Is Vietnam on the Brink of a Currency Crisis?—Deciphering Signs of Increased Vulnerability Resulting from Globalization—

By Yuji Miura
Senior Researcher
Center for Pacific Business Studies
Economics Department
Japan Research Institute

Summary

1. Investment and consumption are the driving forces behind economic growth in Vietnam. Reforms implemented over the past decade have brought significant benefits in terms of Vietnam’s transition from an agrarian country into an industrial country, and from a planned economy into a market economy. Vietnam appears to be advancing steadily toward the middle-income stage, yet its economic outlook has become increasingly uncertain recently, as evidenced by the fact that the Ministry of Planning and Investment has substantially reduced its real GDP growth rate forecast for 2008 from the 8.5-9.0% figure published late last year to 7.0%. Inflation is higher, and there have been conspicuous declines in both share prices and real estate values.

2. Factors behind the rise in inflation include the supply of vast amounts of money into the market. In 2007, there were massive inflows of funds through remittances from overseas Vietnamese, stock market investment, and foreign direct investment. Fearing a loss of export competitiveness, the government tried to keep the value of the dong low by intervening to buy dollars. This caused an excess liquidity situation. This flood of funds poured into the stock market in the first half of 2007 and the real estate market in the second half of the year. The result was an abnormal rise in prices and growing financial instability.

3. The government succeeded in curbing stock market investment and real estate investment by implementing a credit squeeze. However, there is no evidence that the inflation is losing momentum. Open market operations and interest rate restrictions implemented by the central bank appear to be based on an ad hoc approach, and the resulting impotence of monetary policy is also affecting the situation.

4. One of the reasons for the lack of consistency in monetary policy is capacity problems in the central bank. However, a closer analysis of this issue shows that there are also structural problems in Vietnam that are both driving inflation and also making it more difficult to bring under control. First, because the central bank is not independent from the government, there is a tendency to shift toward a more relaxed monetary stance. Second, expectations of declines in the value of the dong have encouraged a shift of household assets away from the dong and into dollars and gold, thereby reducing the effectiveness of monetary policy. Third, state-owned enterprises have played a leading role in investment in the stock market and real estate.

5. The consumer price index is the most important indicator for economic forecasting. The key factor is whether or not the excess liquidity problem is being rectified through increases in base rates. When analyzing the sustainability of the current account balance of payments position, we need to include the capital account surplus and the curbing of investment through interest rate increases in our calculations. It would therefore be premature to say the position is unsustainable at this stage. Vietnam’s net external asset position is positive, and it seems unlikely that Vietnam will slide into a capital account crisis like that experienced by Thailand in 1997.

6. In view of the fact that the establishment of financial subsidiaries by major state-owned enterprises has hindered the sound growth of financial markets, or the fact that a decline in the share of the state-owned sector has not necessarily meant progress toward the development of a market economy, we must assume that the economic distortions caused by the existence of state-owned enterprises has been greater than expected, and that the effects of these distortions have been widespread. To leverage globalization into economic development while also minimizing the risk of this approach, Vietnam will need to redraw its reform map after assessing the merits and demerits of its SOE reforms.
Introduction

The Vietnamese economy is approaching a turning point. Just half-a-year ago, it was assumed that Vietnam would be the next star market after China and India. Now the situation has been reversed, and Vietnam’s outlook is clouded in uncertainty caused by factors that include rising inflation, falling share prices, an expanding trade deficit, and the falling value of the dong. Some economists working for Western banks now believe that Vietnam will be forced to seek assistance from the International Monetary Fund (IMF), like Thailand after the onset of the currency crisis.

This article analyzes the problems that are happening in Vietnam. In Part I we will identify the factors that have supported Vietnam’s growth and verify Vietnam’s development stage through comparisons with other Asian economies. We will also examine the factors behind the dramatic rise in economic uncertainty and examine the rise in inflation and the collapse of the stock market and real estate bubbles. The greatest cause of concern at present is inflation. Vietnam’s CPI rate of increase is higher than those of other East Asian economies, including China, and there is a strong possibility that anti-inflation measures implemented by the government and the central bank are not functioning adequately. Particularly serious is the problem of excess liquidity.

In Part II we will analyze the processes through which the excess liquidity situation evolved and triggered the stock market and real estate bubbles. There is no evidence of progress toward the correction of the excess liquidity problem, and the inflationary outlook remains uncertain. Reasons for this include the fact that monetary policy has been inconsistent and become ineffective. An analysis of the mechanisms through which policies, including monetary and exchange rate policies, influence inflation shows that structural problems are both driving higher inflation in Vietnam and also making inflation more difficult to control.

In Part III we will identify policy issues in the three areas of monetary policy, foreign exchange policy and SOE reforms. In Part IV we will examine the effects of increases in base interest rates and the outlook for the exchange. We will also highlight some areas in which Vietnam needs to redraw its reform road map.

Because of its large population and high growth rate, Vietnam has attracted keen interest as one of the China+1, VISTA(1) and Next11(2) economies. Assessments of its medium- to long-term potential remain high, though this potential cannot be realized without macroeconomic stability. Stability is threatened above all by shifts in the external environment, including rising crude oil prices. Obviously, we will need to examine the effect of these factors on the Vietnamese economy.

However, Vietnam’s inflation rate cannot be explained solely by these factors. The real problem is Vietnam’s vulnerability to changes in the external environment. An analysis of the benefits of past reforms shows that monetary policy has failed to function effectively because the central bank is not independent from the government, or because the government has intervened to keep the value of the dong low, and that the sound growth of financial markets has been hindered by the establishment of financial subsidiaries by major state-owned enterprises. The current upheavals are certainly not transitional problems caused by changes in the external environment. They can be attributed to the fact that growth sustainability has not risen to the same extent as the apparent growth rate.

There are few analyses based on verification of growth sustainability. Until 2007, the stability of the Vietnamese economy and its potential, as indicated by the size of its population and the scale of foreign direct investment, could be interpreted as evidence of medium- to long-term growth sustainability. However, the economy has rapidly lost its stability in 2008, with the result that stability, as symbolized in inflation and exchange rate trends, is now seen as a key indicator with the potential to influence economic growth in the foreseeable future. The current mingling of optimism and pessimism reflects widely differing assessments of potential and stability, as well as a tendency to confuse those assessments with growth sustainability.

Obviously we need to consider the problems
relating to potential, stability and sustainability separately. Currently attention is focused exclusively on stability. However, there is a tendency to overlook the fact that the Vietnamese economy has been destabilized by problems left unsolved in a high-growth period. The sustainability of growth has been influenced ultimately by the commitment to reform. The message of this article is that this is also the most fundamental variable influencing stability and potential.

There is a lack of adequate statistical evidence relating to many of the issues examined in this article. This is because only a limited amount of statistics and other information is published, and because the publication of this material tends to be extremely late. Most of the evidence used is based on fragmentary information, such as newspaper articles. Where possible, this is indicated in the footnotes. This article was based on information covering the period up to early June 2008.

I. Mingled Optimism and Pessimism

We will begin by analyzing the supply-side factors that have supported economic growth in recent years. We will also ascertain Vietnam’s growth stage by comparing its growth record over the past 10 years with those of other Asian economies. Finally we will look at the role of trends in inflation, the stock market and the real estate market in triggering the emergence of a more pessimistic view.

(1) Buoyant Performance

Since 2000, Vietnam has shown the second highest growth rate in East Asia after China. The consensus view is that this momentum will continue in the foreseeable future, despite the destabilizing impact of global financial uncertainty triggered by the sub-prime mortgage crisis in the United States, and rising resource and grain prices. In its April 2008 World Economic Outlook, the IMF predicted continuing growth at around 8% (Fig. 1). In April 2008, the World Bank was also forecasting growth of 8.0% in 2008 and 8.5% in 2009.

Growth is driven by investment and consumption. Both stagnated temporarily under the impact of the 1997 currency crisis but have been recovering since 2000 (Fig. 2). One of the driving forces for investment is domestic private sector investment. The Enterprise Law, which has been in force since 2000, has not only channeled previously dormant private funds into investment, but has also helped to improve the employment environment. The unemployment rate peaked at 7.4% in 1999 and is now in decline.

Foreign direct investment has also made a significant contribution. Foreign direct investment in Vietnam (approval basis) peaked out in 1996 and entered a period of stagnation. However, 2005 brought a return to growth, and in 2007 investment set a new record of $17.9 billion (Fig. 3). One key factor was Vietnam’s emergence as a candidate location for distributed production operations, especially by Japanese, South Korean and Taiwanese companies, because of rising labor costs in China and a decision by the Chinese government to review preferential measures for...
labor-intensive industries. Additional impetus was provided by expectations of an improvement in the investment environment following Vietnam’s admission to membership of the World Trade Organization (WTO) in January 2007. Foreign direct investment in the first five months of 2008 amounted $14.2 billion that was 3.9 times higher than the total for the same period in 2007. The total for the whole of 2008 is expected to reach $22 billion (3).

Personal consumption has also been buoyant, reflecting an improved employment environment and rising incomes (Fig. 4). Between 1999 and 2006, monthly per capita income increased 2.2 times (4). Since the CPI rose 35.7% over the same period, there was a conspicuous increase in real incomes. According to the Vietnam Automobile Manufacturers’ Association, car sales in 2007 were double the previous year’s level at 80,000. This growth is attributed to a shift from motorcycles to cars.

The growth of the middle class can be surmised from escalating competition to open large-scale retail stores (5). Current estimates place the number of major retail outlets in Vietnam at around 160. Both foreign retailers, such as the German company Metro and the French company Big C, and Vietnamese retailers, including Saigon Co-op Mart, are aggressively expanding their store

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**Fig. 2 Contributions of Demand Items**

![Graph showing contributions of demand items](image)

Source: Compiled using CEIC data

**Fig. 3 Foreign Investment Approvals**

![Graph showing foreign investment approvals](image)

Notes: Supplementary or expanded investment and investment approved by regional governments or industrial estates are not included. Source: Compiled using data from the General Statistics Office of Vietnam

**Fig. 4 Rates of Increase in Retail Sales and CPI**

![Graph showing rates of increase in retail sales and CPI](image)

chains. Vietnam’s admission to WTO membership is expected to result in an easing of restrictions on retail sector investment in 2009. A number of companies, including Carrefour and Wal-Mart, are thought to be preparing to invest into Vietnam. In 2007, Vietnam’s per capita GDP was only $834. However, it is generally believed that the consumer market is bigger than indicated by the statistics. This is because of remittances from overseas Vietnamese, which at $10 billion are equivalent to 14.1% of GDP\(^\text{(6)}\) and supplementary income from informal economic activities.

### (2) Development and the Transition to a Market Economy

Many observers support a scenario of high growth in Vietnam. Goldman Sachs predicts increased inputs of both capital and labor and an improvement in productivity. It has published a report forecasting average annual growth of 8% between 2007 and 2020 (Qiao [2008])\(^\text{(7)}\). When PricewaterhouseCoopers predicted average annual growth rates for 20 emerging economies between 2007 and 2050, it placed Vietnam at the top of the group with a growth rate of 9.8%, on the grounds that growth will be driven by foreign direct investment (Hawksworth and Gordon [2008]). The Goldman Sachs forecast was published in April 2008, and that of PricewaterhouseCoopers in March. It is significant that both assess the Vietnamese economy as being firmly based, despite the impact of global financial instability and rising oil and grain prices.

In retrospect, it is clear that the reforms of the past 10 years have yielded significant benefits. Vietnam has been transformed from an agrarian country into an industrial country, and from a planned economy into a market economy. The contribution of agriculture to GDP and the state-owned sector’s share of industrial production have both declined conspicuously over the past 10 years (Fig. 5). The shrinking contribution from agriculture can be seen as evidence of development, and the shrinking role of the state-owned sector as evidence of the shift to a market economy. Both trends also suggest that Vietnam is catching up with the leading ASEAN economies, such as Thailand.

Growth has also accelerated the development of the financial sector. In the past 10 years Vietnam has overtaken the Philippines and caught up with Thailand in terms of its M2/GDP ratio, which is regarded as an indicator of financial deepening (Fig. 6). Financial deepening has been driven by an upward trend in the savings ratio. Vietnam’s gross domestic savings were equivalent to just 2.9% of GDP in 1990. By 2005 Vietnam had overtaken the Philippines and Thailand with a ratio of 30.2% (Fig. 7). Financial deepening indicates that financial institutions are able to create credit, and that funds have started to circulate from households to financial institutions to businesses. The lending patterns of banks are also changing. The fact that borrowers outside of the SOE sector are tending to account for a growing share of loans (Fig. 8) suggests that financial deepening and the transition to a market economy are occurring in unison.

The rise in Vietnam’s savings ratio is attributable to increased confidence in the dong, Vietnam’s domestic currency, because of the improved exchange rate and price stability. Exchange rate...
adjustments under the *Doi Moi* (reform) policy continued until 1992, but thereafter the dong-dollar rate remained stable, with the value of dong gradually drifting lower over a period of many years (Fig. 9). Inflation followed a similar trend, and the CPI rate of increase remained in single figures from 1996 to 2006. Compared with the growth rate, Vietnam’s inflation rate remained gradual throughout this period. This rise in confidence in the dong is also apparent from the deceleration of dollarization. Economies in which foreign currency deposits...
make up over 30% of M2 are generally classified as “highly dollarized economies” (Hatase [2001]). This level was briefly exceeded in Vietnam because of increased dollarization under the impact of the 1997 Asian currency crisis, which caused the value of the dong to fall and inflation to accelerate. However, Vietnam has been emerging from this dollarized economy status since 2002 (Fig. 10).

Dollarization benefits households by preventing the erosion of asset values, even when the inflation rate is rising and the value of the dong is falling. However, from the perspective of the government and central bank, dollarization has a negative impact by eroding the independence and effectiveness of monetary policy, because of the presence of a currency for which they have no freedom to make decisions about interest rates and the amount of money in circulation. The increase in confidence in the dong signifies that the central bank is now gaining the ability to carry out its core role of stabilizing the inflation rate and the economy. As a result of development and the transition to a market economy, Vietnam appears to be climbing steadily toward the status of a middle-income country.

(3) Uncertainty Heightened by Government

In the January-March quarter of 2008, the real GDP growth rate was 7.4%, a moderate decline from the 7.8% growth recorded in the same period in 2007. The World Bank and the IMF have both stated that the economy was overheated in 2007, and that monetary tightening will inevitably result in deceleration in 2008\(^{(8)}\). The key question is the extent of this slowdown. In June the World Bank stated that the growth rate was unlikely to fall below 7.5\%\(^{(9)}\), and that the correction would be minor. This contrasts with a more pessimistic view that has spread within Vietnam.

In April 2008, the Ministry of Planning and Investment has substantially reduced its real GDP growth rate forecast for 2008 to 7.0%, compared with the 8.5-9.0% growth rate predicted at the end of last year. With no clear time frame for the stabilization of inflation, monetary policy needs to be tightened further. This will inevitably impact on investment and personal consumption, which have driven growth until now. A government growth rate forecast lower than those of international financial institutions is unprecedented, and this symbolizes the growing sense of crisis.

In fact, there is much direct evidence that the tide is turning. The most significant source of concern is inflation. In May 2008, consumer prices were 16.0% increase compared with the end of 2007 and 25.2% increase compared with the same month of previous year (Fig. 11). The government has described this as “crisis level.” The rise in the price index is mainly the result of higher prices for food items, which make up over one-half of the index. Retail food price statistics for April 2008 show a powerful upward trend, with rice increasing by 81.8%, wheat by 108.3% and pork by 68.9% compared with levels in April 2007. Rice and wheat prices have been affected by soaring world prices for grain and fertilizer, while pork prices have risen because of reduction in supply due to a pig disease epidemic. There have also been sharp rises in the prices of gasoline, for which Vietnam is entirely dependent on imports, as well as cement and steel, for which a high percentage of raw materials are imported.
These increases are pushing up the price indexes for transportation, telecommunications, housing and construction materials.

Another serious problem is the decline in stock and real estate prices. In May 2007 the Ho Chi Minh City stock price index (VNIndex) reached an all-time high of 1,081. (This and other figures cited below are monthly averages.) The average had doubled in two successive years, rising from 247 in May 2005 and 539 in May 2006. There was also a dramatic rise in the aggregate value of stocks listed on the market, which reached 311 trillion dong in November 2007 (Fig. 12). This is equivalent to 27.2% of GDP in that year. However, the stock market showed increasing signs that a correction was imminent in 2007, and prices plummeted early in 2008. By the start of June the index was below 400 and had fallen to less than one-half of its peak level. The aggregate value was below 200 trillion dong, indicating a loss of value equivalent to one-tenth of GDP.

There has also been a conspicuous decline in real estate prices. The prices of urban land and housing climbed sharply in 2007, when the stock market was entering a correction phase. Land prices in Hanoi and Ho Chi Minh City rose from $3,120-3,750 per square meter at the start of 2007 to $5,000, with prime land prices hitting $62,500 per square meter\(^{10}\). The price of housing in Ho Chi Minh City rose from $1,200 per square meter at the start of year to $4,500\(^{11}\). However, prices peaked out early in 2008. While the prices of prime office space intended for foreign companies have remained firm because of buoyant demand\(^{12}\), by April land prices in Ho Chi Minh City had fallen by 40% and housing prices by 30% from the start of the year\(^{13}\).

II. The Merits and Demerits of Globalization

Of all the many problems affecting Vietnam, the government is most concerned about inflation. Inflation accelerated in 2007, and the trend shows no signs of abating in 2008. International prices for resources, including crude oil and grain, are clearly rising. However, this alone does not explain why Vietnam’s CPI rate of increase is higher than that of any other East Asian economy, including China.

In simple terms, the reason for the high inflation rate is the fact that the price control policies of the government and central bank are not work-
ing adequately. Prices have risen not only because of factors beyond Vietnam’s control, such as higher food rises resulting from a reduction in supplies caused by abnormal weather, or increased resource and grain prices, but also because of factors specific to Vietnam. These include the effects of price control, as discussed in the next section, as well as the falling value of the dong, and an influx of speculative funds into commodity markets.

Excess liquidity appears to be the most important specific factor. We will begin our analysis of this problem by tracing trends in the money supply since 1997. Because the excess liquidity problem is also linked to stock market and real estate bubbles, we will also analyze the actions of the central bank in response to overheating in these markets. Finally, we will look at the reasons for the continuing acceleration of inflation in 2008 and highlight the role of ad hoc monetary policy in this problem.

(1) Excess Liquidity Triggered by Influx of Funds

An analysis of the rate of increase in M2 up until June 2007 highlights the growing seriousness of the excess liquidity problem (Fig. 13). Clearly this is one of the reasons for Vietnam’s conspicuously high inflation rate. Where have these funds come from? There have been massive inflows of foreign funds from three sources: remittances from overseas Vietnamese, stock market investment, and foreign direct investment. Remittances from overseas Vietnamese have been expanding year by year because of the easing of restrictions on the purchase of businesses and housing by this group. Another factor has been an increase in the number of Vietnamese going overseas to work in the Middle East and other parts of the world. In 2007, the amount of remittances doubled compared with the previous year’s level to $10 billion.

In addition to a global glut of funds, stock market investment has also soared because of a decision in September 2005 to lift the share ownership ceiling for foreign investors from 30% to 49%. Another factor was a flurry of new listings ahead of the cut-off date for tax concessions in 2006. In 2007, inflows of foreign funds reached $18 billion (Fig. 14).

Funds flowing into Vietnam through foreign direct investment are estimated to total $8.0 billion. Of course, some of these funds are used...
predicted that the value of the dong would fall by 2% over the year\(^{(16)}\). The government adopted a policy of maintaining a gradual decline in the value of the dong by intervening to buy dollars. This stance was motivated by fears of a loss of export competitiveness and the resulting expansion of the trade deficit, as well as the impact on efforts to attract foreign investment\(^{(17)}\). The fall in the value of the dong since March 2007 must be seen as the result of this intervention\(^{(18)}\). At the end of 2007, Vietnam’s foreign currency reserves amounted to $23.9 billion, an increase of $10.3 billion over the position at the end of the previous year (Fig. 15). The build-up of foreign currency reserves was especially conspicuous in the period to September, indicating that intervention to buy dollars can be seen as a likely reason for the decline in the dong’s value during this period.

The basic cause of the excess liquidity situation was continuing intervention to buy dollars with the aim of maintaining Vietnam’s export competitiveness despite massive inflows of funds. The symbol of Vietnam’s uncertain economic outlook is its rising inflation rate. This phenomenon emerged in 2008, but the seeds were sown in 2007.

\(\text{(2) From the Stock Market to Real Estate—The Role of the Joint-Stock Banks}\)

In 2007 the CPI rate of increase exceeded 10% for the first time in 12 years, with a 12.6% rise from the level at the end of 2006. The central bank raised the deposit reserve ratio from 4% to 10% in one move. It also used buying operations to absorb 90% of the dong equivalent of $10 billion, which flowed into the market as a result of dollar-buying intervention\(^{(19)}\). However, the fact that interbank rate remained low even after the increase in the reserve ratio indicates that the effectiveness of these moves was limited.

The dong that leaked into the market were channeled into the stock market. This money was soaked up by the informal market for unlisted shares, which is believed to be even bigger than the formal stock market (World Bank [2006b])\(^{(20)}\). However, some personal investors were so eager
to invest that they even borrowed money from relatives. This massive influx of funds caused prices to rise far above their real value. By mid-2007, the price-earnings ratio (PER) of listed companies had reached 32.4% and was even higher than levels in China and India (Fig. 16).

This trend was given additional impetus by small and medium joint-stock banks, which provided loans secured by securities. Some banks are estimated to have provided loans of this type amounting to as much as 30-40% of their total loan balances (IMF [2007a]). This increase in loans secured by securities increased the risk exposure of financial institutions, causing the IMF and the World Bank to issue a warning about the risk of financial instability. In January 2007, the central bank raised the risk weighting of loans secured by securities from 100% to 150%, and in May it moved to limit investment by directing banks to reduce this type of lending to no more than 3% of their total loan balances by the end of 2007. A flurry of new share listings at this time raised expectations of an over-supply situation, and by the second half of 2007 there were growing signs of a correction in the stock market.

The next stop for funds in search of investment opportunities was the real estate market, which was booming under the impact of large-scale development projects funded by direct foreign investment. Here, too, financial institutions were actively involved as lenders on both the supply and demand sides and played a key role in the price rises that occurred in the second half of 2007. However, by early 2008, the government and the central bank took steps to cool down the market because of their increasing concern that financial institutions were exposing themselves to new risk through the expansion of their real estate lending.

In January 2008, the central bank raised its discount rate, which had remained unchanged since the end of 2005, from 4.0% to 4.5%. It also announced a guideline requiring banks to limit the growth rate of their lending balances to 30%. Given that the year-on-year increase in 2007 was 53%, this 30% ceiling may seem moderate. However, there are still numerous loans approved in 2007 but not yet actioned, which means that some banks will need to keep the increase in their new lending in single figures.

The main target of these moves was real estate lending by joint-stock banks. Some banks have been forced to stop handling new housing loans. The Vietnamese Ministry of Finance has also moved to limit investment, including the initiation of a study concerning a progressive tax system in which the tax rate will rise according to the number of properties owned.

Both the stock market and the real estate market fell sharply early in 2008 and were showing no signs of recovery in early June. The measures described here have clearly had some effect, but the decisive factor has been a shift in the government’s sense of alarm about the rising inflation rate, which has prompted a shift in its main policy focus from growth to price stability. The central bank has reacted to this situation by implementing a series of powerful monetary tightening measures.

In February 2008, the central banks lifted the deposit reserve ratio to an all-time high of 11% and raised the discount rate from 4.5% to 6.0% in one step. It also announced selling operations based on the mandatory purchase of short-term central bank securities worth 20.3 trillion dong ($1.26 billion). This is equivalent to 6.1% of the

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**Fig. 16 Price-Earnings Ratios (Mid-2007)**

![Price-Earnings Ratios](image-url)
total loan balance of commercial banks as of June 2007 (817.7 trillion dong). Banks became increasingly concerned about the resulting shortage of funds, and by the end of February the interbank rate had reached 40%, and even the short-term interest rates of commercial banks was over 10%.

Higher interest rates have caused funds to shift out of stocks and real estate into deposits, adding further impetus to the decline in stock and real estate prices. In the stock market, the cycle of 2007 has been reversed into a vicious circle in which expectations of price declines have caused investors to retreat, driving down prices still further\(^{24}\). A similar pattern is expected to emerge in the real estate market, albeit to a different extent.

(3) Central Bank Indecisive

Monetary tightening has been effective in the sense that it has curbed investment in stocks and real estate. However, the inflation rate, which is the most important problem, is still rising (Fig. 17). On a month-on-month basis, consumer prices rose by 2.3% in January, 3.6% in February, 3.0% in March and 2.2% in April. This moderate downward trend was greeted with growing optimism by the government and the central bank. However, May brought another steep rise of 4.4%.

The main reason for this is a continuing upward trend in the prices of food and construction materials.

With international prices for crude oil, resources and grain all setting new records, inflation is still a threat. However, a more important issue for Vietnam is the unresolved problem of excess liquidity. This is believed to be causing unused funds to flow into the markets for commodities, such as rice and cement, in anticipation of price increases\(^{25}\). There are data that cast doubt on the effectiveness of monetary tightening, including the fact that the rate of increase in lending in the first four months of 2008 was higher than the same period in 2007\(^{26}\). The central bank must play a key role. As discussed later in this article, however, its monetary policy shows a conspicuous tendency toward stop-gap measures, as well as lack of consistency in terms of both ends and means.

One problem relates to open market operations. In mid-February 2008, the central bank announced that it would implement a 20.3 trillion dong selling operation. Just one week later it implemented a 10 trillion dong ($630 million) buying operation on the grounds that a few smaller joint-stock banks were in danger of becoming insolvent\(^{27}\). In early April, it again supplied money in response to the deteriorating cash flow position of key export companies, including manufacturers of textiles, footwear and seafood\(^{28}\). The central bank does not reveal details of its open market operations, but it is clear that the effectiveness of monetary tightening measures was compromised when it implemented selling and buying operations at almost the same time.

A similar problem can be identified in the central bank’s actions in relation to interest rate regulation. After the announcement of the selling operation, many banks raised their interest rates out of concern that they would be short of funds. However, banks then began to compete to offer higher rates, increasing the danger of a “adverse selection” situation, in which the banks with the worst financial positions attract funds by offering the highest interest rates, as well as the risk of term mismatching when banks use funds procured
on a short-term basis to provide long-term loans. There were also complaints that the rising cost of funds could cause a downturn in economic performance. The central bank responded by imposing a 12% interest rate cap two weeks after announcing its selling operation.

However, the interest rate cap did not remain in place for long, and in May the central bank introduced new interest rate controls. Under the new rules, banks can set their interest rates at any level provided that they do not exceed 150% of the base rate announced by the central bank(29). An interest rate cap is the exact opposite of a situation in which banks are free to set their own interest rates, and the new rules are positioned mid-way between these two extremes.

The new rules were touted as progressive measures that would enhance the effectiveness of policy interest rates and facilitate the macroeconomic management based on market economic principles. In reality, they were introduced because the central bank was forced to make changes when it reached a dead-end with its interest rate cap policy. This dead-end was symbolized by growing financial instability emanating from small and medium joint-stock banks(30).

When the interest rate cap was imposed, interest rate variation was reduced, and most depositors concluded that it would be safer to transfer their funds to larger banks. This caused funds to shift from small and medium joint-stock banks into large state-owned commercial banks. The central bank anticipated this situation when it introduced the interest rate cap system and promised to provide loans to banks that found themselves short of funds. Although it issued a similar communication in March(31), the promise was not fulfilled.

An additional blow was the withdrawal of government funds from state-owned commercial banks. In April, the government announced a phased withdrawal of the 30 trillion dong ($2 billion) that it had deposited with state-owned commercial banks, stating that these funds would be transferred to the central bank by September. This had the effect of reducing the availability of funds to the state-owned commercial banks, which dominate money markets, and the interbank rate rose to 22%(32). Access to funds became even more difficult for the joint-stock banks.

The decision to abolish the interest rate cap system was also prompted by the lack of any easing of the pace of inflation. Even the central bank, which had introduced the system, became increasingly convinced that it would not be able to solve the excess liquidity problem by keeping interest rates below the inflation rate, and that this would cause funds to flow out of banks and trigger speculation in rice, cement and other commodities(33).

The central bank’s indecisiveness about interest rate rules is a sign that monetary policy in Vietnam is still at the developmental stage, and that it is too early to predict whether the new rules will make a decisive contribution to economic stability. In fact, the introduction of the new rules has been followed by increases in interest rates, especially among small and medium joint-stock banks. One-year time deposits now attract 14% interest, and loan interest rates have reached 18%(34). Although funds are flowing back into the joint-stock banks, there is escalating competition among banks to offer higher interest rates. There is a possibility that the movement of funds between banks will leave some banks with shortfalls, and that shrinking interest rate spreads will lead to the emergence of financially troubled banks. It is clear that financial instability will not be eliminated under the new rules. If the rising cost of funds triggers protests from the industrial sector, the debate over interest rate regulation may flare up again.

**III. Root Causes of Confusion**

We cannot identify the reasons for the ineffectiveness of Vietnam’s anti-inflation simply by comparing them with policy menus and policy effects in neighboring countries. However, it should be possible to explain a significant portion of the problem by clarifying the specific factors that affect the mechanisms behind monetary and exchange rate policies and other measures that influence inflation.

In the following analysis, we will approach the
problem from the perspectives of policy priorities in the areas of monetary policy, exchange rate policy and SOE reforms. Inconsistencies in these areas are deeply involved in the excess liquidity situation and the ineffectiveness of monetary tightening measures. This analysis will show that the current confusion is not a temporary phenomenon caused by changes in the external environment, but rather the result of structural problems that not only cause Vietnam’s inflation rate to rise, but also make inflation more difficult to control.

(1) The Need for an Independent Central Bank

Issues within the central bank are clearly apparent from inconsistencies in the bank’s behavior. While signaling a tighter monetary stance through selling operations, it was forced to implement buying operations. This suggests the bank failed to ascertain beforehand how banks with differing amounts of funds and financial positions would be affected by its open market operations. As noted earlier in this article, the shift to a market economic system has been accompanied by financial deepening (Fig. 6). However, the central bank appears to lack the capacity needed to cope with this change.

This problem is attributable to the central bank’s poor data gathering and analysis capabilities. The range of data that can be accessed through the central bank’s website (http://www.sbv.gov.vn/vn/home/index.jsp) is very limited compared with the availability of data in China, Indonesia and Philippines. The central bank conducts no research to monitor economic trends and the flow of funds. To some extent, this is inevitable given Vietnam’s development stage. However, the trend toward globalization is steadily magnifying the impact of monetary policy on economic stability, and the development stage cannot be used to justify delays in efforts to improve this situation.

This lack of data gathering and analysis capacity affects not only monetary policy, but all facets of economic policy. The government tries to improve the quality of its policies by adjusting them after observing their effects, and in many cases ratification of the status quo has been substituted for policy implementation. This might be seen as a realistic approach. However, when applied to monetary policy, which requires a proper understanding of the situation and subtle modulation, it can erode economic stability and increase the risk of downturn.

This lack of consistency in monetary policy also erodes the authority of the central bank and the effectiveness of its monetary policy. For example, one of the most important duties of the central bank is to control the rate of increase in lending. Yet the Vietnamese central bank has admitted that it lacks the capacity to fulfill this role, stating that its instructions to banks to curb increases in their lending since 2007 have been totally ignored, and that there is a strong possibility that the 30% target will be exceeded again in 2008(35). There are institutional problems, such as the lack of any clearly defined system of fines for violations. However, this does not mean that there are no problems with the effectiveness of monetary policy.

Furthermore, not all banks have complied with the interest rate cap introduced in February. The decision to implement this regulation followed consultation between the central bank and the Vietnam Banking Association. Officially, the policy was implemented by the Banking Association as a voluntary rule in response to a notification from the central bank. Because it was implemented through the Banking Association, the notification was seen as a gentlemen’s agreement. This inevitably weakened its authority. In late April, short-term rates appear to have exceeded the cap, climbing to 18-20% as a result of a rise in the interbank rate(36). This indicates that the cap had become ineffective even before it was abolished.

These are technical or institutional problems and should not be difficult to rectify. In May 2008, the central bank initiated studies concerning measures to prevent financial instability, including a daily reporting requirement for banks(37), and fines for banks that failed to comply with interest rate regulations(38). Yet when we look at the fundamental problem of the central bank’s inadequate data gathering and analysis capabilities, we ultimately run into the question of central bank inde-
pendence. The implication of this is that efforts to improve the capacity of the central bank and the effectiveness of monetary policy are likely to take a considerable period of time.

In Vietnam, the central bank is positioned as a government organization alongside other central government ministries and agencies. It has no independence from the government in terms of either financial policy objectives or the tools used to achieve those objectives. For this reason, monetary policy reflects the intentions of the government, especially the state-owned enterprises, which have a strong influence on the government. This is reflected in a tendency toward monetary easing. The central bank is only required to fulfill its role in relation to inflation and the stability of the financial system when the government decides that this is necessary. There is no incentive in this environment for the central bank to improve its capabilities in these areas.

A statement by Prime Minister Nguyen Tan Dung at a national banking conference in January 2008 highlights the situation of the central bank. The Prime Minister said that the tasks of the central bank were to curb inflation and establish a financial environment capable of sustaining a 9% economic growth rate\(^{(39)}\). Should the central bank tighten monetary policy or ease it? Clearly these two tasks are incompatible. The Prime Minister’s statement can be seen as evidence that the government does not view the economy from monetary and real economic perspectives, but instead regards monetary policy as a mere adjunct to real economic policy. This contrasts with the stance taken by China, which had a lower inflation rate than Vietnam during this period. Around the same time as Mr. Dung’s statement, Premier Wen Jiabao directed that efforts should be made to prevent economic overheating and curb inflation\(^{(40)}\).

Because there are no incentives for the central bank to improve its capacity, there can be no improvement in the effectiveness of monetary policy. This dilemma has come to the fore as a result of policies that have sought to curb inflation while maintaining high growth. It is certainly not a new problem. As globalization advances, the importance of financial services is likely to increase rather than decline. What steps are needed to transform Vietnam into an economy that can use globalization as an opportunity for economic development, while adapting quickly to environmental changes? The government should review the status of the central bank immediately.

(2) **Vicious Circle of a Falling Dong and Rising Inflation**

Policies that give priority to economic growth are also the cause of distortions in Vietnam’s currency policy. Fluctuation in the dong-dollar exchange rate expanded in 2007 (Fig. 18), and the dong can no longer be expected to follow a gradual downward trend. We will now examine issues relating to currency policy by analyzing changes in the dong and the dong supply-demand balance and the resulting fluctuations in dong-dollar rate, and the policies that have influenced these changes.

Signs of abnormalities in the exchange rate first emerged in November 2006. The value of the dong rose in response to an influx of foreign funds into the stock market. Remittances from overseas Vietnamese and money brought back to Vietnam

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**Fig. 18 Fluctuations in the Dong-Dollar Exchange Rate (Monthly)**

![Graph showing fluctuations in the Dong-Dollar Exchange Rate](source: Compiled using CEIC data)
by these people during the Lunar New Year Period gave additional impetus to this trend. As described earlier in this article, upward pressure on the dong during this period exceeded the central bank’s expectations, and in March 2007 the government intervened to buy dollars because of concern about the impact on export industries\(^{41}\).

Until this point, the government still had considerable freedom with regard to currency policy. The allowable range of fluctuation was narrow, and there was little concern about inflation or the economic outlook. In this environment, the government was able to use intervention to guide the exchange rate in what it saw as a more desirable direction. However, this freedom would become a curse. Because currency policy was dominated by the view that the dong should be induced to fall in order to alleviate the trade deficit, it became incompatible with monetary policy. As noted earlier, this triggered the excess liquidity situation.

In September 2007, the dong-dollar rate rose again. This resulted from a fall in dollar interest rates resulting from interest rate cuts in the United States. There was also clear evidence that the inflation rate was strengthening, and the government was keenly aware of the need to tighten its monetary stance. In July 2007, the central bank adopted a tight stance by raising the reserve ratio and implementing selling operations. Thereafter the government refrained from dollar-buying intervention. At the end of 2007, the central bank expanded the tolerable range of fluctuation in the exchange rate from 0.5% to 0.75%, and in March 2008 the range was increased to 1.0%. The government and the central bank appear to have formed a consensus that inflation could be brought under control by tolerating a higher value for the dong.

All developing countries with fixed exchange rates share a common problem that is known as the “impossible trinity.” This term refers to the fact that it is impossible to achieve the three policy goals of fixing the exchange rate, allowing the free international movement of capital and implementing independent monetary policy at the same time. Two of these goals can be achieved without conflict, but not all three (Okabe [2003]). If the government continues its dollar-buying intervention in response to a continuing influx of capital, eventually economic stability will be eroded by the resulting dong over-supply situation. Ultimately, the only way to reconcile the international movement of capital with independent monetary policy will be to expand the tolerable range of fluctuation and allow the dong to move higher.

However, the government resumed its dollar-selling intervention at the end of March 2008. This decision was prompted by an increasingly serious shortage of dong under the tight monetary policy, and by fears of a decline in competitiveness of export industries\(^{42}\). In April, Prime Minister Dung stated that the government would continue to guide the dong down through intervention\(^{43}\). Currency policy had reverted to the situation that existed before August 2007. High-added-value products account for a small percentage of Vietnam’s exports, and the trade deficit is expanding. This means that Vietnam has less leeway than China to tolerate a higher value for its currency. Although the government was aware that a higher dong would be effective in curbing inflation, alarm over the expanding trade deficit led to a decision to give priority to the real economy.

A resumption of dollar-buying by the government, despite the fact that monetary policy was not functioning adequately, would inevitably add fuel to rising inflation. This policy shift heightened uncertainty about the economic outlook. However, the situation changed completely in May 2008, and currency policy has entered a new phase, with the dong losing value without government intervention. This shift has been attributed to structural changes. First, the inflow of funds has begun to dwindle because of the stock market slump. Second, the expanding trade deficit is reflected in increased demand for dollars.

The government and the central bank have monitored this trend quietly in the expectation that would strengthen Vietnam’s export competitiveness. Yet the trade deficit for the first five months of 2008 was $14.4 billion, which is 3.4 times higher than the figure for the same period in 2007. The fall in the value of the dong has been faster than the government anticipated. This dramatic depreciation has attracted speculative funds
in the expectation of exchange gains, adding further impetus to the dong’s descent. At the end of May, the benchmark rate announced by the central bank was slightly above 16,000 to the dollar, but the black market rate had reached 18,000, and the dong was being traded above 22,000 to the dollar on overseas markets (12-month forward contracts).

In late May, the central bank responded to this situation by announcing that if the dong continued to fall, it would intervene to sell dollars at around 17,500 dong to the dollar. In June it expanded the tolerable range of fluctuation to 2%. In just two months, Vietnam has shifted from a currency policy designed to guide the dong downwards, to one that seeks to prop up the currency. This is the first time since the adoption of the doi moi policy that the government has intervened to sell dollars with the aim of preventing a fall in the value of the dong. This is indicative of the enormous environmental changes that are affecting Vietnam as a result of globalization.

This decline in the value of the dong may seem to be a welcome phenomenon with the potential to strengthen Vietnam’s export competitiveness. However, there is also a downside. The greatest source of concern is the likelihood that rising import prices will make it impossible even to predict when the pressing problem of inflation can be brought under control. Given that there is still no end in sight for the current global rise in resource and grain prices, this is not an imaginary fear.

Because rising inflation signifies a fall in the real value of the dong, inflationary expectations will inevitably fan expectations of a lower dong. This in turn will encourage households to move their assets out of dong (and into dollars and gold), putting further downward pressure on the dong and upward pressure on import prices. There is a strong possibility that Vietnam has already fallen into this vicious circle. Furthermore, a falling dong will also lengthen the stock price slump, since foreign investors will be reluctant to invest in the stock market. Another negative impact will be the expansion of Vietnam’s external debt.

Some economists working for Western banks see the current fall in the value of the dong as symbolic of the crisis situation in which Vietnam now finds itself. There have also been predictions that Vietnam will eventually need IMF support, just as Thailand did during its currency crisis. This view reflects predictions that the trade deficit for the whole of 2008 will reach $20 billion (Fig. 19), and that this will trigger a capital flight, resulting in an unsustainably large current account deficit. This problem will be examined in greater detail in Part IV. However, predictions of unsustainability are premature and could cause the government to take the wrong policy direction.

The problem that the government and the central bank should be concerned about is the fact that the decline in the value of the dong will cause dollarization to accelerate, eroding the effectiveness of monetary policy and depriving them of the capacity to exercise control at the macroeconomic level. Households are leading the dollarization trend, and their expectations of further falls in the value of the dong continue to intensify. The government and central bank need to recognize that measures to curb inflation will be far more effective in reducing those expectations than import restrictions or intervention in the foreign exchange market.
(3) Measuring the Progress of SOE Reforms

In 2008 the government has begun to explore policy options other than monetary and currency policies. At a cabinet meeting in March, Prime Minister Dung directed state-owned enterprises to freeze the prices of 10 items, including fuel, electric power, transportation, cement, steel, water and coal. Initially the price freeze was set to expire in June. However, many within the government are alarmed about a price rebound after the freeze is lifted, and it is possible that it will be extended until the end of the year.

Since the price freeze will have little impact on food prices, which are the main source of rising inflation, its effectiveness is likely to be limited. The government’s decision to implement the freeze despite the limited benefits suggests that it has been forced to exercise all policy options, and that it is seeking to avoid criticism by pushing the burden onto the state-owned enterprises.

Yet the price freeze is not a remedy without side-effects. In fact it could have a serious impact on the Vietnamese economy. The first area of concern is the macroeconomic effect. The government has avoided explicit statements about how losses incurred by enterprises as a result of the freeze will be handled. If it provides subsidies to cover these losses, the fiscal deficit will inevitably expand, and this could put further upward pressure on prices and downward pressure on the dong.

There are other problems. The price freeze has shown that the relationship between the government and the state-owned enterprises is ambiguous, and that there is no clear boundary between the financial management of the state-owned enterprises and the financial management of the state. The state-owned enterprises are saying that the price freeze will cause them to incur losses because of rising prices for imported raw materials. However, they are currently complying with the freeze because they recognize that the situation has gone beyond the financial problems of individual enterprises. There appears to be tacit understanding between the government and the state-owned enterprises that they will negotiate later on how to deal with the losses.

This situation raises concerns that there has been no fundamental change in the relationship between the government and the state-owned enterprises since the days when public money was used to cover losses caused by lax management. Like China, Vietnam has implemented reforms based on the separation of ownership and management under a reform scenario designed to improve efficiency by increasing management independence. Some within the government believe that this approach has helped to improve the management of state-owned enterprises, but the credibility of this commonly accepted view must be seen as doubtful.

The same problem could arise even if the government decides not to cover the losses. This is because the government cannot afford to turn its back on loss-making enterprises, while the enterprises will seek to recover their “loans” to the government. Instead of subsidies to cover their losses, the enterprises will seek alternative forms of compensation, such as government guarantees for bank loans, and the government will be forced to accede, causing the relationship between the government and the state-owned enterprises to become even more opaque. While price controls are in force, it will be impossible to judge whether the losses of state-owned enterprises are the result of lax management or the price freeze. The state-owned enterprises will have no incentive to improve their management. Governance will deteriorate, and contingent liabilities will inevitably expand.

During the high-growth period, these problems with the governance of state-owned enterprises were simply overlooked. It is no exaggeration to say that this was the root cause of the present upheavals. The percentage of investment provided by the state sector (the government and state-owned enterprises) has been declining since 2001 and reached 43.3% in 2007 (Fig. 20). Compared with China, where state investment now accounts for less than 30% of total investment, Vietnam is still only part-way along the path to a market economy in relation to investment. The state-owned enterprises clearly played a major role in the stock market and real estate investment
The Vietnam Shipbuilding Industry Group (VINASHIN) actually invested 3.3 trillion dong ($200 million), equivalent to 1.1 times its capital, in the establishment of subsidiaries in such areas as securities, finance and real estate. As described later in this article, other major state-owned enterprises engaged in similar behavior. This leads inevitably to the conclusion that the state-owned enterprises have played a leading role in stock market and real estate investment.

There is no evidence that the government tried to restrain this behavior. It was not until April 2008 that the government directed state-owned enterprises to limit investment in non-core activities to 30% of their total investment. While investment may be curbed by this directive, the governance problems of the state-owned enterprises will remain. The government will need to take a closer look at the situation of major state-owned enterprises.

IV. The Future

Our final task is to examine the effects of the increase in the base rate and the outlook for the falling value of the dong. We will also show that the declining share of the state-owned sector does not necessarily indicate progress toward a market economy, and that the time has come to assess the merits and demerits of the SOE reform process.

(1) Testing the Benefits of a Higher Base Rate

When the government’s Central Institute for Economic Management (CIEM) published a growth rate forecast of 7.2% in May 2008, it added a rider stating that the growth rate could fall to 6.6-6.7% in a worst-case scenario. The World Bank has refrained from making this kind of pessimistic statements and said in June 2008 that the GDP growth rate was unlikely to fall below 7.5%. However, inflationary pressure remains strong, and we need to consider the possibility that the growth rate will fall below the worst case scenario.

The Economist was sounding warning bells about the future of the Vietnamese economy when the prevailing mood was still optimistic. The Economist predicted that rising inflation would erode the living standards of low-income urban dwellers, leading to strikes and other forms of social unrest. It also predicted that uncompetitive state-owned enterprises, which would normally fall by the wayside as a result of trade liberalization, would delay the reform process through lobbying activities. The Economist also highlighted risk factors, including the possibility of bankruptcies among business corporations and financial institutions because of the slump in the stock market and real estate market, saying that the growth rate could fall below 5% (Collins [2008]).

The pessimistic view now appears increasingly realistic and less extreme. Supporting evidence includes a chain reaction of strikes in the Thang Long Industrial Park in northern Vietnam, where many Japanese-owned companies are based. The inflation rate is obviously the most important indicator of the economic outlook.

However, the inflation rate is influenced by factors other than excess liquidity, including (1) food shortages, (2) the global rise in resource and resource
grain prices, and (3) inflows of speculative funds into these markets. The indicator is useless unless we can distinguish among these factors. If there is progress toward rectifying the excess liquidity problem, the downside risk will be reduced, even if there is no price movement. We first need to assess the effectiveness of monetary policy by focusing on this aspect.

In June the central bank raised the base rate to 14%. The effectiveness of this move in curbing lending will have a key bearing on the economic outlook for the second half of the year. If demand is reduced, downward pressure on dong will ease, and the trade deficit will also shrink. A lower value for the dong would normally be expected to result in reduced imports, but it is possible that this effect was cancelled out by an increase in speculative imports driven by inflationary expectations. If higher interest rates reduce inflationary expectations, speculative importing can also be expected to decline, allowing the import-reducing effect of a lower dong to come to the fore.

(2) Exchange Rate Destabilized by Market Uncertainty

How will the exchange rate move in the second half of the year? With the trade deficit expanding, expectations of a lower dong will not easily be overcome, and downward pressure on the currency is unlikely to dissipate. The central bank decided to increase its tolerable range of fluctuation as a way of curbing dollar speculation. However, there is a still a wide gap between bank rates and black market rates. Ultimately the central bank will probably be forced to widen the tolerable range of fluctuation until this gap disappears. In other words, it will have to accept further declines in the value of the dong.

The central bank’s stance calls for dollar-selling intervention to prevent sudden falls in the value of the dong. However, the use of intervention to guide the exchange rate is not an advisable policy, in part because of Vietnam’s foreign currency reserves have been shrinking since early 2008. Unlike China, it is uncertain whether Vietnam has sufficient foreign currency reserves to guide the exchange rate. This factor will lead to increased market uncertainty. The first step should be to curb speculation in anticipation of exchange gains by raising interest rates.

Expectations of a lower dong are being fueled not only by the view that the current account deficit has reached an unsustainable level, but also by market uncertainty. In fact, rumors that foreign investors were pulling out the stock market have previously triggered falls in the value of the dong. The government and the central bank should try to eliminate this uncertainty and remove factors that could destabilize the exchange rate through the timely publication of information about the international balance of payments.

It would be premature to conclude the current account deficit is unsustainable at present, since the rapid growth of imports is the result of temporary factors, such as the importation of materials, machinery relating to foreign direct investment and the purchase of aircraft (World Bank [2008]), and also because there is unlikely to be any significant change in inflows of funds through foreign direct investment, remittances from overseas Vietnamese, net buying on the stock market by foreigners, and aid.

The current account balance of payments reflects the investment-savings (IS) gap. As a percentage of GDP, Vietnam’s current account deficit is tending to diminish in step with the shrinkage of the IS gap (Fig. 21). It would be illogical to assume that the current account deficit will move away from the IS gap and continue to expand indefinitely. Like other developing countries, Vietnam keeps its current account balanced by covering trade account deficits with capital account surpluses. To assess the sustainability of the current account, we also need to take the demand-reducing effect of interest rate increases and the capital account surplus into consideration.

We also need to recognize that it is Vietnamese, not foreigners, who are driving a vicious circle in which expectations of a lower dong are causing the dong to be sold off, raising expectations of further declines. Vietnam’s capital market is not entirely open, and the results of the monetary survey (the aggregate of central bank accounts and
accounts in depository institutions) in June 2007 confirmed that at 430 trillion dong, Vietnam’s external assets were substantially larger than its liabilities (49 trillion dong). Net assets are positive figures and amount to less than 0.1% of GDP. This contrasts with Thailand’s position in 1997, when its net assets were negative 18.7% of GDP. It therefore seems unlikely that Vietnam will be immediately plunged into a “capital account crisis” (Yoshitomi [2003]).

If the government can rectify the excess liquidity problem and curb rising inflation by raising interest rates, and if it can then cool expectations of a lower value for the dong by disclosing information, it should be possible to halt this vicious circle. How should the central bank approach increasingly worried markets? What it needs is the ability to talk with markets.

(3) Distortions Caused by State-Owned Enterprises

Both the stock market and the real estate market, which have been the receptacles for investment inflows, are areas in which the systems needed to support a market economy are still inadequate. An analysis of the situation since 2007 shows that the harmful effects of economic heating have come to the fore in these vulnerable areas. In the financial sector, smaller joint-stock banks have aggravated financial instability by inducing funds to flow into both markets. They have also become a source of financial instability under the tight monetary policy because of the possibility that they will become undercapitalized. Despite financial deepening, the markets are still immature, and this appears to have worsened the upheavals.

These problems are not limited to Vietnam. In fact, they occur in many developing countries during the transition to a market economy. However, the severity of the problems varies according to the situation of each country. Vietnam is seen as one of the next generation of star markets after the BRICs. The amounts of goods and money flowing in and out of Vietnam are substantial compared with the scale of its economy. In this sense, Vietnam is better positioned than other countries to accelerate its economic development. However, there are risks that are just as significant as this opportunity. To minimize these risks, Vietnam will need to implement reforms that will improve the maturity of its financial markets to a level beyond its development stage.

Unfortunately, this will not be an easy goal to achieve. The immaturity of the financial markets reflects the fact that the SOE reforms are not proceeding in the right direction. This makes it extremely unlikely that the maturity of the markets will improve beyond Vietnam’s own development stage. In Part III of this article we looked at the governance problems of major state-owned enterprises and highlighted the need for change. This situation has prevented the sound growth of financial markets by spawning another problem: overbanking caused by the proliferation of financially weak small and medium joint-stock banks.

According to a report from the National Steering Committee for Enterprise Reform and Development, 28 of the 70 major state-owned enterprises, especially the “general corporations,” have established subsidiaries in such areas as finance and real estate. The report states that total investment in these companies has reached 23
trillion dong ($1.4 billion), which is equivalent to 8.7% of total capital. Amazingly, 21 banks holding funds belonging to state-owned enterprises or the government are still awaiting approval. The government’s basic SOE reform strategy has allowed major state-owned enterprises to establish banks. Financial markets cannot be expected to achieve qualitative growth while this loophole remains open.

Because of this proliferation of joint-stock banks owned by major state-owned enterprises, the fact that the state-owned commercial banks’ shares of deposits and lending are shrinking cannot be seen as a sign of progress toward the development of market economy in the financial sector. This is a problem affecting the entire Vietnamese economy. In the early 1990s, Vietnam had 12,000 state-owned enterprises. This number was reduced through the closure of some enterprises and the conversion of others into joint-stock companies as part of Vietnam’s transition to a market economy. By 2005 the number had fallen to 4,086. There was a corresponding decline in the state-owned sector’s share of industrial production (Fig. 22). This reduction in the number of state-owned enterprises and their share of industrial production was seen as a symbolic indicator of Vietnam’s transition to a market economy.

However, the falling number of state-owned enterprises does not necessarily signify progress in the transition to a market economy. State-owned enterprises are shareholders in a significant number of joint-stock companies that are classed as private enterprises. The number of joint-stock companies has increased not only because of the establishment of companies by private capital, but also because of the formation of companies by major state-owned enterprises known as “general corporations,” as well as the conversion of state-owned enterprises into joint-stock companies. From a legal perspective, these are all private enterprises, even though they include some pseudo-private companies that are very similar to state-owned enterprises in terms of their management structures. The inclusion of investment and added value generated by these companies in the private sector could cause progress toward a market economy to be overestimated.

The extent of this problem could be ascertained through an enterprise census based on the classification of joint-stock companies according to whether or not they have received government capital (Fig. 23). In terms of the number of companies, the number with government capital has on aver-
age increased by only around 30 per year, compared with an average of 400 companies per year without government capital. However, an analysis based on sales per company shows that joint-stock companies with government capital far outweigh those without government capital. It would be reasonable to conclude that this is attributable to the fact that these companies enjoy the protection and patronage of state-owned enterprises on various levels, including capital and markets.

What are the prospects for sustainable growth in this environment? According to Goldman Sachs, productivity is improving in Vietnam. However, this improvement in productivity is being driven partly attributable to urbanization caused by the movement of workers from agriculture, which has extremely low productivity, into manufacturing and service industries. Another factor is the emergence of private enterprises. Higher productivity does not necessarily guarantee that Vietnam is making progress toward a market economy. The sustainability of growth cannot easily be improved without a reform process that is subject to continual review.

The governance problems of state-owned enterprises also have implications for development. In recent years, Vietnam has tended to experience increasingly serious electricity shortages in the dry season. It has been suggested that the root cause of this problem is not, as is generally assumed, the fact that Vietnam is heavily reliant on hydroelectricity, but rather the fact that Electricity of Vietnam (EVN) has expanded its investment in non-core activities, such as telecommunications and real estate, in pursuit of short-term profit. We must conclude that the economic distortions caused by the existence of state-owned enterprises have been greater than anticipated, and that the effects of these distortions are widespread. The government needs to review the merits and demerits of the SOE reform process and redraw its reform roadmap.

**Conclusions**

Vietnam began its journey toward a market economy and open-door stance with the adoption of the *đoì mới* (reform) policy at the sixth congress of the Vietnamese Communist Party in 1986. In terms of the history of this reform process, Vietnam appears to be approaching a third turning point.

The first turning point came in the late 1980s and early 1990s. Under Mikhail Gorbachev, the former Soviet Union adopted a policy of *perestroika* (restructuring) that resulted in radical changes to Soviet aid to Vietnam. Vietnam was forced to abolish the rationing and price control systems, which were the symbols of its planned economy. While these reforms brought pain, in the form of hyper-inflation, they helped Vietnam to lay the foundation for a market economy and contributed to the subsequent stabilization of the economy.

The second turning point was the enforcement of the new Enterprise Law in 2000. A slump in foreign direct investment following the currency crisis, and the deteriorating performance of state-owned enterprises as a result of growing pressure for trade liberalization left the economy without any driving force. The private business sector, which had previously been seen as a “necessary evil,” was now entrusted with the role of economic engine. The government implemented a number of deregulatory measures, including the replacement of the approval system for the establishment of private enterprises with a registration system. These reforms accelerated the transition to a market economy and created a structure capable of supporting self-sustaining economic development.

Vietnam has reached its third turning point in the period since 2007. Pressure for liberalization has intensified as a result of WTO membership. Inflows of foreign capital are expanding, and the prices of resources and grain are rising. These environmental changes signal the start of a new phase in Vietnam’s reform process. The existing policy design has been to allow market principles to operate by easing restrictions left over from the planned economy era. It is now apparent that this approach will not provide an answer to question of how Vietnam can leverage globalization into economic development while minimizing the risks involved.
The downside risk will be increased by a loss of reform momentum and contradictory policies. There are no quick-fix solutions that will allow just the risks to be eliminated. The government will need to identify the distortions caused by the accumulation of partial and surface reforms, and to implement radical, comprehensive reforms. As stated at the beginning of this article, the sustainability of growth will ultimately depend on the extent of the government’s commitment to reform.

Over the past 18 months, many problems that were previously obscured have become visible. Much needs to be done, including the improvement of infrastructure for the stock market and real estate market. However, the core task in terms of remedying the vulnerability caused by globalization will be the reform of the central bank and state-owned enterprises. We can no longer assume that Vietnam’s future is bright simply because of foreign direct investment is buoyant, or because there has been progress toward the establishment of a market economy. The growing sense of crisis offers an excellent opportunity to improve the sustainability of growth.

### End Notes

1. This acronym refers to the next group of emerging nations after the BRICs, including Vietnam, Indonesia, South Africa, Turkey and Argentina.

2. The Next11 are 11 emerging economies identified by Goldman Sachs as having the potential to follow in the footsteps of the BRICs. They are Mexico, Nigeria, Egypt, Turkey, Iran, Pakistan, Bangladesh, South Korea, the Philippines, Vietnam and Indonesia.


4. Specifically, per capita income (monthly) rose from 295,000 dong in 1999 ($14.10, 1 dollar = 16,000 dong) to 636,000 dong ($39.30) in 2006.


7. This is a long-term trend. In May 2008, Goldman Sachs lowered its 2008-2009 growth rate forecast for Vietnam from 8.5% to 7.3% and 7.5%. For details see the VietnamBridge website: “Goldman Sachs: high inflation the biggest problem now for Vietnam,” May 22, 2008 (http://english.vietnamnet.vn/biz/2008/05/784420/).


20. For example, the combined total of companies listed on the Ho Chi Minh and Hanoi markets was less than 300 in May 2008, yet in February 2008 833 stocks were being traded on the over-the-counter (OTC) market. The number of joint-stock companies stood at 11,600 at the end of 2005.


22. Another local report puts the figure at 37.8%. *Dow Jones Factiva*, “Vietnam: Central bank urged to adopt flexible money policies,” January 10, 2008.


24. In February 2008, the central bank eased its investment policy by raising the ceiling for loans secured by securities from 3% of the outstanding loans to 20%. In March, the State Securities Commission reduced the maximum daily fluctuation in the prices of stocks listed on the stock market to one-fifth (from 5% to 1% in Ho Chi Minh, and from 10% to 2% in Hanoi). Despite these measures, stock prices have continued to fall. In May 2008, the State Securities Commission reacted to the slump in market transactions resulting from falling stock prices by announcing that approval would not be given for the establishment of new funds or securities companies in the foreseeable future. *Vietnam Investment Review*, “SSC pulls the plug on new stock companies,” No.864/May 5-11, 2008, and other sources.


29. The new system is expected to function under a civil code provision prohibiting interest rates from exceeding 150% of the base rate. The civil code has been in effect since 1996, so the legal basis for the system was already in place. However, financial institutions took little notice of this rule in the past, and the base rate did not function as a policy interest rate. The base rate is announced each month, together with the discount rate, but in practice it is merely calculated post facto as the average of the prime rates of the top 15 banks (Trung et al. [2006]) and is merely used a reference by financial institutions.


41. The dong’s slide is also attributable to external factors, including profit-taking sales by foreign investors after the stock market entered a correction phase, and increased demand for the dollar because of the rapid expansion of the trade deficit. Dow Jones Factiva, “State Bank plays with a straight bat,” April 28, 2008.


48. The government is also reducing fiscal expenditure and state-owned sector expenditure. Prime Minister Dung directed central government ministries, regional governments and state-owned enterprises to submit lists of unnecessary and non-urgent projects by the end of May. In practice, these groups are expected to make the smallest possible concessions while carefully monitoring other trends and the Prime Minister’s reaction to them. This means that reduction in expenditure is likely to be limited in scope.


References


