexible interest rate. For example, if inflation is high, lead to a drop of real interest rate, the nominal interest rate of bonds will be changed to set off negative impact of high inflation.

When Vietnam economy is integrating strongly in the global economy and influenced more and more by macroeconomic fluctuations in United States and Asian countries, preserve the relative stability of the bond price is important to attract the investors. For example, issuing bonds whose interest rate is secured by gold, or the real interest rate is secured to be always positive when the inflation rate is high. This guarantee will strengthen investors' confidence.

Besides, bonds will become more attractive as convertible bonds or bonds with warrant. Vinaconex issued the bonds with warrant of buying its partner companies' stocks at a favourable price. In fact, this bond's interest is not too high (only 5%) but with the right to buy stocks at the price as much as 1.5 times as par value will help to reduce the PV of bonds.

Firm can also issue convertible bonds that can be converted into stocks after a definite time with a fixed ratio. At that time, their debt will be changed into equity. The bond holders will become the shareholders, can receive the surplus benefit from firms' performances which bond holder could not have. On the other hand, firm will avoid to pay the principal to bond holders because now they become shareholders.

Encourage the participation of investment funds investing in bonds

Nowadays, the investment funds or the mutual companies are developing in Vietnam, with both of direct and indirect investment portfolios. They are active in improving the liquidity of bonds. Not like the market makers, the investment

funds collect pieces of capital from non-professional investors and invest in to bond and stock portfolios on behalf of them. At that time, they will be more professional and have more opportunities to approach information, and will have more opportunities to make profit.

According to a survey of World Bank in 2006 (World Bank, 2006), in ASEAN+3 countries, the total value of the bonds which the investment funds holding was from 40% to 60% GDP, while the pension funds from 20%, 30% of GDP and the insurance companies from 5% to 10% of GDP. These figures are "dreaming" in comparision with those of the investment funds in Vietnam. It can be said that it's the active participation of the mutual companies and pension funds which has improved the liquidity of the stock market in general and the bond market in particular.

4. Conclusions

In summarize, the industrialisation in Vietnam puts a pressure on a huge capital demand, the role of corporate bond market could not be denied. However, the bond market in Vietnam is under-developed, although it is the key channel to mobilization long term funds. To encourage this market, it should be considered both from primary market and secondary market approach. The first one relates to policies which helps to encourage firms issue bonds such as flexible interest rate, diversifying types of bonds, determining exactly the cost of equity and cost of debt and promoting the credit rating agencies. The latter one refers to policies which push up the secondary market such as setting up yield curve, developing market makers, encouraging the participation of investment funds to improve the market liquidity.

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