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# Vietnam: Selected Issues

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INTERNATIONAL MONETARY FUND

VIETNAM

**Selected Issues**

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Approved by Asia and Pacific Department

August 28, 2003

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## List of Acronyms

| | |
|---|---|
| AFTA | ASEAN Free Trade Agreement |
| ASEAN | Association of South-East Asian Nations |
| CIEM | Central Institute for Economic Management |
| CPI | Consumer Price Index |
| CPRGS | Comprehensive Poverty Reduction and Growth Strategy |
| DAF | Development Assistance Fund |
| DATC | Debt and Asset Trading Company |
| FDI | Foreign Direct Investment |
| FIE | Foreign-Invested Enterprises |
| GC | General Corporation |
| GDP | Gross Domestic Product |
| GIR | Gross International Reserves |
| GSO | General Statistics Office |
| HP | Hodrick-Prescott |
| IAS | International Accounting Standards |
| ICOR | Incremental Capital Output Ratio |
| IMF | International Monetary Fund |
| MFN | Most Favored Nation |
| MoF | Ministry of Finance |
| MPI | Ministry of Planning and Investment |
| MTEF | Medium-Term Expenditure Framework |
| NIR | Net International Reserves |
| NPL | Non-performing loan |
| ODA | Official Development Assistance |
| PRGF | Poverty Reduction and Growth Facility |
| PRSC | Poverty Reduction Support Credit |
| SBV | State Bank of Vietnam |
| SOCB | State-Owned Commercial Bank |
| SOE | State-Owned Enterprise |
| S&P | Standard and Poor's |
| USBTA | United States-Vietnam Bilateral Trade Agreement |
| VAR | Vector Autoregression |
| VAS | Vietnamese Accounting Standards |
| VAT | Value Added Tax |
| WEO | World Economic Outlook |
| WTO | World Trade Organization |

# I. INFLATIONARY DYNAMICS IN VIETNAM[1]

## A. Introduction

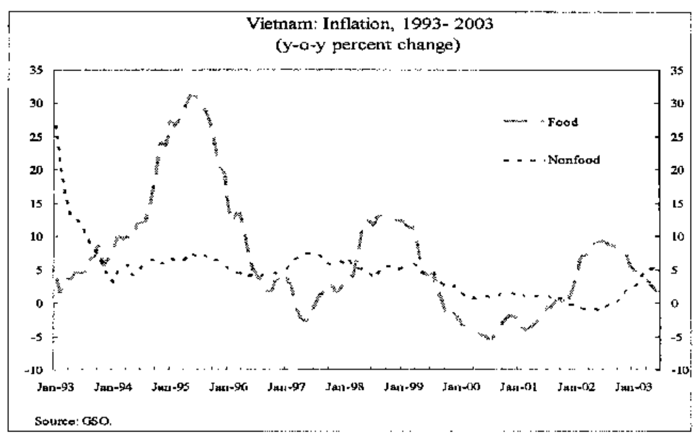
1. **Vietnam has experienced modest inflation over the past decade,** after a period of very high inflation during the early years of the "doi moi" reform program. Inflation has averaged 6 percent per annum since 1993, ranging from -2 percent to 17 percent, having peaked at about 370 percent in 1988, during the first years of price liberalization.


2. **Key factors influencing price developments during this low inflation period have included:**

- **Food price shocks**, reflecting a combination of domestic supply shocks and movements in key international prices (notably rice).[2] Food and foodstuffs account for 48 percent of the CPI basket, and food prices have tended to move in a very different manner to that of nonfood prices.[3]

- **Oil prices,** which have affected the CPI primarily via the costs of transportation, housing and construction materials.

- **and a significant degree of persistence,** perhaps arising from the sluggish adjustment of inflationary expectations.




[1] Prepared by Shanaka J. Peiris.

[2] Vietnam is the world's second largest exporter of rice, exporting some 10 percent of domestic production in 2002.

[3] Food and foodstuffs had a weight of over 60 percent in the CPI prior to July 2001, when a new weighting system based on the living standard survey of 2000 was introduced.

3. **In analyzing inflation developments, staff have found it useful to examine separately the movements of both food prices and non-food prices**, using the latter indicator as a proxy for "core" inflation, given that it is less volatile than the food price indicator.[4] But this "core" inflation concept needs to be used with caution, since it too has been quite volatile in the past and, by construct, excludes almost half the items included in the headline CPI.

4. **To better understand inflation dynamics, this chapter presents an econometric model of short-term price determination,** which seeks to allow for the influences of several potentially important factors,[5] including the impact of exchange rate pass-through, international commodity prices (e.g. rice and oil), monetary/credit conditions, and domestic demand conditions.[6]

## B. Methodology and Literature Survey

5. **Inflationary dynamics are examined using a seven-variable recursive VAR approach.**[7] The structure is a stripped-down version of McCarthy (2000), who employs a production chain model of price determination. The underlying model of the distribution chain translates into a recursive structure of the variance-covariance matrix, which enables the identification of shocks stemming from external and policy developments and their effects on consumer inflation. The 'structural shocks' are recovered from the VAR residuals using the Cholesky decomposition of the variance-covariance matrix.[8] The VAR comprises seven variables in the following order: (1) international oil prices, (2) international rice

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[4] The standard deviation of food price inflation was some 10 percent while non-food inflation was only 2½ percent during 1995-2002, although the difference was less pronounced the longer the time period considered. For example, extending the sample period to 1990-2002 gives a standard deviation of 28 and 21 percent for food and non-food inflation respectively.

[5] A number of prices are administered in Vietnam, which may have a significant influence on the consumer price index but are excluded from the analysis due to insufficient information.

[6] For example, the spike in headline inflation in 1994-95 was largely seen as a consequence of higher food prices due to natural calamities and rising international prices (IMF 1996).

[7] A structural VAR model was not attempted given the focus of the paper and lack of a rich array of reliable high frequency macroeconomic data (e.g. productivity, unemployment).

[8] The Cholesky decomposition imposes the correct number of restrictions for just identification and imposes a recursive structure on the system; the most endogenous variable is ordered last, i.e. it is affected by all contemporaneous 'structural' shocks.

prices, (3) industrial production, (4) the exchange rate, (5) monetary or credit conditions, (6) import prices, and (7) consumer prices.[9]

6. **The system encompasses the four key sources of inflation** identified by Loungani and Swagel (2001) in their analysis of the sources of inflation in developing countries.

- First, inflation in developing countries is often linked to underlying fiscal imbalances. Such imbalances can lead to an increase in inflation by causing excessive money creation or by triggering a balance of payments crisis and exchange rate depreciation.
- Another source of inflation may be macroeconomic overheating – that is, an excessive expansion of aggregate demand over potential output supply.
- A third source of inflation is supply-side 'cost shocks' – movements in key commodity prices, such as oil and food prices, that lead to persistent changes in the aggregate price level.
- Finally, inflation may have a substantial inertial component arising from the sluggish adjustment of inflationary expectations or the existence of staggered wage contracts.

**Data**

7. Monthly CPI data are available from 1990, with substantial quality improvements introduced in 1995. Monthly UK Brent oil prices and WEO international rice prices (Bangkok) in US dollars are used to capture international price movements. Monthly data for the exchange rate and monetary and credit aggregates are from the SBV. The monthly industrial production index is available from 1995 and is considered to be a very comprehensive measure: demand conditions are identified by the industrial production index and/or its deviation from potential (output gap) using a HP filter. Data on aggregate unit import prices are not readily available, and hence are constructed using monthly volume and value data for a limited number of broad commodity items weighted by their corresponding share of imports. An analysis of the time series properties of the variables reveals that they are integrated of order one or I(1), except the output gap, which is stationary or I(0) as expected.

8. **The VAR is estimated from January 1995 to March 2003 in log differences with three lags.**[10] Variance decompositions are computed next, which break down the variation

[9] See Appendix I for more detail.

[10] The choice of three lags was intended to account for the additional noise present in monthly series compared to quarterly observations. The series are differenced depending on the order of integration to avoid the spurious and inconsistent regression problem.

in the endogenous variables down to the component shocks, followed by impulse response functions that trace out the effects of orthogonal shocks to international supply conditions, demand conditions, the exchange rate, and monetary aggregates on prices through the dynamic structure of the VAR.

9. Implicit in the variable ordering mentioned above is the assumption that causality runs from external shocks to output, the exchange rate, to money and prices,[11] with the degree of endogeneity increasing. This is a potential drawback of the recursive structure because it precludes the feedback of prices to exchange rates and monetary policy within one time period, although the use of monthly data minimizes such effects. Therefore, alternative orderings of the variables are estimated to check for the robustness of the preferred ordering. Several other modifications are made to the basic setup, including using alternative measures of the nominal exchange rate (bilateral versus nominal effective), monetary conditions (reserve money and broad money), and consumer prices (headline and core inflation).

## C. Results

10. **In general, variances of all variables are mainly explained by their own innovations at all time horizons.**

- This holds true for headline inflation, but with international rice prices, domestic demand conditions and broad money growth explaining between 10-20 percent of its variation (see below).

- Core inflation is explained by its innovations and to a lesser extent (about 10 percent) by oil prices (particularly, in the first few periods), exchange rate depreciation, and broad money growth (with a lag of few months).

- Its own innovations also play a large role in the variation of import prices, but international oil prices and exchange rate changes also account for nearly 30 percent of variation each, thus having a significant influence on import prices.

11. **The import price index is significantly influenced by changes in the exchange rate while the more consumer-oriented retail price index is not,** reflecting the large weight on non-tradeables in the CPI. It is also clear that import prices do not directly feed

[11] Results from pairwise Granger causality tests are somewhat inconclusive, finding little evidence of granger causality in either direction, although lending support for a transmission of external and domestic shocks to consumer prices.

into consumer prices even with the greater degree of openness observed, with other domestic and external factors modeled playing a larger role.[12]

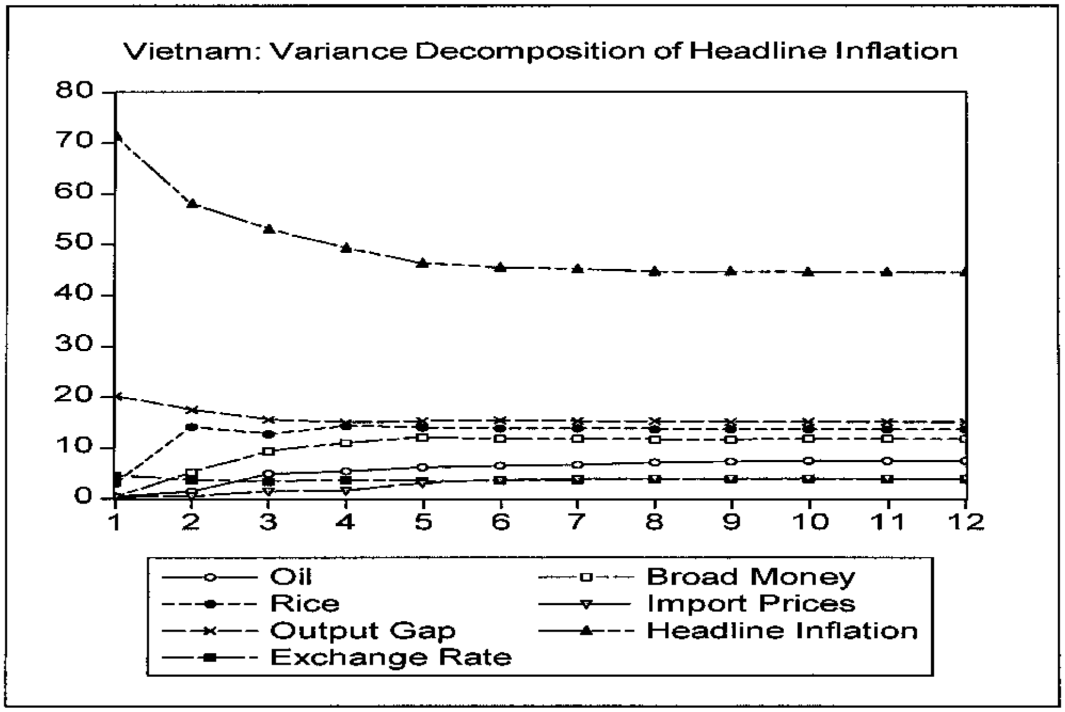
12. **The inclusion of alternative measures of demand conditions, monetary conditions, or the exchange rate does not substantially alter the results.** Moreover, the variance decomposition is not significantly susceptible to a change of order in the variables, attesting to the robustness of the estimated results.

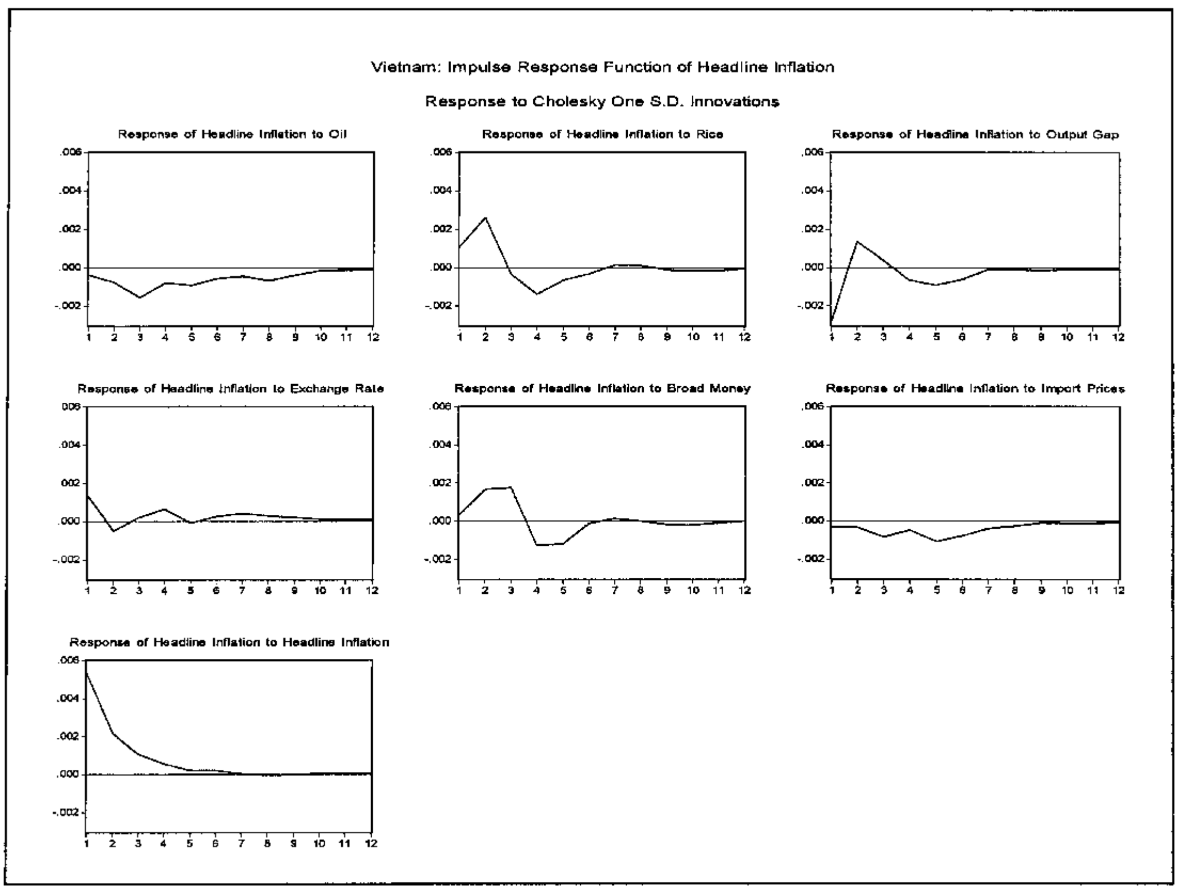
13. **Impulse response functions corroborate the findings of the variance decompositions that international rice prices, domestic demand conditions and broad money growth have a modest impact on headline inflation, along with substantial persistence.** Own innovations have a significant impact effect on headline inflation lasting for about 5-6 months, with rice price shocks having the second largest effect persisting for a few months. Monetary and demand shocks also have an influence on headline inflation but with demand shocks showing a initial contractionary effect while broad money displays a more gradual positive impact (see below).

14. **Core inflation is susceptible to oil price shocks and exchange rate changes,** consistent with the results of the variance decompositions but with broad money having a smaller impact than that implied by the variance decompositions. Own innovations to core inflation seem more persistent than headline inflation.

15. **Impulse response functions of the import price index show a much larger impact of external shocks than consumer prices.** Oil price and exchange rate shocks have a substantial impact on import prices and show a complete exchange rate pass-through to import prices within a few periods, compared to a modest exchange rate pass-through to consumer prices. For example, a one percentage shock to the exchange rate leads to a quarter percentage change in headline inflation within a year with very little further pass-through in subsequent periods. A pass-through elasticity of 0.25 is somewhere in the mid-to-lower range of previous studies for developing countries.

[12] This could be due to measurement issues associated with the construction of the import price index which captures a limited number of import items, and/or because foodstuffs are largely domestically produced.


Vietnam: Variance Decomposition of Headline Inflation
80
70
60
50
40
30
20
10
0
1 2 3 4 5 6 7 8 9 10 11 12
Oil
Rice
Output Gap
Exchange Rate
Broad Money
Import Prices
Headline Inflation


Vietnam: Impulse Response Function of Headline Inflation
Response to Cholesky One S.D. Innovations
Response of Headline Inflation to Oil
Response of Headline Inflation to Rice
Response of Headline Inflation to Output Gap
Response of Headline Inflation to Exchange Rate
Response of Headline Inflation to Broad Money
Response of Headline Inflation to Import Prices
Response of Headline Inflation to Headline Inflation

## D. Conclusion

16. **Variance decomposition and impulse response functions suggest that international rice prices, domestic demand conditions and broad money growth have a modest impact on headline inflation along with substantial persistence.** Non-food inflation is more affected by international oil price fluctuations and exchange rate changes. In general, the impulse response functions of many pairs of variables do not show a high degree of significance, which could be attributed to a number of factors: a) the sample period is relatively small, b), observations are monthly and thus subject to a high signal-to-noise ratio, and c) the low variation in data, particularly consumer prices and exchange rate, reduces the efficiency of the estimations.

17. **The degree of exchange rate pass-through to consumer prices is modest, particularly when compared to the almost one-to-one pass-through to import prices.** The less than one-to-one and modest pass-through on consumer prices may be explained by pricing-to-market under imperfect competition, the low weight given to importables in the consumption basket, and by distribution costs, which likely comprise a large share of nontraded inputs. Institutional factors, such as administered prices and state-trading companies, also reduce the impact of exchange rate changes.

18. **The role of monetary aggregates on consumer price inflation is not robust or very significant**, providing little guide to monetary policy[13]. The substantial inertial component may reflect the sluggish adjustment of inflationary expectations and nominal rigidities, or could be due to weaknesses in model specification. Further research could usefully explore price developments through a money demand function and other partial equilibrium frameworks over a longer time horizon, or through simulation models that rely less on time series data.

[13] No cointegrating relationship was found between the monetary aggregates and consumer prices over the sample period.

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IMF, (1996), "Vietnam: Transition to a Market Economy," IMF Occasional Paper 135, Washington, DC.

Loungani, P. and Swagel, P. (2001), "Sources of Inflation in Developing Countries," IMF Working Paper 01/198 , Washington, DC.

McCarthy, J (2000), "Pass-Through of Exchange Rates and Import Prices to Domestic Inflation in Some Industrialized Countries" (unpublished, Federal Reserve Bank of NY).

## Appendix

### Structure of Estimated VAR

International supply conditions are controlled for by including oil price inflation $\pi_t^{oil}$, which is a function of the previous period's expectation and an unanticipated shock, $\varepsilon_t^{oil}$ (see equation 1). International commodity price conditions is controlled for by including international rice price inflation $\pi_t^{Rice}$, which is once again a function of the previous period's expectation and an unanticipated shock, $\varepsilon_t^{rice}$ plus the oil price shock $\varepsilon_t^{oil}$ (see equation 2). Demand conditions at time t are captured by the output gap ($y_t$) equation, which is determined by expectations in period t-1 plus the impact of the external shocks (see equation 3). The international supply and domestic demand shocks are assumed to be orthogonal to the exchange rate shock, (equation 4), and the ordering assumes that these shocks are exogenous to money at time t (equation 5); while these structural shocks then feed into import price inflation, $\pi^0$ (equation 6), and finally consumer price inflation, $\pi^c$.

$$\pi_t^{oil} = E_{t-1}(\pi_t^{oil}) + \varepsilon_t^{oil} \tag{1}$$

$$\pi_t^{Rice} = E_{t-1}(\pi_t^{Rice}) + \alpha_1 \varepsilon_t^{oil} + \varepsilon_t^{Rice} \tag{2}$$

$$y_t = E_{t-1}(y_t) + \beta_1 \varepsilon_t^{oil} + \beta_2 \varepsilon_t^{Rice} + \varepsilon_t^y \tag{3}$$

$$\Delta e_t = E_{t-1}(\Delta e_t) + \chi_1 \varepsilon_t^{oil} + \chi_2 \varepsilon_t^{Rice} + \chi_3 \varepsilon_t^y + \varepsilon_t^e \tag{4}$$

$$\Delta M_t = E_{t-1}(\Delta M_t) + \delta_1 \varepsilon_t^{oil} + \delta_2 \varepsilon_t^{rice} + \delta_3 \varepsilon_t^y + \delta_4 \varepsilon_t^{\Delta e} + \varepsilon_t^{\Delta M} \tag{5}$$

$$\pi_t^o = E_{t-1}(\pi_t^o) + \phi_1 \varepsilon_t^{oil} + \phi_2 \varepsilon_t^{rice} + \phi_3 \varepsilon_t^y + \phi_4 \varepsilon_t^{\Delta e} + \phi_5 \varepsilon_t^{\Delta M} + \varepsilon_t^o \tag{6}$$

$$\pi_t^c = E_{t-1}(\pi_t^c) + \gamma_1 \varepsilon_t^{oil} + \gamma_2 \varepsilon_t^{rice} + \gamma_3 \varepsilon_t^y + \gamma_4 \varepsilon_t^{\Delta e} + \gamma_5 \varepsilon_t^{\Delta M} + \gamma_6 \varepsilon_t^o + \varepsilon_t^c \tag{7}$$

Once the recursive model has been estimated a number of analyses can be undertaken. Variance decompositions show for each variable the ratio of the forecast error variance that is attributable to its own shock and to shocks stemming from other (upstream) variables. Impulse response functions show the estimated response of each variable to an impulse in one of the innovations. The impulse responses of import prices, core inflation and headline inflation to domestic and external shocks will provide estimates of the importance of these influences for inflation at different stages. VAR modeling implies that contemporaneous correlations are reflected in the cross-equation residual correlation. The Cholesky factorization sets to zero the residual correlation between a given variable and another variable prior in the (causal) ordering.

## II. EXTERNAL TRADE POLICY, PERFORMANCE AND COMPETITIVENESS[14]

### A. Introduction

19. Increasing integration into the international economy has been an important component of Vietnam's economic reform strategy initiated in the late 1980s. Since then, Vietnam's trade regime has been liberalized gradually, while its trade openness has increased sharply. This chapter takes stock of Vietnam's trade regime and performance over the past decade or so, and examines its external competitiveness with a view to assessing the prospects for sustained export growth over the medium term.

### B. The Evolution of the External Trade Regime

20. **Vietnam's external trade regime has evolved gradually**. Under the central-planning regime in place prior to 1989, most decisions on foreign trade were made by the central authorities in the context of official protocols negotiated with CMEA countries, and implemented through such measures as trading rights, quantitative restrictions (QRs), and a multiple exchange rate system. Following the loss of CMEA markets in 1989, trade barriers on the export side were dismantled rapidly, with a view to expanding and diversifying the export base. Progress in reducing import tariffs and QRs was more gradual. In early 2001, a multiyear trade policy roadmap for 2001-05 was announced, a change from the earlier practice of announcing one-year regimes. The roadmap provides for tariff reduction, QR removal, and other trade measures, aimed at laying the basis for WTO accession by 2005.

21. **Bilateral and multilateral agreements serve as important external anchors for Vietnam's trade liberalization**. Under AFTA (1995), tariffs on imports from ASEAN countries were reduced to below 20 percent in July 2003 and are to be below 5 percent by 2006.[15] Under the USBTA (2001), Vietnam has made substantial commitments to further liberalize its trade regime, including tariff and quota reductions, and to other trade reform measures, including improving transparency, introducing dispute settlement procedures, protecting intellectual property, and facilitating investment.[16]

22. **Since 2001, Vietnam's trade regime has been further liberalized.** QRs now remain on only two products (sugar and petroleum). Mean tariff rates have remained broadly stable at about 15-16 percent, as tariff reductions have been offset by tariffication of QRs. Most

[14] Prepared by Qing Wang.

[15] The inclusion list (IL) covers about 95 percent of the tariff lines.

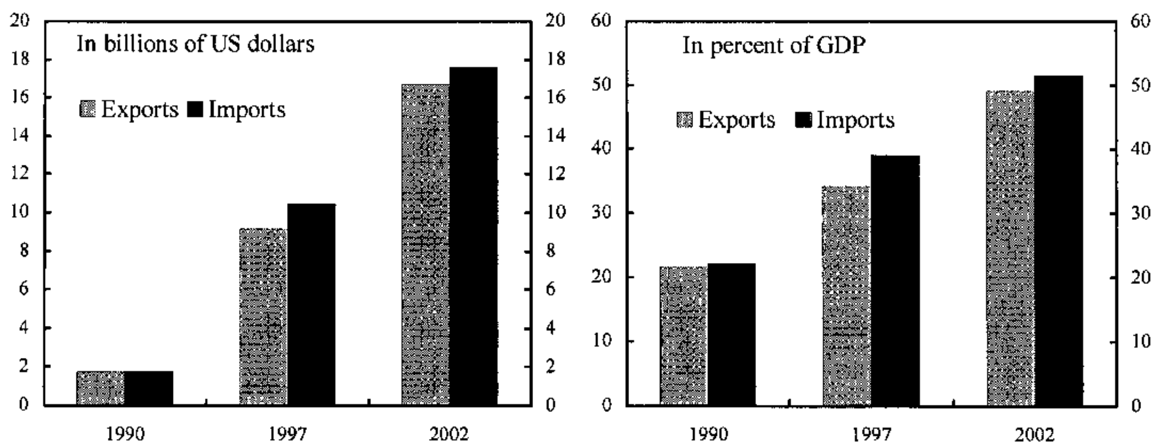
[16] Reciprocally, Vietnam's exports to the US have been granted MFN status, resulting in an estimated drop in the average tariff rate levied on Vietnamese imports into the US from some 40 percent to 3-4 percent (see The CIEM and Star-Vietnam Project, 2003).

export QRs have been eliminated, except for those imposed by the importing countries under bilateral agreements (i.e., textile and garments). Foreign trading rights, which were liberalized for domestic firms in 1998, are to be further liberalized for U.S. firms under USBTA commitments. The foreign exchange surrender requirement, after being cut gradually from 80 to 30 percent during 1999-2002, was reduced to 0 percent in May 2003.

## C. External Trade Performance

23. **Vietnam's external trade has grown rapidly since the early 1990s.** Total exports and imports of goods (in U.S. dollar terms) both increased on average by 21 percent per year during 1990-2002, substantially faster than GDP.

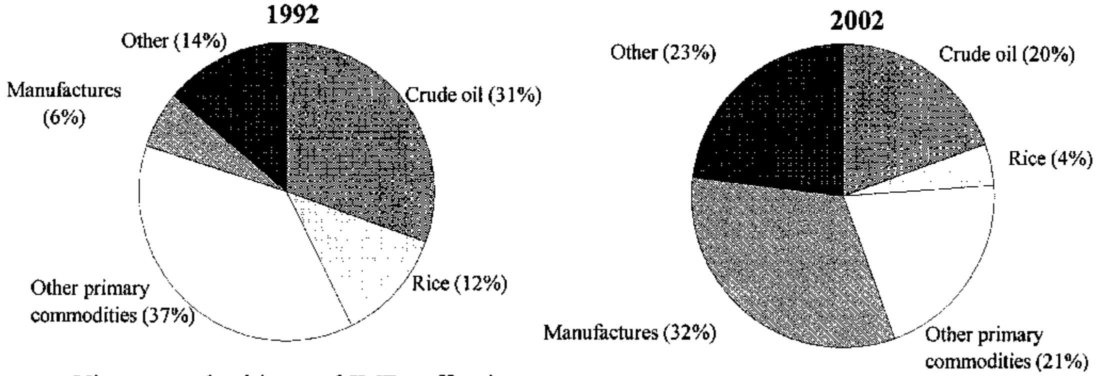
Vietnam: External Trade Performance




Source: IMF staff estimates.

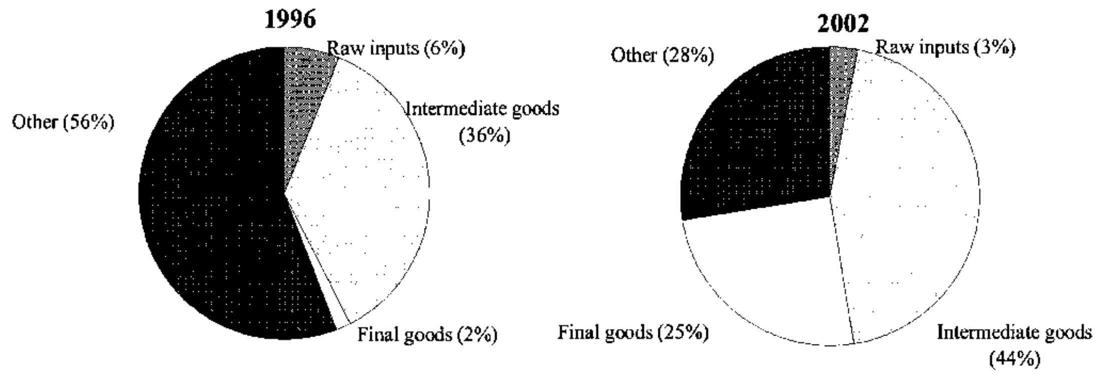
24. **The merchandise structures of both exports and imports have become increasingly diversified.** The share of crude oil in total exports declined from a third in the early 1990s to a fifth by 2002, while that of manufactures rose from 6 percent to almost one-third. The share of final goods in total imports jumped from 2 percent in 1996 to 25 percent in 2002, with that of intermediate goods increasing from 36 to 44 percent.

Vietnam: Export Structure




Source: Vietnam authorities; and IMF staff estimates.

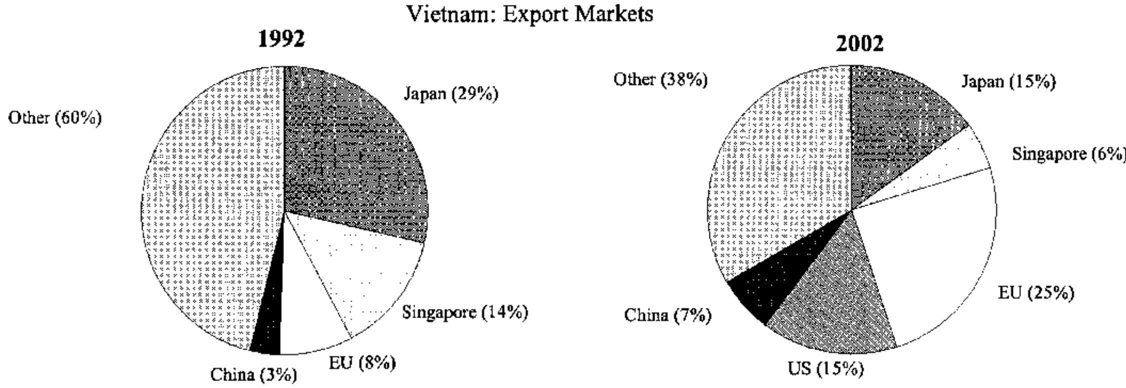
Vietnam: Import Structure




Source: Vietnam authorities; and IMF staff estimates.

25. **There has been a significant diversification in Vietnam's export markets as well,** with the share of exports to the G-3 increasing significantly[17]. With Vietnam becoming less dependent on oil exports, Japan and Singapore have become less important as destinations for Vietnam's exports. The EU and U.S. have over time become major markets for Vietnam's exports of manufactured goods such as textiles, garments, and footwear. The degree of concentration of trading partners, as measured by the Herfindahl Index, declined from 0.18 in 1992 to 0.11 in 2002[18].

Vietnam: Export Markets

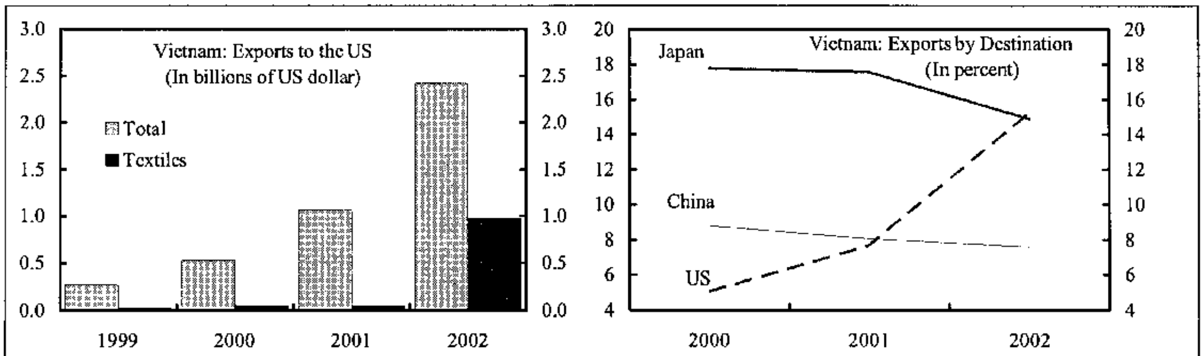



Source: IMF Direction of Trade Database.

[17] Exports to the U.S. had been negligible until 1994 when the bilateral trade relations were normalized.

[18] The Herfindahl Index is the sum of the squared market shares of all trading partners; a decrease indicates reduced concentration/increased diversification.

26. **The USBTA has provided a sizable fillip to exports since it became effective in December 2001**, with exports to the U.S. increasing by 128 percent and accounting for 82 percent of total export growth in 2002, making the U.S. Vietnam's largest export market.




Source: Ministry of Trade

## D. External Competitiveness

27. **Three sets of indicators—market shares, real effective exchange rates (REER) and business costs—are employed to shed light on the evolution of Vietnam's external competitiveness vis-à-vis its competitors.** Six countries are selected as significant competitors for Vietnam: China, India, Pakistan, Philippines, Thailand and Indonesia.

**Relative market shares**

28. **Vietnam has increased its share of global exports at a strong pace**, registering faster growth (albeit from a low base) than the competing countries, even during the Asian crisis period of 1997-98 (Figure 2.1).

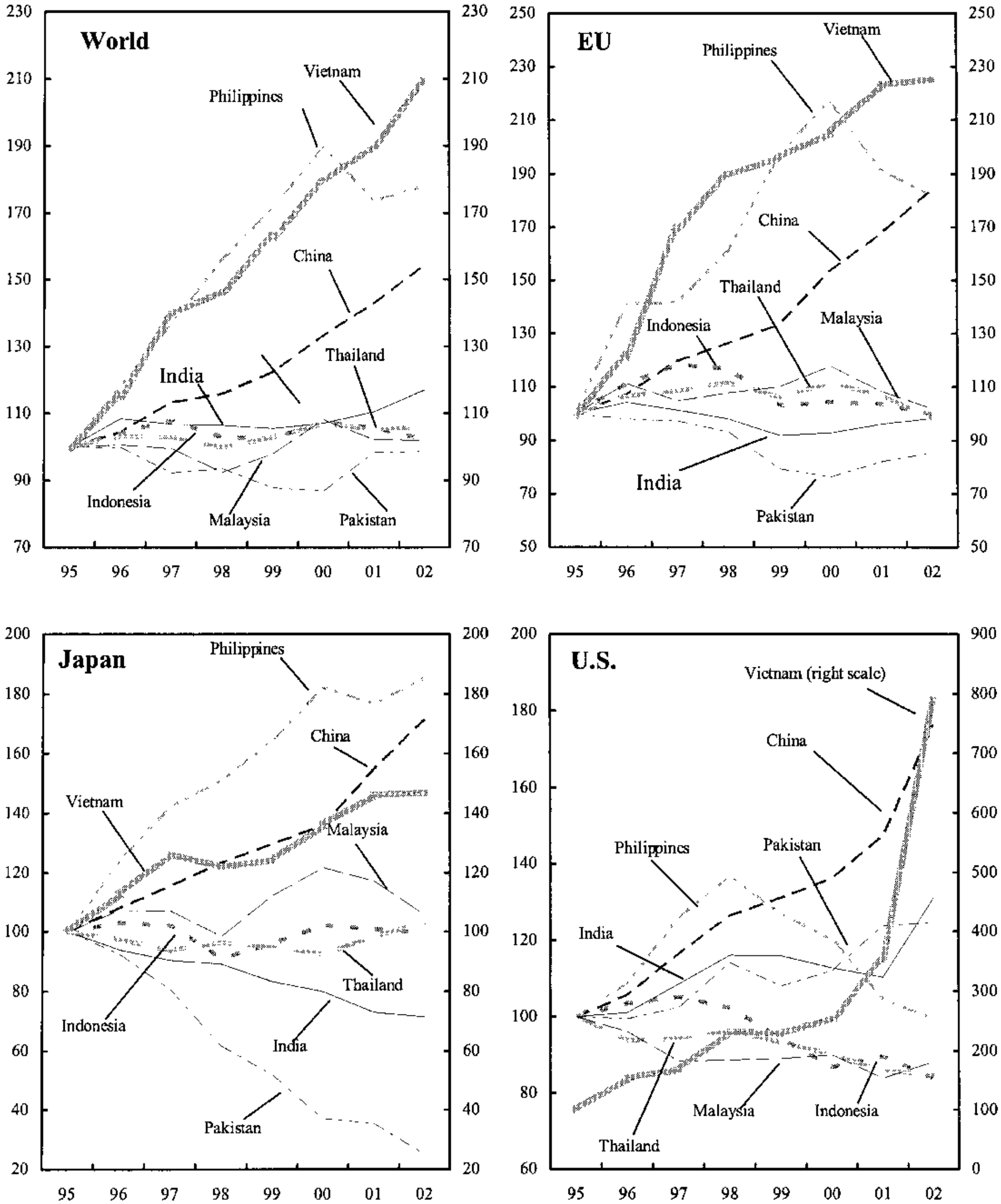
Export Market Shares in 1995 and 2002
(In percent )

| Markets of destination: | World | | EU | | Japan | | US | |
|---|---|---|---|---|---|---|---|---|
| | 1995 | 2002 | 1995 | 2002 | 1995 | 2002 | 1995 | 2002 |
| **Vietnam** | **0.12** | **0.25** | **0.08** | **0.18** | **0.51** | **0.75** | **0.03** | **0.21** |
| China | 4.52 | 6.97 | 1.69 | 3.11 | 10.69 | 18.33 | 6.29 | 11.10 |
| Thailand | 0.87 | 1.07 | 0.48 | 0.47 | 3.01 | 3.12 | 1.54 | 1.30 |
| India | 0.69 | 0.80 | 0.55 | 0.54 | 0.87 | 0.62 | 0.79 | 1.04 |
| Indonesia | 0.93 | 0.95 | 0.42 | 0.42 | 4.23 | 4.20 | 1.03 | 0.86 |
| Malaysia | 1.68 | 1.72 | 0.59 | 0.60 | 3.14 | 3.31 | 2.33 | 2.06 |
| Pakistan | 0.16 | 0.16 | 0.14 | 0.12 | 0.18 | 0.04 | 0.17 | 0.21 |
| Philippines | 0.39 | 0.69 | 0.16 | 0.29 | 1.04 | 1.93 | 0.96 | 0.95 |

Source: IMF Direction of Trade Database

29. **In the individual G-3 markets, Vietnam's overall performance has been generally strong**, although the pace of market share expansion in the EU and Japan has

**Figure II.1: Vietnam: Export Market Share Evolution vis-à-vis Competitors**
(1995 = 100)

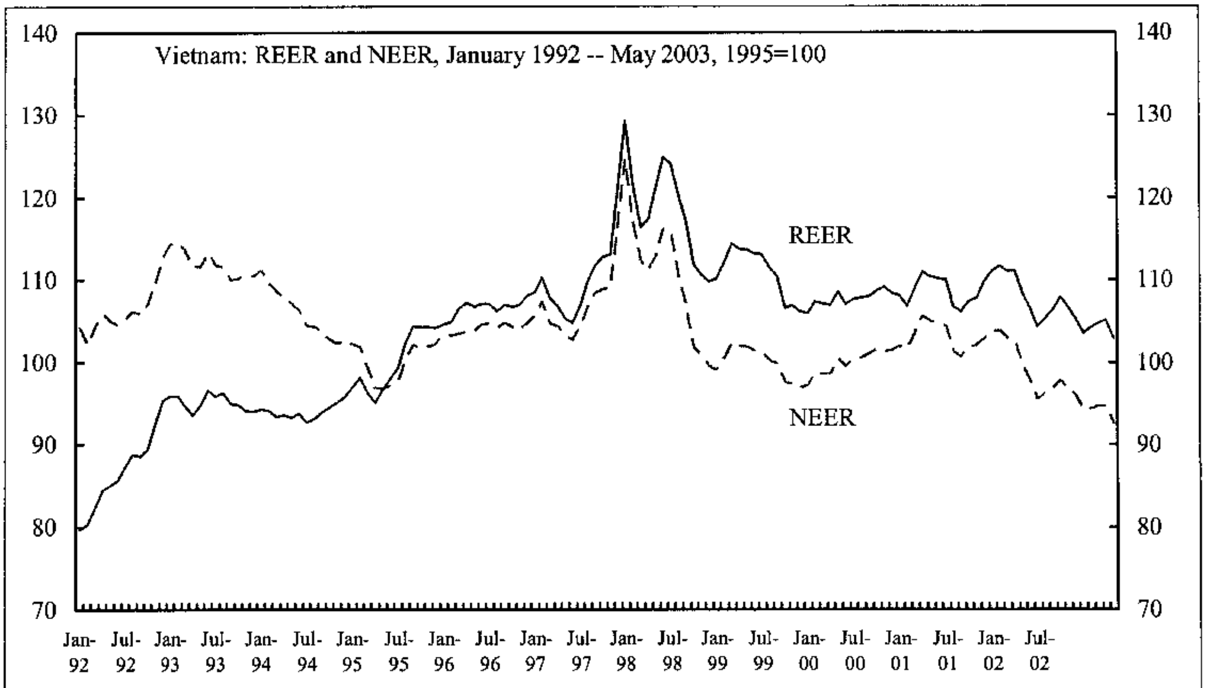



Source: IMF Direction of Trade Database

lagged behind that of China in recent years. Vietnam has expanded its exports to the U.S. very significantly, largely reflecting normalization of the trade relations with the U.S. in 1994 and the implementation of the USBTA in December 2001.

**Real effective exchange rates**

30. The REER for Vietnam appreciated sharply in 1992-95, partly reflecting the impact of price deregulation in the early stages of reform and the strong inflows of FDI. The dong depreciated by nearly 20 percent during the Asian financial crisis, but has demonstrated broad stability with a mild depreciation since then.



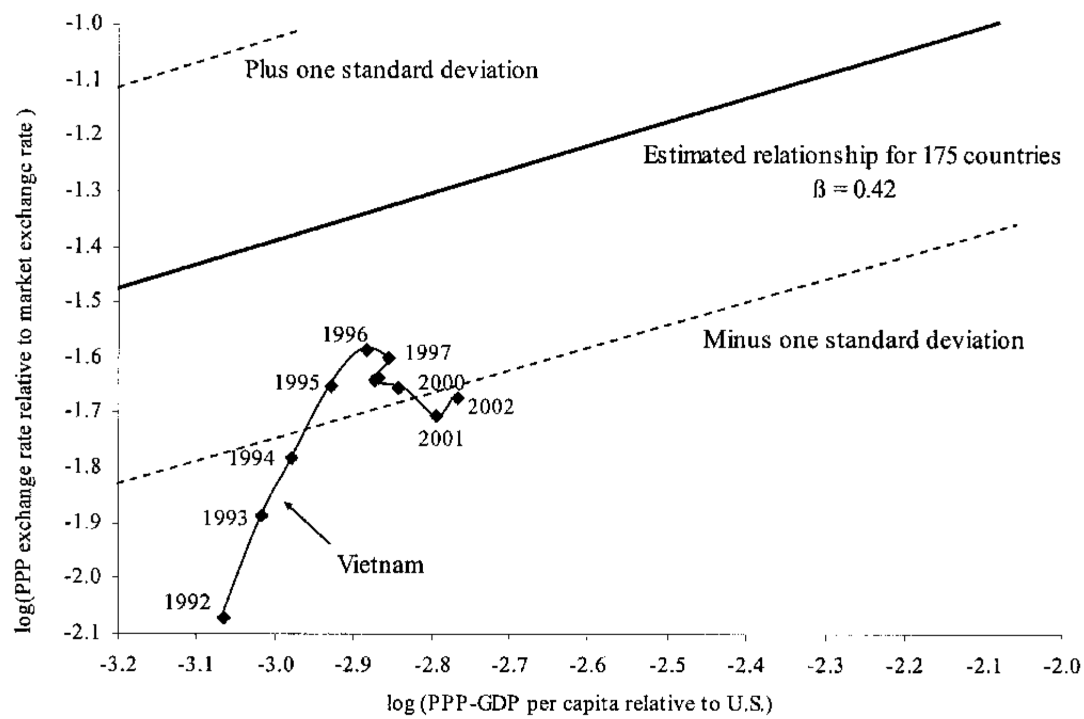
Source: IMF Staff estimates

31. The appreciation of the real exchange rate over the past decade is broadly consistent with the estimated relationship between real income *per capita* and the equilibrium real exchange rate, predicated on the so-called Balassa-Samuelson (B-S) effect (i.e., a rising relative price of non-tradeables as countries catch up with higher income countries)[19]. The pattern of movement – strong initial appreciation partly as a correction of the early

[19] The cross-sectional regression is between the log of the 1995-2002 average of the ratios of the nominal exchange rate to its PPP value and the log of the 1995-2002 average of GDP per capita (also on a PPP basis) for 175 countries. Both variables are measured relative to the U.S.. This estimated relationship implies that catch-up in relative *per capita* income of 10 percentage points is generally associated with a real appreciation of 4 percent (see De Broeck and Slok (2001)).

undervaluation, followed by some depreciation since 1997 – appears to be also attributable to regional factors, with FDI inflows to Vietnam falling significantly with the onset of the Asian crisis.

Relationship between Real Exchange Rate and Real Income

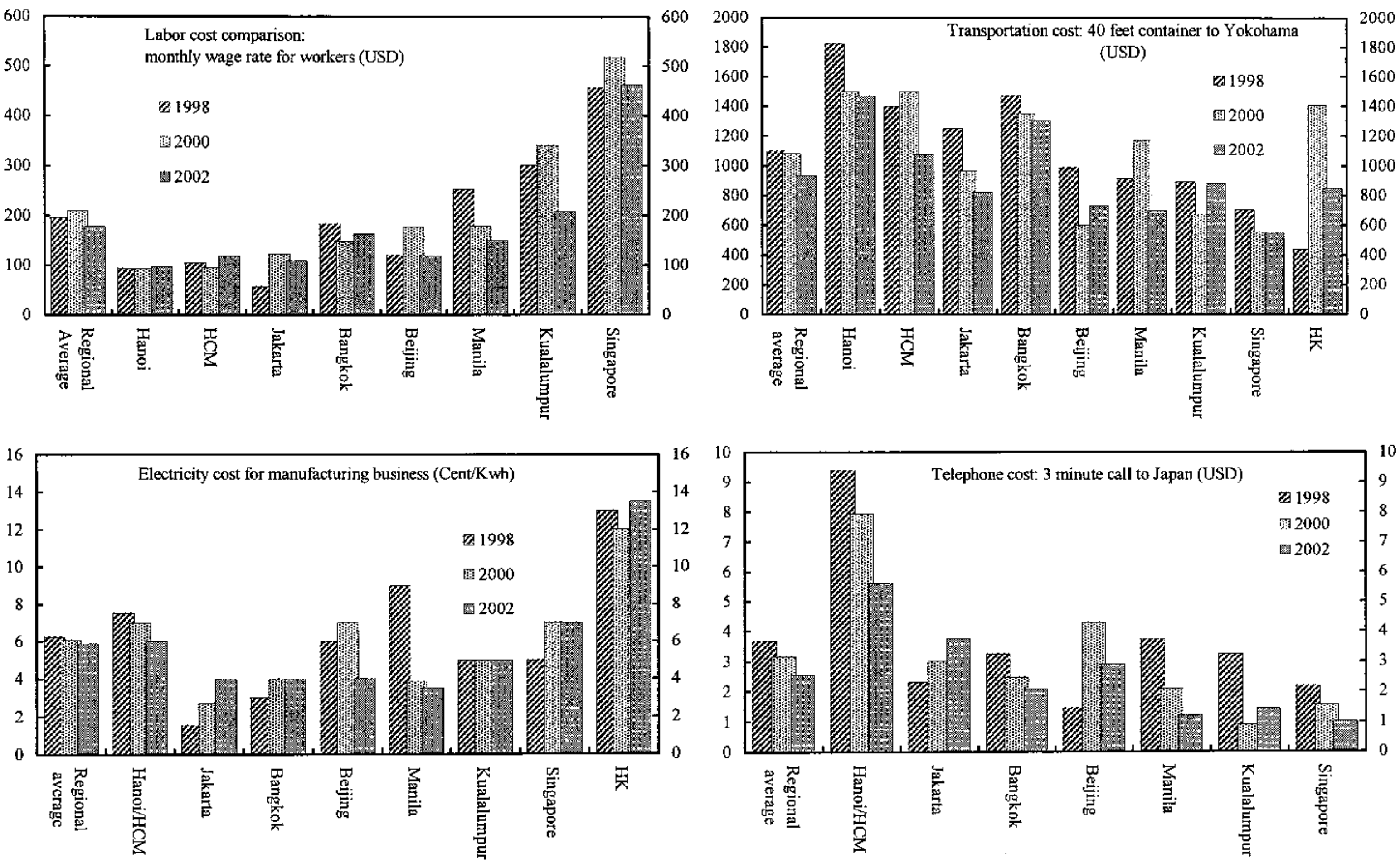



Source: IMF staff estimates.

## Business costs

32. **Cross-country comparisons in the business cost environment provide useful insights into country competitiveness.** Comparative data based on surveys conducted by Japan External Trade Organization (JETRO), provided to the Vietnamese government during a government-business dialogue in Hanoi in June, indicate that Vietnam has significant cost advantages relative to other countries in the region in regard to labor costs, but suffers cost penalties in regard to core infrastructure services – notably electricity, transportation costs, and telecommunications (Figure 2.2). With the costs of infrastructure services having trended down in recent years, some of these cost penalties should be further alleviated over the medium-term, as physical infrastructure is improved and dual pricing of key inputs (whereby foreign firms pay a higher price than domestic firms) is eliminated. A reasonably elastic supply of labor should help maintain Vietnam's labor cost advantage.

## Figure II.2: Cross-country Comparison of Business Costs




Source: JETRO Survey

## E. Can Vietnam Sustain its Strong Export Growth over the Medium Term?

33. East Asia has many cases of countries that have experienced a sustained period of strong export growth as they become increasingly integrated into the global trading system.

Sustained Strong Export Growth Experienced by Selected East Asian Economies (In percent)

| | Period | No. of years | Average annual export growth rate |
|---|---|---|---|
| **Vietnam** | **1990-02** | **13** | **21** |
| China | 1978-02 | 25 | 15 |
| Hong Kong SAR | 1960-95 | 36 | 17 |
| Indonesia | 1970-97 | 28 | 15 |
| Japan | 1954-81 | 28 | 19 |
| Korea | 1960-95 | 36 | 26 |
| Malaysia | 1968-96 | 29 | 15 |
| Philippines | 1970-00 | 31 | 13 |
| Thailand | 1971-95 | 25 | 19 |

Source: IMF Staff calculation

34. **Several features suggest that Vietnam can follow the path of neighboring countries**:

- Vietnam's low income level relative to the more advanced ASEAN neighbors provides a core advantage in labor-intensive manufacture.

- Manufactured exports per capita are still quite low in Vietnam, pointing to scope for substantial expansion.

Manufacture Exports Per Capita in 2001 (In U.S. dollar)

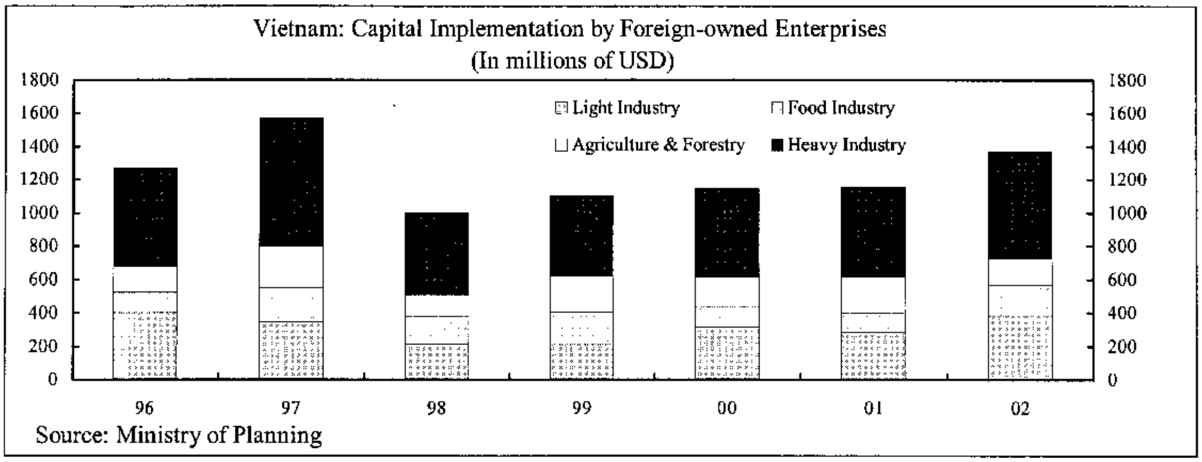
| Vietnam | China | Thailand | Indonesia |
|---|---|---|---|
| 55 | 178 | 733 | 142 |
| | Malaysia | Philippines | Korea |
| | 2,835 | 223 | 2,636 |

Source: IMF staff estimates.

- The USBTA has significantly improved Vietnam's market access to the largest market in the world. In view of its still very low share (i.e., 0.2 percent in 2002) in the U.S. market, Vietnam should expect to benefit from this improved market access and increase its penetration of the U.S. market for a sustained period of time.

- Vietnam, although effectively a price-taker in most markets, is sufficiently large to be registered on foreign investors' radar screens in their search for suitable locations for export-oriented investments.

- Recent trends point to a pick-up in investment in tradable sectors by the foreign-owned enterprises in Vietnam, which accounted for over one-third of total non-oil exports in recent years, and contributed nearly two-thirds of the overall growth in 2002




35. **China's rapid economic expansion and its accession to the WTO bring both opportunities and challenges for Vietnam.** China has been a significant destination for Vietnam's exports (over 7 percent)[20], and Vietnam should continue to be able to take advantage of China's strong growth and import expansion. But China is also an important competitor in third markets, and is likely to benefit significantly from the phasing out of quotas on textiles and clothing at the beginning of 2005 under the WTO Agreement on Textile and Clothing (ATC).Vietnam's early entry into the WTO will be an important move in ensuring equal market access for Vietnamese exporters.

## F. Conclusion

36. **Vietnam's integration into the global economy is making steady progress**: international trade has expanded rapidly in absolute terms and relative to both Vietnam's GDP and world trade. This strong external performance has been underpinned by sound macroeconomic management, a large pool of low-cost labor, a solid natural resource base, and sizable FDI inflows.

37. **Looking ahead, the key challenge for Vietnam is to sustain strong export growth over the medium term.** Meeting this challenge will hinge on:

- Maintaining prudent macroeconomic policies;
- Safeguarding export market access by implementing bilateral and regional trade agreements and achieving early membership in the WTO;
- Remove remaining barriers to investment, both domestic and foreign, to lower business costs and facilitate further diversification of export structure.

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[20] The border trade between China and Vietnam is considered to be very active, but is not fully reflected in the official statistics.

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# III. TAX POLICY – MEDIUM TERM CHALLENGES[21]

## A. Introduction

38. **Vietnam's budgetary revenues are heavily dependent on three sources: oil sector taxes, taxes on international trade, and other taxes collected through state enterprises.** With each of these revenue sources likely to contract relative to GDP over the medium term, and demands for budgetary resources likely to increase, the government needs to develop alternative sources of revenue in ways that are non-distortionary and conducive to growth. Important steps have been taken to develop the revenue base, including the introduction of a VAT in 1999, and to modernize tax administration, but further reforms will be needed in the coming years.

39. **This chapter considers the policy issues associated with strengthening the revenue base over the medium term**. It first takes a macroeconomic perspective, examining the levels and composition of revenues and the future risks to revenues; and then takes a microeconomic perspective, examining the design features of major taxes and suggesting future avenues for reform.

## B. Composition and Trends of Revenue Mobilization

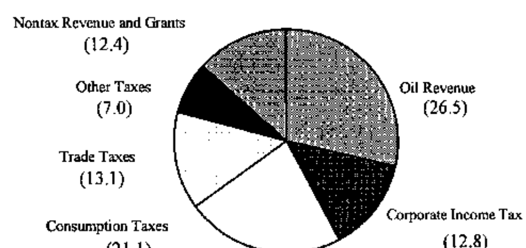
**Government Revenue as a share of GDP 1/**

| | |
|---|---|
| ASEAN-4 2/ | 19.7 |
| China | 15.7 |
| Vietnam | 21.3 |

Source: MOF and WEO database.
1/ Unweighted average 1998-02. In percent.
2/ Indonesia, Malaysia, Phillipines, Thailand.

40. **Budgetary revenues have averaged 21 percent of GDP in recent years**, a relatively high level by the standards of neighboring economies. Key revenue sources are the oil sector, consumption taxes (VAT and excises), taxes on international trade, and corporate income tax raised on the nonoil sector. Oil sector revenues come primarily from the production of crude oil, all of which is currently exported; taxes on imported (refined) oil products accounted for about one-quarter of oil revenues in 2001-02.

**Vietnam: Tax Structure**
**(Percentage share of Revenue, 1998-02)**




Source: MOF.

41. **Budgetary revenues have risen somewhat relative to GDP in recent years,** aided by rising world oil prices (Table III.1). Nonoil revenues have shown no trend movement, with some recovery in 2000-02 compensating for revenue declines in 1998-00: corporate income tax and consumption taxes have increased in

[21] Prepared by Erik Lueth.

importance since 1998 (the combined yield rose from 7.1 percent of GDP to 9.0 percent in 2002), offsetting declines in trade taxes and other minor tax items.

**Table III.1. Vietnam: General Government Revenue, 1998-2002**

| | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|
| | | | (in percent of GDP) | | |
| Total revenue and grants | 20.2 | 19.8 | 21.1 | 22.7 | 22.9 |
| Oil revenue | 4.1 | 4.7 | 6.6 | 7.8 | 6.8 |
| Crude oil revenue | 2.4 | 3.1 | 5.5 | 5.7 | 4.9 |
| Corporate income tax 1/ | 1.0 | 1.3 | 2.3 | 2.4 | 2.0 |
| Nontax revenue | 1.4 | 1.8 | 3.2 | 3.4 | 2.9 |
| Taxes on imported oil | 1.7 | 1.5 | 1.2 | 2.1 | 1.9 |
| VAT 2/ | 0.3 | 0.3 | 0.6 | 0.6 | 0.5 |
| Excises | 0.1 | 0.1 | 0.2 | 0.3 | 0.3 |
| Import duties | 0.9 | 0.8 | 0.4 | 1.2 | 1.1 |
| Other | 0.4 | 0.3 | 0.0 | 0.0 | 0.0 |
| Non-oil revenue | 15.6 | 14.5 | 14.0 | 14.4 | 15.7 |
| Tax revenue | 12.8 | 12.3 | 11.8 | 12.1 | 13.3 |
| Corporate Income Tax 1/ | 2.6 | 2.3 | 2.9 | 3.3 | 3.4 |
| Personal Income Tax 3/ | 0.5 | 0.5 | 0.4 | 0.4 | 0.4 |
| VAT 2/ | 3.0 | 4.0 | 3.4 | 3.6 | 4.5 |
| Excises | 1.5 | 1.0 | 1.0 | 1.1 | 1.1 |
| Taxes on trade | 3.6 | 3.1 | 2.8 | 2.6 | 3.1 |
| Other taxes | 1.6 | 1.4 | 1.3 | 1.1 | 0.6 |
| Nontax revenue | 2.8 | 2.2 | 2.2 | 2.3 | 2.4 |
| Grants | 0.6 | 0.6 | 0.5 | 0.4 | 0.4 |
| Memorandum Item: | | | | | |
| Oil price annual average (US$/bbl) | 13.1 | 18.0 | 28.2 | 24.3 | 25.0 |
| Crude oil exports (in billions of metric tons) | n.a. | 14.9 | 15.4 | 16.7 | 16.9 |
| Oil imports (in millions of metric tons) | 6.9 | 7.4 | 8.8 | 9.0 | 10.0 |
| Nominal GDP (trillions of dong) | 361 | 397 | 430 | 458 | 520 |

Source: Vietnamese authorities and staff estimates.
1/ Before 1999 a profit tax.
2/ Before 1999 a turnover tax.
3/ Before 2001 Ordinance on High-income Earners.

42. **Viewed in a comparative context, Vietnam obtains substantial revenues from the corporate income tax and from taxes on international trade, and remarkably little revenue from personal income taxes** (Table III.2). The corporate income tax contributes 28 percent of tax revenues (21 percent of nonoil tax receipts), compared with under 10 percent in a large sample of OECD and emerging market economies; while proceeds from trade taxes amount to some 4 percent of GDP, substantially more than in any other ASEAN-4 country. By contrast, the personal income tax yields only 0.4 percent of GDP in Vietnam and 2½ percent of total taxes – minimal levels by international standards.

**Table III.2. Vietnam: Tax Structure of the General Government – International Comparison 1/**

| | Sample Size 2/ | Total Revenue | Nontax Revenue | Tax Revenue | Personal Income Tax | Corporate Income Tax | Soc. Sec. Contri-butions | VAT/Sales/ Turnover Tax | Excise Taxes | Trade Taxes | Property Taxes | Other Taxes |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | (in percent of GDP) | | | | | | |
| OECD countries | 1996-00 | 37.4 | 0.3 | 37.0 | 10.0 | 3.3 | 10.3 | 6.6 | 3.5 | 0.5 | 1.9 | 1.0 |
| Selected Non-OECD countries 3/ | 1996-00 | 29.5 | 4.5 | 25.0 | 3.4 | 2.1 | 5.9 | 6.1 | 2.5 | 1.4 | 0.7 | 2.8 |
| ASEAN-4 4/ | 1995-01 | 20.2 | 4.5 | 15.7 | 2.5 | 3.5 | 0.7 | 3.2 | 2.2 | 1.7 | ... | 2.1 |
| Vietnam | 1998-02 | 22.0 | 4.8 | 17.2 | 0.4 | 4.8 | 1.3 | 4.2 | 1.3 | 3.9 | 0.8 | 0.4 |
| | | | | | | (in percent of total tax revenue) | | | | | | |
| OECD countries | 1996-00 | 101.1 | 1.1 | 100.0 | 26.3 | 8.8 | 27.1 | 17.8 | 9.3 | 1.4 | 5.4 | 4.0 |
| Selected Non-OECD countries 3/ | 1996-00 | 119.1 | 19.1 | 100.0 | 12.3 | 9.3 | 20.4 | 24.6 | 10.6 | 6.7 | 3.0 | 13.2 |
| Vietnam | | | | | | | | | | | | |
| incl. oil revenue | 1998-02 | 128.9 | 28.9 | 100.0 | 2.6 | 27.9 | 7.0 | 24.5 | 7.7 | 22.8 | 4.8 | 2.6 |
| excl. oil revenue | 1998-02 | 117.2 | 17.2 | 100.0 | 3.3 | 21.4 | 8.8 | 27.2 | 8.1 | 22.0 | 6.0 | 3.3 |

Source: Revenue Data Base maintained by FAD. Vietnamese authorities.

1/ The table includes social security contributions, which are off-budget in Vietnam. Unweigthed averages for OECD, non-OECD, and ASEAN-4 countries.

2/ Five year average, if available.

3/ Comprises Albania, Argentina, Azerbaijan, Belarus, Bolivia, Brazil, Bulgaria, Chile, China, Croatia, Estonia, India, Israel, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Malaysia, Moldova, Mongolia, Peru, Romania, Russia, Slovenia, South Africa, Thailand.

4/ Comprises Indonesia (central government only), Malaysia, Phillipines, Thailand.

43. **State-owned enterprises (SOEs) play a key role in tax collections** (see also Table III.3). Some 80 percent of the corporate income tax in 2002 came from state-owned enterprises, crude oil production (dominated by the state-owned Petro Vietnam), and the state lottery. 60 percent of VAT revenues, and 75 percent of excise proceeds were collected from these entities.[22]

**Vietnam: Selected Revenue by Source, 2002**

| | CIT | VAT | Excises |
|---|---|---|---|
| | | (in percent of total) | |
| State | 79.7 | 59.7 | 73.6 |
| FIE (nonoil) | 8.0 | 18.0 | 25.4 |
| Private enterprises | 12.3 | 22.3 | 0.9 |

Source: MOF.

1/ Comprises crude oil production, SOEs, and state lottery.

[22] The contribution of state-linked entities to tax revenues is understated in that many FIEs are joint ventures between foreign investors and SOEs.

| Table III.3. Vietnam: Revenue by source, 1997 - 2002 | | | | | | |
|---|---|---|---|---|---|---|
| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
| | | | (in percent of GDP) | | | |
| Total | 20.8 | 20.2 | 19.8 | 21.1 | 22.7 | 22.9 |
| State 1/ | 8.7 | 8.0 | 8.1 | 10.5 | 11.3 | 10.3 |
| FIE | 1.2 | 1.2 | 1.0 | 1.1 | 1.2 | 1.4 |
| Private enterprises | 2.1 | 1.8 | 1.4 | 1.4 | 1.5 | 1.5 |
| Others 2/ | 8.9 | 9.2 | 9.3 | 8.1 | 8.6 | 9.7 |
| Memorandum Item: | | | | | | |
| Share in nonoil industrial production (in percent) | | | | | | |
| SOE | ... | 51.7 | 49.4 | 46.9 | 46.6 | 44.7 |
| FIE (nonoil) | ... | 23.4 | 25.6 | 27.8 | 26.7 | 27.9 |
| Private enterprises | ... | 24.9 | 25.0 | 25.3 | 26.7 | 27.4 |

Source: MOF.
1/ Comprises crude oil production, SOEs, and state lottery.
2/ Reporting systems do not allow an assignemnet to any of the above categories.

## C. Medium-Term Challenges

44. **Budgetary revenues are likely to come under pressure from several sources:**

- **Oil sector revenues will likely decline relative to GDP over the next five years**, as world prices ease from the high levels of recent years and oil production expands more slowly than aggregate output. Oil prices are expected to decline by as much as 25 percent between 2003 and 2007, while oil production capacity is expected to remain unchanged through 2005 and then rise by some 15-20 percent by 2010. While the aggregate revenue impact of falling prices will likely be alleviated by some offsetting adjustments in import tariffs on oil imports, oil revenues could drop by some 2 percentage points of GDP between 2002 and 2007.

- **Revenues from trade taxes will fall somewhat as Vietnam implements AFTA and USBTA commitments, and will likely fall further over the longer-term as Vietnam accedes to WTO membership.** AFTA liberalization commitments directly affect about one-eighth of Vietnam's imports; the revenue loss is projected to be around 0.3 percent of GDP. Imports from the US account for only 7 percent of overall imports, and with tariff reductions planned for only 244 tariff lines, the revenue impact is estimated by the authorities to be below 0.1 percent of GDP. The revenue impact of WTO membership will obviously depend on the package of measures adopted in this context – but the cross-country comparisons cited above suggest that trade tax receipts will fall steadily in importance over time.

- **The state-owned sector of the economy, which generates a disproportionate share of nonoil tax revenues, can be expected to decline in relative importance over time**, as output growth depends increasingly on the expansion of private sector activity. Tax revenues will come under pressure unless tax policy and administration are re-calibrated to the task of collecting revenue from private firms.

45. **The tax administration system requires substantial modernization.** The current system lacks the capability and procedures to implement self-assessed accounts-based tax collection; tax administration is organized by tax type rather than by function (accounting, audit, collection, enforcement, and appeals); headquarters staffing to guide and supervise field offices is insufficient. Other impediments to effective tax administration are the complexity of the tax system, weak accounting standards, and poor bookkeeping in small and medium-size firms.

## D. The Reform Agenda

46. **Important efforts are underway to address some of the challenges in tax administration.** A pilot program for collecting CIT and VAT on a self-assessment basis will be launched in two provinces (Ho Chi Minh City and Quang Ninh) in 2004, albeit restricted to SOEs and FIEs given their stronger capabilities in bookkeeping and accounting. Key issues for the success of this program will be the training of staff and the implementation of adequate computer systems, which are being pursued with FAD technical assistance. In addition, a new accountancy law has been passed to require the use of proper accounting techniques and regulate the activities of the accounting profession.

47. **The National Assembly in May 2003 approved a package of tax reforms that simplify the tax system and reduce distortions; the reforms take effect in January 2004.** The authorities are also currently fleshing out a tax reform agenda for the period through 2010. The remainder of this section takes a tax-by-tax approach in explaining the recent measures and discussing reform priorities.

### Corporate Income Tax

48. **The main feature of recent reform of the corporate income tax is the equal treatment of domestic and foreign invested enterprises:**

- A new standard rate of 28 percent applies equally to FIEs and domestic enterprises. This replaces the existing standard rates of 25 percent and 32 percent, respectively.
- Preferential CIT rates and other tax incentives are made uniform for FIEs and domestic enterprises.
- The supplementary income tax for domestic enterprises is eliminated, as is the profit remittance tax for FIEs.

The overall revenue impact of these measures is expected to be negative (about 0.5 percent of GDP), with the decline resulting from the reduction in CIT rates for domestic enterprises (0.5 percent of GDP). Looking ahead, the authorities hope to reduce the standard CIT rate to 25 percent by 2010.

49. **The equal treatment of FIEs and domestic enterprises eliminates distortions, enhances tax compliance, and reduces administrative costs** through simplifying the tax system. The latter will become particular relevant under self-assessment.

50. **The authorities' objective of reducing the corporate tax rate over time is ambitious**, and will need to be reviewed in light of broader revenue developments. Consideration needs to be given to broadening the tax base by simplifying tax incentives, notably preferential rates and tax holidays, which could act as a significant drag on revenues as economic activity shifts towards the private sector.[23]

**Value Added Tax**

51. **The principal thrust of the VAT reform is a reduction in exemptions and the number of (positive) rates from 3 to 2 (5** and **10 percent):**

- Goods previously exempted from VAT on the grounds that they were subject to excises are subjected to the standard VAT rate of 10 percent.
- Several goods are moved from the 20 and 5 percent rates to the 10 percent rate, and the 20 percent rate is eliminated.
- Most exported services are zero-rated rather than merely exempted from VAT. To prevent tax fraud, tax administration requires exported goods and services on which input VAT is claimed to be verified with customs, have sales contracts, and have payments made via banks.

The revenue impact of the reform is positive as the broadening of the tax base outweighs the zero-rating of services. Over the long run, the authorities plan to abandon the 5 percent rate and further reduce exemptions.

[23] For a review of tax incentives in Vietnam see Fletcher (2002), for a general reference see Zee (...).

**Vietnam: Regional Comparison of Tax Efficiency, 2001**

| | CIT | | | VAT | | |
|---|---|---|---|---|---|---|
| | standard rate | yield (% of GDP) | efficiency ratio 1/ | standard rate | yield (% of GDP) | efficiency ratio 1/ |
| Cambodia | 20 | 0.8 | 3.9 | 10 | 2.8 | 27.7 |
| Indonesia | 30 | 1.6 | 5.3 | 10 | 3.9 | 39.0 |
| Malaysia | 28 | 6.2 | 22.1 | ... | ... | ... |
| New Zealand | 33 | 4.5 | 13.6 | 12.5 | 8.0 | 64.0 |
| Papia New Guinea | 25 | 2.6 | 10.4 | 10 | 2.9 | 29.0 |
| Phillipines | 32 | 2.7 | 8.4 | 10 | 3.0 | 30.0 |
| Singapore | 25.5 | 6.2 | 24.5 | 3 | 1.5 | 51.1 |
| Sri Lanka | 35 | 1.3 | 3.7 | 12.5 | 3.3 | 26.4 |
| Thailand | 30 | 2.9 | 9.7 | 10 | 2.6 | 26.0 |
| Unweighted average | 28.7 | 3.2 | 11.3 | 9.8 | 3.5 | 36.7 |
| Vietnam | 32 | 5.6 | 17.6 | 10 | 4.2 | 42.2 |

Source: For tax rates "The Modern VAT (2001)" and "Price Waterhouse Coopers (2001)", for revenue and GDP data IMF Staff Reports.

1/ Defined as revenue to GDP divided by the standard tax rate, expressed in percent. In the case of Indonesia the top rate is taken.

52. **These measures simplify the VAT system and should make it easier to administer,** but further reforms along the lines envisaged by the authorities (fewer exemptions, a single positive rate) are warranted. Administration of the VAT seems to have worked well to date, as evidenced by the high efficiency ratio, but further improvements can be achieved by increasing the threshold, which is extremely low by international standards,[24] and replacing the presumptive VAT for tax payers below the threshold with a simple turnover tax.

53. **Raising the basic VAT rate would be an appropriate way to offset the revenue losses projected from other tax sources in the coming years.** Substantial revenues can be raised – increasing the standard rate to 12.5 percent would generate additional revenue of at least 1 percent of GDP – in a relatively non-distortionary fashion.[25]

## Excise Tax

54. **Excise taxes (called special consumption taxes) are a modest source of revenue in Vietnam.** Rates vary between 15 and 100 percent and the tax is imposed on a range of goods

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[24] Among 79 countries for which data is available, only 3 have a lower threshold than Vietnam.

[25] See Keen and Ligthart (2001).

deemed to have negative externalities or inelastic demand. Temporary reductions in mandated excise taxes have been granted to the auto industry, as an industrial development incentive. The government is considering some minor rate changes for beer and other spirits with uncertain revenue effect as well as an extension of taxes to gambling; the rates on motor vehicles will be reduced, while the temporary reductions in rates enjoyed by the industry will be phased out. Raising excise rates could play a role in compensating for future revenue losses, particularly in cases where envisaged tariff reductions will reduce the retail price of certain goods.

**Personal Income Tax**

55. **The personal income tax (PIT) was not included in the May 2003 reform package,** although an overhaul of the system is warranted given its low yield (less than ½ percent of GDP) and complexity. The PIT in its current form is a tax on employee income, with self-employed persons subject to the CIT; the system is progressive, with 6 bands and rates ranging from zero to 50 percent. Vietnamese citizens are also subject to a supplementary income tax levied at 30 percent of net income in excess of a specified threshold.

56. **Administrative costs are high relative to yield, while redistributive objectives are met only to a limited extent.** Tax compliance is weak, with survey evidence suggesting that only 3 percent of the non-agricultural working population pay PIT and very few individuals paying the highest marginal rates. The large discrepancy between the top tax rates under the PIT (65 percent) and the CIT (32 percent, now reduced to 28 percent) provides strong incentives for taxpayers to choose the corporate form of doing business. Redistributive aims are further undercut by exemptions that benefit those with high income (e.g., exemptions for financial income, educational expenses, air fares of foreigners).

57. **Some shortcomings of the PIT are to be addressed in the authorities' medium-term reform agenda.** The authorities plan to (i) eliminate the supplementary income tax, (ii) bring tax rates on foreigners closer to those of Vietnamese, (iii) narrow the gap between the top PIT and CIT, (iv) submit regular and irregular income to the same tax regime, and (v) expand the tax base to include income from interest, bonds, dividends, and rent. Stronger actions to simplify the system and reduce the top marginal tax rates are likely warranted.

## E. Conclusion

58. **Budgetary revenues will come under pressures from several sources over the medium-term, although some buoyancy can be expected from the expansion of the formal sector of the economy.** Important reforms to simplify the tax system and modernize administration are underway, but further reforms to simplify the corporate income tax and VAT and overhaul the personal income tax code would help boost revenues. Increases in consumption taxes over the medium-term may be needed to support the revenue base.

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# IV. The Evolving Role of the State[26]

## A. Introduction

59. **Vietnam has made substantial progress in the transition to a market economy since embarking on economic reforms in the late 1980s.** The start of Vietnam's transition *(Doi Moi)*, which paved the way for far-reaching reforms, was intended to alleviate the inefficiencies of the centrally planned system. There has been considerable progress in the context of price liberalization, exchange rate unification, tax reform, and the liberalization of the trade regime. Additionally, the laws and institutions needed to support a market-based economy are gradually being put in place.

60. **Vietnam's approach to transition has involved a relatively gradual transformation of ownership structures in the non-agricultural economy**. Large and medium-sized enterprises owned by the State have remained in government ownership, but the State Owned Enterprise (SOE) reform plan provides for equitization, liquidation, and merger of a significant number of smaller and medium-sized enterprises. Private enterprises (often household-based) have begun to develop in various sectors of the economy, and foreign-invested enterprises (FIEs) (typically a joint venture between a foreign partner and a SOE) grew rapidly during the 1990s. More recently, the passage of the Enterprise Law and the amendment of the Foreign Investment Law in 2000 have resulted in over 50,000 new enterprise registrations.

61. **This chapter seeks to quantify the changing role of government-owned firms in the national economy, and to compare the main developments with China's experience.**[27] Separate chapters examine the reform program being pursued for non-financial state-owned enterprises (chapter 5) and the state dominated financial system (chapter 6).

## B. Changing Ownership in the Vietnamese Economy

62. **Vietnam has recorded strong economic growth since the beginning of the reform program,** with output growing at an annualized average rate of 6½ percent during 1988-2002. Growth has been accompanied by substantial shifts in the sectoral composition of output, as in other developing economies, with agriculture's

Vietnam: GDP by Sector and Ownership, 1990-2001 1/

| | 1990 | 1995 | 2001 |
|---|---|---|---|
| Total | 100 | 100 | 100 |
| Agriculture | 32 | 26 | 22 |
| Industry | 25 | 30 | 37 |
| Services | 43 | 44 | 41 |
| State | 29 | 40 | 38 |
| Non-State sector | 70 | 60 | 62 |

Sources: General Statistics Office
1/ At current prices

[26] Prepared by Rania Al-Mashat.

[27] Most numbers used here are derived from data provided by Vietnam's General Statistics Office. Data have significant limitations, particularly those pertaining to the earlier years.

contribution to GDP almost halving over the period and that of industry rising sharply.

| Vietnam: GDP Main Sectors by Ownership, 1990-2000 1/ | | | | |
|---|---|---|---|---|
| | 1990 | 1994 | 1998 | 2000 |
| Agriculture | | | | |
| State | 4 | 4 | 4 | 4 |
| Non-State sector | 96 | 96 | 96 | 96 |
| Industry & Construction | | | | |
| State | 45 | 51 | 47 | 45 |
| Non-State sector | 55 | 49 | 53 | 55 |
| Services | | | | |
| State | 48 | 55 | 56 | 55 |
| (excluding state management) 2/ | 29 | 47 | 49 | 48 |
| Non-State sector | 52 | 45 | 44 | 45 |

Sources: General Statistical Office

1/ At current prices.

2/ State management includes public administration, defense, and compulsory social security.

63. **The state sector currently accounts for about two-fifths of GDP,** a share that has increased by about 9 percentage points since 1990. The rising share of the state sector reflects mainly shifts in the sectoral composition of output from agriculture, where the formal state sector's share was already small in 1990, to industry and services, in which the state's share continues to be sizeable.[28]

| Vietnam: Industrial Output Value By Ownership,1991-2000 1/ | | | | |
|---|---|---|---|---|
| | 1991 | 1996 | 1998 | 2000 |
| Total | 100 | 100 | 100 | 100 |
| State | 48 | 50 | 45 | 36 |
| Non-State | 52 | 50 | 55 | 64 |
| Collective | ... | 1 | 1 | 1 |
| Private | ... | 2 | 2 | 2 |
| Households | ... | 15 | 12 | 11 |
| Mixed | ... | 5 | 7 | 9 |
| FIE | ... | 26 | 33 | 41 |

Source: General Statistics Office

1/ At current prices; certain figures may not add-up due to rounding

64. **The share of the state sector in gross industrial output has declined somewhat in recent years, while that of FIEs has risen significantly.**[29,30] FIEs accounted for some two-fifths of industrial output in 2000, partially reflecting their role in mining.[31] Between 1997-2000, the average annual growth rate of industrial output produced by the non-state sector was 26 percent, more than double that of the state sector.

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[28] Data availability precludes a more detailed analysis of the role of the state production in agriculture. Prior to the reform program, agriculture was largely collectivized; production is now mainly in the hands of individual households.

[29] The share of the state in industry sector GDP has remained broadly unchanged between 1990 and 2000, while its share in industrial output has been declining. These divergent patterns can be explained in part by different definitions of the industrial sector.

[30] The Law on Foreign Investment (1987) provides for three basic forms of investments: joint ventures (which typically include a State enterprise as a partner), wholly-foreign owned enterprises and business cooperation contracts. The foreign party to a joint venture is required to contribute at least 30 % of the legal capital.

[31] Excluding mining (mainly extraction of crude oil and natural gas) from industrial output reduces the share of FIEs to 28 percent in 2000.

**Table 32. Vietnam: Summary of Normal Tariff Schedule, 2000–2003 1/**

| Rates in 2000 | | | Rates in 2001 | | | Rates in 2002 | | | Rates in 2003 2/ | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Bands | Number of lines: | | Bands | Number of lines: | | Bands | Number of lines: | | Bands | Number of lines: | |
| | number | percent | | number | percent | | number | percent | | number | percent |
| 0 | 2,029 | 32.0 | 0 | 2,070 | 32.4 | 0 | 2,076 | 31.8 | 0 | 3,087 | 28.9 |
| 1 | 173 | 2.7 | 1 | 170 | 2.7 | 1 | 159 | 2.4 | 1 | 196 | 1.8 |
| 3 | 381 | 6.0 | 3 | 349 | 5.5 | 3 | 360 | 5.5 | 3 | 614 | 5.3 |
| 5 | 679 | 10.7 | 5 | 677 | 10.6 | 5 | 701 | 10.8 | 5 | 1,110 | 10.4 |
| 7 | 7 | 0.1 | 7 | 3 | 0.0 | 7 | 4 | 0.1 | 7 | 1 | 0.0 |
| 10 | 519 | 8.2 | 10 | 550 | 8.6 | 10 | 576 | 8.8 | 10 | 1,047 | 9.8 |
| 12 | 2 | 0.0 | 12 | 3 | 0.0 | 12 | 3 | 0.0 | 12 | 0 | 0.0 |
| 15 | 79 | 1.2 | 15 | 68 | 1.1 | 15 | 79 | 1.2 | 15 | 177 | 1.7 |
| 18 | 1 | 0.0 | 20 | 502 | 7.9 | 18 | 2 | 0.0 | 18 | 0 | 0.0 |
| 20 | 516 | 8.1 | 25 | 5 | 0.1 | 20 | 512 | 7.9 | 20 | 855 | 8.0 |
| 25 | 3 | 0.0 | 30 | 663 | 10.4 | 25 | 3 | 0.0 | 25 | 121 | 1.1 |
| 30 | 633 | 10.0 | 35 | 1 | 0.0 | 30 | 679 | 10.4 | 30 | 1,164 | 10.9 |
| 40 | 678 | 10.7 | 40 | 671 | 10.5 | 35 | 1 | 0.0 | 35 | 0 | 0.0 |
| 45 | 2 | 0.0 | 45 | 2 | 0.0 | 40 | 683 | 10.5 | 40 | 985 | 9.2 |
| 50 | 569 | 9.0 | 50 | 575 | 9.0 | 45 | 2 | 0.0 | 45 | 0 | 0.0 |
| 55 | 1 | 0.0 | 60 | 11 | 0.2 | 50 | 602 | 9.2 | 50 | 1,001 | 9.4 |
| 60 | 12 | 0.2 | 80 | 2 | 0.0 | 60 | 5 | 0.1 | 60 | 25 | 0.2 |
| 80 | 9 | 0.1 | 100 | 50 | 0.8 | 70 | 0 | 0.0 | 70 | 0 | 0.0 |
| 100 | 48 | 0.8 | 120 | 8 | 0.1 | 80 | 2 | 0.0 | 80 | 3 | 0.0 |
| | | | | | | 100 | 62 | 1.0 | 100 | 291 | 2.7 |
| | | | | | | 120 | 8 | 0.1 | 150 | 12 | 0.1 |
| Total | 6,341 | 100.0 | Total | 6,380 | 100.0 | Total | 6,519 | 100.0 | Total | 10,689 | 100.0 |

Source: Ministry of Finance.

1/ The normal tariff rates are termed *preferential* in the official schedule. There are also nonpreferential tariff rates about 50 percent higher than these rates, which are applied to imports from countries without a trade agreement (or not in the process of negotiating one).

2/ Effective September 1, 2003.

## C. State Ownership in China: A Comparison

67. **China was more industrialized than Vietnam when it began the transition process,** with industry accounting for close to one-half of GDP, as compared with about one–fifth of GDP in Vietnam.

| China: GDP by Sector, 1980-2001 1/ | 1980 | 1990 | 1995 | 2001 |
|---|---|---|---|---|
| Total | 100 | 100 | 100 | 100 |
| Agriculture | 30 | 28 | 27 | 19 |
| Industry | 49 | 43 | 42 | 49 |
| Services | 21 | 29 | 31 | 32 |

Source: CEIC Database
1/ In current prices

68. **The role of state enterprises in China's industrial sector declined steadily during the 1980s, and more rapidly during the 1990s.** Much of the industrial growth during the 1980s was accounted for by collectively-owned enterprises,[32] with the aggregate share of individually-owned and foreign-owned firms representing a modest 8 percent of production in 1990. This dynamic shifted during the 1990s, aided by high growth rates, continued liberalization efforts and the evolution of the political and legal environment. Between 1990 and 2000, the private sector share of industrial output increased from 5 percent of total output to 17 percent, while the share of the foreign-owned sector surged from 3 percent to 24 percent.

| China: Gross Industrial Output by Ownership, 1980-2000 1/ | 1980 | 1990 | 1995 | 2000 |
|---|---|---|---|---|
| Total | 100 | 100 | 100 | 100 |
| State 2/ | 78 | 56 | 37 | 26 |
| Non-State | 22 | 44 | 63 | 74 |
| Collective Owned | 21 | 36 | 38 | 33 |
| Individual Owned | 0 | 5 | 10 | 17 |
| Other Ownership 3/ | 1 | 3 | 15 | 24 |

Source: CEIC Database
1/ In current prices.
2/ State-owned or controlling shareholding.
3/ Shareholding and foreign-funded.

69. **Viewed against the Chinese experience, Vietnam has relied more heavily on FDI earlier in its transition.** Given the limited degree of industrialization at the outset of its transition, there was a greater need for foreign technology and capital in Vietnam. The Foreign Investment Law was passed in the early 1990s, encouraging the establishment of FIEs, which grew rapidly in mining (oil and gas extraction) and manufacturing. In China, the collectively-owned enterprises, which sprang up after the agricultural reforms, accounted for the bulk of non-state activity at the beginning of its transition, and for much of the ensuing twenty years, a feature not observed in Vietnam.

70. **In China, the role of state enterprises in foreign trade has declined considerably since the beginning of its transition.** Prior to that, China's foreign trade was conducted only through twelve state-owned foreign trade corporations (FTCs). FTCs were progressively given more autonomy with a growing number of other enterprises allowed to trade on their

[32] At the beginning of its transition, the distinction between private and collectively-owned enterprises was blurred in China. Collectively-owned enterprises were not managed by the State but their ownership was shared by the community, therefore they were considered publicly-owned (IMF 1993).

own behalf. In Vietnam, exclusive trading rights granted to state-trading companies have limited the engagement of other enterprises in some trading activities.

China: Employment Share, 1980-2001 1/

| | 1980 | 1990 | 1995 | 2001 |
|---|---|---|---|---|
| Total | 100 | 100 | 100 | 100 |
| State | 76 | 61 | 59 | 32 |
| Non-State | 24 | 39 | 41 | 68 |

Source: China Statistical Yearbook and CEIC Database
1/ Includes total urban and rural employment

71. **A significant feature of the Chinese transformation process has been the dominance of the state in the banking sector, a feature replicated in Vietnam.** In China, four large state-owned commercial banks account for about three-quarters of banking sector assets, as is also the case in Vietnam.

72. **Compared to China, Vietnam may be in a better position to handle labor redundancies.** At the outset of reforms, employment in the SOE industrial sector was quite significant in China due to the high level of industrialization. Consequently, the SOE reforms carried out in the late-nineties led to significant levels of redundancies. In Vietnam, the share of the state sector in total employment is relatively small, and the overall impact of SOE labor redundancies on the labor market could be quite modest, easing the SOE reform process.

## D. Conclusion

73. **Vietnam has followed a gradual transformation in its ownership structure**, a pattern likely to continue in the years ahead. This transformation process could accelerate, as in China during the second decade of its transition, if the implementation of measures to promote the private sector's development are expedited. Such measures include facilitating the private sector's access to land and capital and eliminating complex bureaucratic and licensing procedures.

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# V. Reform of State-Owned Enterprises[33]

## A. Introduction

74. **Vietnam began a gradual transition from a centrally-planned to a market-based economy in the late 1980s.** The transition has involved (a) increased decentralization of powers to state-owned enterprises (SOEs), who now have much more autonomy, along with (b) entry of foreign-invested enterprises (FIEs) into Vietnam (typically in joint ventures with SOEs), (c) an increasingly deregulated, and less protectionist, trade regime for imports, and (d) easier entry conditions, in recent years, for domestic private enterprises.[34]

75. **Vietnam did not adopt a broad-based privatization program**, preferring to retain a leading role for SOEs in strategic sectors while pursuing gradual equitization of non-strategic SOEs, using a sales process that favors incumbent workers and managers. The equitization process has to date focused on small- and medium-scale enterprises, and has fallen behind schedule.

76. **Financial and economic performance of the SOE sector has been uneven,** although it is hard to draw strong conclusions in light of limited data availability. Some 50 percent of SOEs were either loss-makers or only marginally profitable in 1999, and the available indicators suggest continued financial difficulties in many enterprises since then. The balance sheets of many SOEs feature mounting debt burdens and shallow capital/asset bases, underscoring the need for financial and operational restructuring.

77. **Governance structures in SOEs remain complex,** characterized by multiple mandates and non-transparent structures of accountability, and poor corporate discipline.

78. **The policy challenges for SOE reform efforts are three-fold:** a) strengthen financial discipline and operational performance in those SOEs to remain within the state sector, b) accelerate the process of transforming non-strategic SOEs into privately controlled and managed firms, and c) ensure that decisions to retain state control of enterprises are made in accordance with soundly-based economic efficiency criteria.

## B. The Role of the SOE sector

79. **SOEs play a lead role in the economy, notably in industry and selected services, employing about 1.7 million workers, some 5 percent of the total labor force.** SOEs play a lead but diminishing role in export and industrial sectors (e.g. coffee, seafood, cement, garments and textiles, paper, steel, etc.) and dominate key services, such as energy, finance,

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[33] Prepared by Shanaka J. Peiris.

[34] See IMF (1996), IMF (2001), and World Bank (2003) for discussion of Vietnam's transition to a market economy.

telecommunications and transportation. The SOE sector share of bank credit has fallen to about 40 percent in recent years, although the share of credit is closer to 50 percent if one includes lending by the Development Assistance Fund (DAF).

**Vietnam: The Role of the SOE Sector**
(in percent; unless indicated otherwise)

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|---|
| Number of SOEs | 5806 | 5861 | 5713 | 5571 | 5326 | 5196 |
| Share of SOEs in industrial production 1 | 48 | 45 | 43 | 41 | 41 | 40 |
| Share of SOEs in non-oil exports | .. | 62 | 54 | 48 | 44 | 35 |
| Share of bank credit going to SOEs | .. | .. | .. | 45 | 42 | 39 |
| Share of bank and DAF credit going to SOEs | .. | .. | .. | 50 | 48 | 46 |
| Bank and DAF credit going to SOEs (in percent of GDP) | .. | .. | .. | 22 | 24 | 25 |

Source: NSCERD, World Bank, GSO, SBV, and staff estimates.
1/ Constant 1994 prices.

80. **There has been no comprehensive financial information on the SOE sector since the SOE census of 1997, but indicators point to a loosening of budget constraints and continued inefficiencies and debt problems.** One-half of SOEs were reportedly loss-makers or marginally profitable, with total SOE debt (including interenterprise debt) estimated at D 190 trillion in an aggregate enterprise census in 1999 (48 percent of GDP, up from 37 percent of GDP at end-1997). The debt-equity ratio for the sector was estimated to have been 1.5 in 1999, up from 1.0 in 1997. Based on domestic accounting standards, about 20 percent of bank debt to SOEs was estimated to have been non-performing at end-2000.[35]

81. **A monitoring system of bank debt and budget support (including DAF) to 200 large indebted SOEs introduced under the PRGF program point to a deteriorating debt situation**, with significant increases in debt in uncompetitive sectors (e.g. sugar, paper, steel); quantitative benchmarks on bank and budget support have been often missed over the last two years. Financial reporting by those 200 large indebted SOEs has been infrequent and incomplete.

82. **Recent detailed SOE diagnostic audits also indicate deteriorating financial conditions in many sectors and poor governance**, compounded by the lack of hard budget

[35] Banking debt to SOEs amounted to D 70 trillion at end 2000 with the four SOCBs reporting NPLs of about D 15 trillion to SOEs (based on Vietnamese accounting standards (VAS)).

constraints (privileged access to bank credit and budget support) and the inability of creditors

**Vietnam: Debt monitoring system for 200 large-debt SOEs, 1999-2003**

| | 1999 | 2000 | 2001 | | | | | 2002 2/ | | | | 2003 3/ |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Dec. | Dec. | Mar. | Jun. | Sept. | Dec. 1/ Orig. | Dec. 1/ Rev. | Mar. | Jun. | Sept. | Dec. | Mar. |
| | | | | | | | | Estimates | | | | Estimates |
| | | | | | | (End of period, in trillion dong) | | | | | | |
| Total | 28.4 | 35.3 | 36.8 | 34.5 | 38.0 | 42.4 | 42.7 | 43.3 | 43.3 | 51.6 | 54.0 | 56.3 |
| of which: bank debt | 26.2 | 30.1 | 31.2 | 32.2 | 35.6 | 38.6 | 38.9 | 40.3 | 41.2 | 49.1 | 47.1 | 49 |
| Central | 21.4 | 26.5 | 27.7 | 25.7 | 29.2 | 33.4 | 33.7 | 34.3 | 34.8 | 42.5 | 44.4 | 46.1 |
| Local | 7.0 | 8.8 | 9.1 | 8.7 | 8.8 | 8.9 | 8.9 | 9.0 | 8.5 | 9.0 | 9.6 | 10.2 |
| | | | | | | (Change since beginning of year, in trillion dong) | | | | | | |
| Total | ... | 6.9 | 1.5 | -0.8 | 2.7 | 7.1 | ... | 0.6 | 0.6 | 8.9 | 11.3 | 2.3 |
| (program benchmark) | ... | ... | 0.6 | 1.2 | 1.8 | 2.4 | ... | 0.6 | 1.5 | 2.3 | 3.2 | 0.7 |

Sources: Ministry of Finance; and staff estimates.

1/ Original data cover list of 200 large-debt SOEs under the first-year PRGF-supported program; revised data cover 200 large-debt SOEs under the second-year program.

2/ Estimates based on partial quarterly data from 176, 188, 169, and 183 SOEs, respectively.

3/ Estimates based on partial quarterly data from 103 SOEs.

to spur debt resolution and restructuring.

## C. Recent SOE Reforms and Outcomes

83. **SOE reforms in Vietnam can be decomposed into a) measures to divest small and medium sized SOEs, and b) general measures to improve governance and financial accountability of retained SOEs:**

- A five-year SOE reform plan was adopted by the government in 2001, with annual targets specified for the first three years (2001–03); it was envisaged that around 1800 out of 5,571 SOEs would be subject to reform measures, mostly in the form of equitization,[36] divestiture, or liquidation. These enterprises accounted for 31 percent of total SOE employment, 11 percent of state capital, and 10 percent of SOE debt.

- The other key components of the reform plan were to strengthen governance structures and the reporting regime, restructure three large general corporations (GCs), and conduct operational reviews (i.e., diagnostic audits) of 100 large SOEs.

84. **There has been some progress in strengthening the equitization process and improving transparency.** The equitization process has been strengthened by: (a) removing ceilings on shareholdings in equitized enterprises (with a 30 percent cap on foreign

[36] Equitization consists of selling a fraction of state capital in the form of shares at book value.

shareholding); (b) improving transparency by requiring advance advertising; (c) moving responsibility of sale to financial intermediaries through auctions instead of SOEs themselves; and (d) establishing a redesigned Social Safety Net Fund to cover voluntary and involuntary redundancy linked to SOE reform (Box V.1).

**Box V.1. Legal Framework for Equitization and Enterprise Restructuring**

**The legal framework needed to accelerate the pace of equitization and SOE restructuring has been strengthened by:**

- **Decree 41 of April 2001 established a social safety net fund for redundant workers**, which became fully operational in October 2002 after the implementing regulations were issued. The compensation provided by the fund is more generous than the labor code, and treats equally enterprises subject to different forms of reform measures and assists workers who opt for early retirement.
- **Decision 58 of April 2002 stipulates strategic sectors** that are to be retained under full state ownership, while also specifying industries where enterprises are to be transformed (equitized, transfer, sold, merged, or liquidated), including general corporations.
- **Decree 64 of June 2002 replaces Decree 44 regarding equitization**, and gives the right to buy shares to both domestic and foreign entities with a cap of 30 percent of capital of a company for foreigners. Transparency of the equitization process was improved by shifting the responsibility for issuing shares from managers of the equitizing SOEs to underwriters. A number of financial incentives were also introduced for equitized enterprises.
- **Decree 69 of July 2002 provides instructions for SOE debt resolution**, with those enterprises that have large unrecoverable debts to be liquidated or declared bankrupt.
- **Circular 79 of September 2002 sets out guidelines for the valuation of enterprises** to be equitized and determines their share structure.
- **Circular 80 establishes priorities concerning to whom shares should be sold**, including employees (at a concessionary price) and outsiders. Shares allocated to insiders can be sold to outsiders if unsold after two months of allocation. The circular also provides guidelines for the auctioning of shares to outsiders, and the role of underwriters and financial intermediaries.
- **Circular 85 of September 2002 provides implementation guidelines for the management and resolution of NPLs** to SOEs and circular 5 of February 2003 specifically deals with NPLs owed by SOEs to SOCBs, while both focus on outstanding debts as of 31st December 2000 or time of transformation for reformed enterprises.

85. **Implementation of enterprise-specific reform measures has been more limited than anticipated,** with the pace of equitization, liquidation, and merger (included in the 'other' category) falling significantly behind schedule. However, implementation of 400 or so transformations from 2001 to October 2002 accounting for 2.5 percent of SOE debt and about 5 percent of SOE employment was in line with PRSC commitments, albeit with delays.[37]

**Vietnam: SOE Roadmap and Transformations to Date**

| | 2001 | | 2002 | | 2003 | |
|---|---|---|---|---|---|---|
| | Roadmap | Actual | Roadmap | Actual | Roadmap | Actual 1/ |
| Total | **710** | **282** | **651** | **214** | **636** | **165** |
| Equitization | 478 | 204 | 460 | 164 | 473 | 101 |
| Transfer, Sale | 55 | 57 | 49 | 44 | 38 | 21 |
| Liquidation, Bankruptcy | 90 | 21 | 68 | 6 | 61 | 11 |
| Other | 87 | 0 | 74 | 0 | 64 | 32 |

Source: NSCERD.
1/ from January to May 2003.

86. **Enterprises that have been equitized have performed better after equitization, suggesting that there are significant payoffs to this approach.** A recent survey of 422 SOEs (CIEM 2002) that were equitized prior to 2001 showed impressive improvement in a number of performance indicators: sales, assets, and value added. Equitized enterprises, however, complained of problems in accessing bank credit, obtaining land user-rights, and cumbersome licensing requirements.

87. **The sluggish pace of SOE transformations necessitated the development of a rephased SOE roadmap (2003-05).** The rephased SOE reform roadmap lists the SOEs to be transformed according to a time schedule and by type of transformation, unlike the previous roadmap which provided only general guidelines. Around 2,300 SOEs are subject to enterprise-specific reform measures, accounting for about 24 percent of SOE employment but only 3 percent of total SOE bank debt. These targets, especially number of equitizations will be a challenge to achieve, given the time taken to complete such transactions in the past (previously, the time scale from start to finish has been about 500 days).

[37] The average number of employees in transformed enterprises was 250, with a charted capital of about US$ 375,000, and US$ 370,000 of bank debts prior to transformation.

**Vietnam: The Original SOE Reform Plan and Rephased Road Map Compared**

| | SOE Reform Plan (2001-2003) | Rephased Reform Plan (2003-05) |
|---|---|---|
| Number of Transformations | 1800 | 2291 |
| Of which | | |
| Equitizations | 1411 | 1747 |
| Divestiture | 142 | 151 |
| Liquidation | 219 | 91 |
| | | |
| Share of SOE Employees (in percent) 1/ | 31 | 24 |
| Share of Capital (in percent) 1/ | 11 | 14 |
| Share of Debt (in percent) 1/ 2/ | 10 | 3 |
| | | |
| Average Number of Employees | 317 | 170 |
| Average State Capital (billions of dong) | 7 | 8 |
| Average Debt (billions of dong) | 10 | 3 2/ |

Source: NCERD and staff estimates

1/ Based on the SOE census of 1999.

2/ Debt recorded for the rephased reform plan is bank debt only.

88. **Realization of this equitization agenda faces a number of obstacles, including difficulties in valuing enterprises, resistance from managers, and capacity constraints.** The pricing of enterprises is handicapped by complexities in valuing the land use rights they hold and resolving the debts they owe:

- The valuation of land is based on rents that are subject to price controls, uncertain and poorly demarcated land-user rights, and lack of a country-wide registry of land user-right issuances and transfers.

- Debt resolution is progressing slowly, with existing Decrees providing insufficient power for creditors to initiate the restructuring of SOEs. The pilot Debt and Asset Trading Company (DATC) approved recently could help address the specific problem of inter-enterprise arrears, but will face the general difficulty of clarifying poorly recorded debt contracts.

89. **The managers of the SOEs lack adequate incentives to equitize** because the state retains a significant shareholding and influence over some equitized enterprises while redundancy benefits do not cover managers. The auctioning of shares is hampered by a small number of poorly equipped underwriters and a cap on underwriting fees.

## D. Corporate Governance and Performance

90. **The accounting, auditing, and reporting regime for SOEs remains weak.** The financial information available on SOEs remains unreliable and dated, while financial accounts (even audited) are generally not available, ensuring that enterprise financial performance escapes the scrutiny it would attract in a market economy. A new Accounting

Law promulgated in mid-2003 provides for time-bound auditing and disclosure of financial statements with transparent accounting of budgetary transactions and clear assignment of responsibility for financial statements to the chief accountant. The effectiveness of the law in improving accountability will depend upon the disclosure requirements to be specified, the accounting standards to be chosen, and the enforcement mechanism to be adopted.

91. **A series of diagnostic audits and operations reviews being conducted on GCs and large SOEs sheds some light on their current situation and the opportunities and challenges faced in key sectors.** SOEs in the oil/gas and aviation sectors are reporting large profits, partly aided by limited competition; SOEs in the important textiles and garment sector are profitable and expanding rapidly, but will face challenges in external markets with the demise of the quota regime for WTO members in 2005; a major state-owned paper company is considered viable, but faces competitive pressures as tariffs are lowered on imports from ASEAN countries, pointing to the need for cost-cutting, debt resolution, and improved management. By contrast, the sugar sector is experiencing significant financial distress, with SOEs continuing to run losses and accumulate large debts; major rationalizations are needed, but officials remain undecided on the key elements of a sector strategy (Box V.2).

**Box V. 2. Summaries of Selected Diagnostic Audits of Large SOEs**

**Sugar Industry – Company A**

Company A lies in the middle of the pack of sugar companies in terms of size, efficiency and profitability and is a member of a GC. The firm is operating significantly below capacity and is approximately 80 percent debt-financed. After recording losses in 1999-2000, the company reports a modest profit in 2001 according to VAS – but a sizeable loss if IAS is applied. Almost half of the company's fixed assets are dedicated to non-sugar businesses. To ensure viability beyond the recommended industry-wide rationalization, the Company should improve its balance sheet by selling non-essential assets, undertaking aggressive cost cutting measures, and make small investments to improve operations.

**Paper Industry – Company B**

Company B is a member of a GC whose constituent SOEs are the sole producers of printing, writing paper and newsprint. It is the most important producer of printing and writing paper, with the main competition coming from imports. Product quality is poor relative to imports, which are expected to increase further with AFTA implementation. The mill is overstaffed and the workforce could be reduced to one third of current levels, yielding a cost reduction of 8%. The company is considered commercially viable, but only marginally so; there is an urgent need to cut costs, better manage cash flows for daily operations, and renegotiate financing with banks.

92. **Restructuring plans for three large 3 GCs (Seaprodex, Vinacafe and Vinatex) have been approved, allowing the conversion of these GCs into holding companies.** General Corporations manage state capital in member SOEs and tend to get involved at a detailed level in operations and investments, often cross-subsidizing among constituent SOEs. But GCs have not been held accountable for their member SOEs, as would be the case

with a holding company structure, and individual SOEs can pursue diversification beyond their own core business. The restructuring plans of GCs recognize these shortcomings, and envisage conversion into conventional holding companies, along with operational and financial restructuring of member SOEs.

93. **Recent reforms have the potential to foster a better governance structure and greater accountability for SOEs,** but are likely to encounter implementation difficulties. Decree 63 provides for the transformation of SOEs into one-owner limited liability companies to be registered under the Enterprise law; the sole-owner structure would improve on the situation where several state oversight agencies have a controlling role or power. The decree also provides for holding the management board, or company president, responsible to the owner for performance, thereby improving accountability. However, implementation of the approach envisaged under decree 63 has been halting (only 4 SOEs have been transformed since September 2001 with another 100 transformations awaiting approval). A draft SOE law, to replace the 1995 SOE law, is now under consideration, which could provide a vehicle for clarifying the objectives of SOEs (profit maximization, other socio-economic objectives), the procedure for establishing new SOEs, and appropriate management structures.

## E. Conclusion

94. **The government's strategy for managing the SOE sector is to equitize smaller 'non-strategic' enterprises and move towards more autonomous decision-making and enhanced accountability in strategic enterprises that remain within state control.** There has been significant progress in streamlining the equitization process and instituting a social safety net for redundant workers but the pace of equitization has been slow, leaving many firms with uncertain futures and weak incentives to perform efficiently.

95. **The detailed diagnostic audits of SOEs suggest accumulating losses in a number of sectors.** Deteriorating financial conditions reflect the failure to address long standing problems in SOEs (large pool of redundant labor, soft budget constraints and debt problems, and state interference in production and investment decisions) and declining demand. A common theme in the audits is the need to restructure and rationalize to be competitive in a more liberalized economic environment; delays in rationalization will inevitable raise the costs of eventual bailouts for the government.

96. **SOE reforms need to push ahead on a number of fronts.** With the legal framework for equitizations now strengthened, the pace of SOE reform should pick up but will require resolute implementation to overcome vested interests and capacity and technical obstacles. SOEs should be encouraged to convert into limited liability companies, while the new SOE law should aim to promote simple channels of control and profit-focused mandates that would ensure improved economic and financial performance.

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# VI. Reform of State-Owned Commercial Banks—Achievements and Challenges[38]

## A. Introduction

97. **This chapter describes key features of Vietnam's banking reform since 2001, assesses the progress made so far and outlines the challenges ahead.** It also compares the developments in Vietnam to the reform experience in other transition economies so as to provide a more balanced understanding of progress under the Vietnamese approach.

98. **Vietnam's banking sector was substantially reorganized at the outset of the transition period, but further evolution during the 1990s was quite modest.**[39] The monobank system was formally replaced by a two-tier banking system in the late 1980s. Defining the new roles and responsibilities for second-tier banks and creating independent institutions was no trivial achievement. However, in part as a legacy of the past, a banking system emerged that has been dominated by state-owned commercial banks (SOCBs), accounting for more than 70 percent of all bank credit and deposits, and segmented along inherited sectoral lines (e.g. agriculture, industry, and foreign trade). Some 26 foreign bank branches and over 30 semi-private joint-stock banks (JSBs) have operated on a limited local scale, serving niche markets. Foreign bank branches have also been restricted in the range of activities, while domestic joint-stock banks, sometimes established as joint-ventures with SOEs, have faced difficulties in overcoming capital shortages.

99. **Operations of the dominant four large SOCBs have been characterized by weak balance sheets, in part reflecting a legacy of directed lending**. The four large SOCBs have maintained an exposure to SOEs significantly above average (Table VI.1) with lack of reforms in the state-sector leading to a build-up of nonperforming loans. By 2000, the big four had accumulated NPLs totaling D 23 trillion[40], representing about twice their capital, 5 percent of GDP, and 15 percent of all outstanding credit to the economy. About two-thirds of the NPLs were to SOEs.[41] The four large SOCBs and their exposure to the SOE sector had thus become a key point of vulnerability in Vietnam's financial system. The need for a more proactive corporate- and financial-sector restructuring increased further at the beginning of

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[38] Prepared by Olaf Unteroberdoerster.

[39] For an analysis and comparison of transition country developments in the 1990s see IMF (2000), and Exeter and Fries (1998).

[40] Based on banks own reports and domestic accounting standards (VAS), these estimates were tentative at best given weaknesses in banks accounting data that hamper a consistent and stringent assessment of NPLs across all banks.

[41] Consisting mainly of directed loans and uncollateralized NPLs.

this decade, as competition following market-opening measures (AFTA, the USBTA, and, in the future, WTO) was set to intensify.

## B. The Vietnamese Approach to Banking Reform

100. **Reform efforts initiated in 2001 were centered on restructuring the four large SOCBs and putting them on a commercial footing.** More broadly, however, the reforms also aim at strengthening the regulatory, supervisory and institutional frameworks for more efficient banking.[42] In addition, the authorities have also pursued consolidation of numerous small and undercapitalized JSBs.

101. **By relying on banks' internal capacity for change, the success of the reforms was to rest on three key components**: (i) phased and conditional recapitalization with public funds, based on SOCBs' meeting bank-specific operational and financial reform targets; (ii) phase-out of policy lending; and (iii) improved accounting and disclosure standards. These principles were adopted by the SBV in its overall bank restructuring framework (Figure VI.1). In line with this gradual approach, the framework also provided for a phasing-in of prudential standards, such as on required capital adequacy ratios[43].

102. **Consistent with the overall restructuring framework, all four large SOCBs completed individual restructuring plans in 2001 with specific reform measures and performance targets.** Key targets were then selected by the SBV as semi-annual milestones setting minimum conditions for a phased recapitalization of each SOCB. Milestones, which primarily consist of NPL resolution targets and operational measures, such as improving credit risk management or undertaking audits based on international accounting standards (IAS), have been monitored by a special unit in the SBV.

103. **Along with this approach, an initial estimate of the cost of SOCB reform was integrated with the overall budget framework.** The initial cost estimate approved by the government in 2001 was D 17 trillion, or about 4 percent of GDP, to be financed primarily by non-negotiable government bonds. However, more recently, analytical audits of the SOCBs in line with IAS, and factoring in rapid credit growth requiring additional capital, point to recapitalization needs and thus an overall cost of reform of around 7 percent of 2003 GDP.

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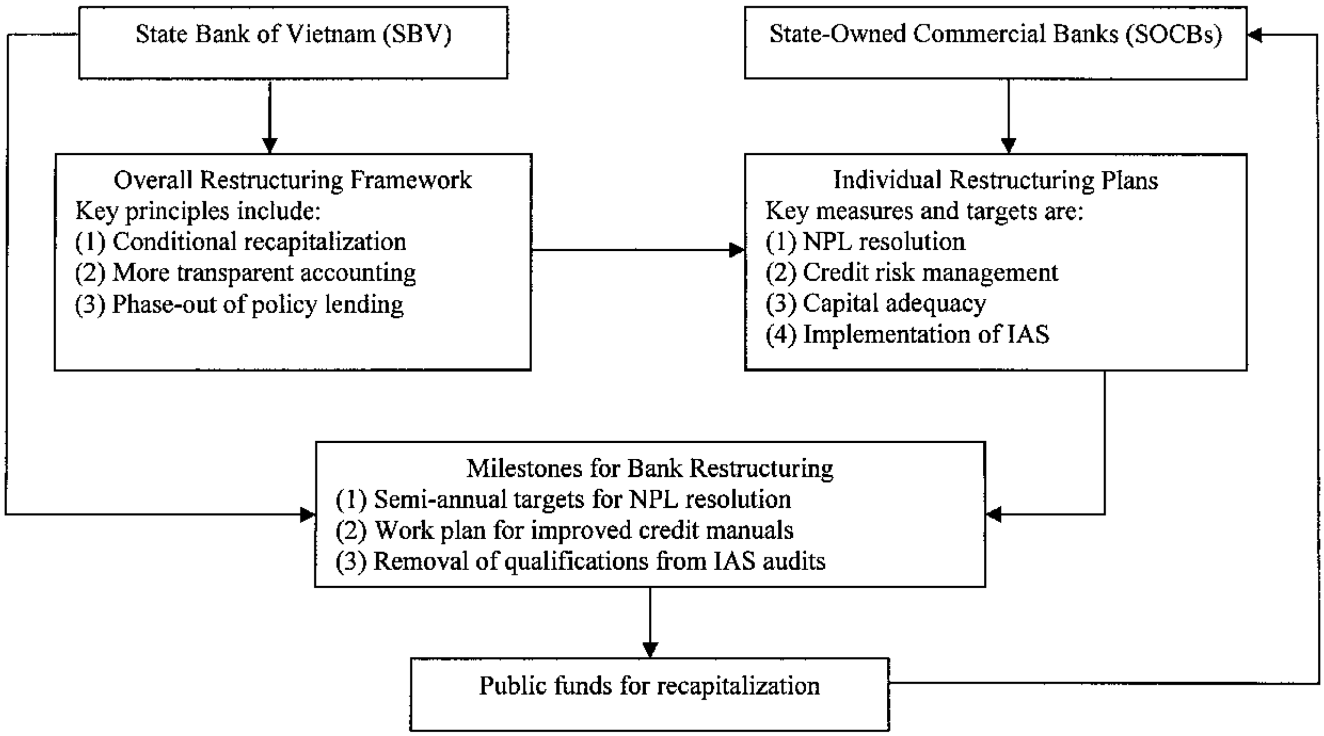
[42] International experience shows that a successful transition towards a sound commercial banking system depends on progress in all these areas (de Juan, 1996).

[43] An 8 percent capital adequacy requirement was adopted in 1999 but not enforced.

**Figure VI.1. Vietnam's Approach to Banking Reform – An Overview**



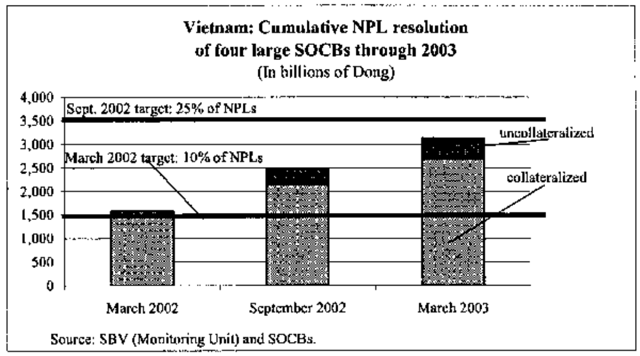

## C. Progress in Banking Reform

104. **Despite a comprehensive and systematic effort to engage all relevant levels of banking, progress in implementing the reform program has been mixed.** Progress has proved particularly difficult in areas that directly affect SOCBs' relation to SOEs, but some initial improvements have been made in resolving collateralized NPLs[44] and in key regulatory areas such as loan classification and provisioning. This notwithstanding, all SOCBs became eligible for state-funded recapitalization. The already limited incentives for reform, given government ownership of the banks, were thus diluted further.[45]

[44] Resolution of collateralized NPLs, which are typically to the private sector, was sped up by streamlining regulations on the sale of collateral, permitting banks to bypass the state auction center.

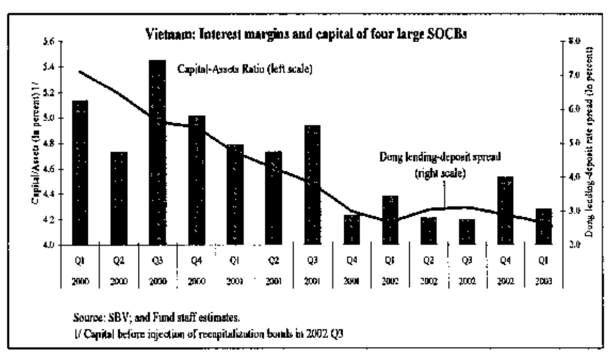
[45] Two phases of recapitalization have been completed by June 2003, providing banks with non-negotiable recapitalization bonds of D 5.3 trillion (nearly 1 percent of GDP).

105. **Resolving NPLs, in particular to SOEs, has been slow.** After meeting the first quarterly NPL resolution target in March 2002, SOCBs missed subsequent targets by a wide margin as they failed to resolve uncollateralized NPLs to SOEs. Debt resolution guidelines[46] issued in October 2001 outlined the principles of the restructuring of SOE bank debt[47], but have not provided banks with sufficiently specific instructions on dealing with such problem debtors. While there are no specific incentives to restructure SOE loans, banks do not have a mandate to trigger loan-workouts. Moreover, restructuring loans to SOEs has been hampered by the entanglement of government agencies and officials at the national and local levels with SOCBs' management.




106. **While some of the new lending to SOEs has been shifted to specialized policy-lending institutions, in particular the Development Assistance Fund (DAF), SOCBs remain by far the single largest provider of credit to SOEs.** Since 2000 bank credit to SOEs has declined from 45 percent to 38 percent of total bank credit (Table VI.1). At the same time, DAF credit to SOEs has grown rapidly, so that the combined bank and DAF credit to SOEs as a fraction of total outstanding loans has bottomed-out at 46 percent in 2002 and is projected to increase in 2003. While non-SOCBs have nearly halved their credit exposure to SOEs, SOCBs' exposure has declined only moderately and remains four times as high as that of the other banks.

107. **In terms of new lending since 2000, SOCBs have given priority to asset growth over profitability.** In spite of liberalized interest rates, interest rate margins have eroded substantially as SOCBs have largely refrained from increasing lending rates while offering higher deposit rates to finance rapid credit growth. As a result, capital-asset ratios (measured using domestic accounting standards) have declined further and the cost of SOCB restructuring –driven by the need to clean-up balance sheets and restore adequate capital - has likely risen.




46 Decision 149/2001/QD-TTg of the Prime Minister.

47 The most important principle is that any debt relief provided by SOCBs to SOE via financial restructuring of NPLs is to be linked to operational restructuring of SOEs.

108. **In the area of transparency, some initial progress has been made to move loan classification closer to international standards and strengthen the accounting information available to monitor progress of SOCB restructuring.** In December 2001 Decision 1627 was adopted, requiring banks to classify the entire loan balance as overdue if any interest and/or principal payment becomes overdue. Furthermore, to help assess the true size of NPLs and accurately monitor improvements in banks' performance, the four large SOCBs have been undergoing IAS audits of their financial statements beginning with the year 2000 accounts. Based on these audits, banks have also been instructed to implement an initial plan for phasing in loan loss provisions. However, implementation of the new loan classification remains non-transparent[48] and plans to address key qualifications of the IAS audits have not yet been carried out.

109. **Strengthening banking supervision, in particular of SOCBs, remains a challenge**. The allocation of supervisory responsibilities among the various departments involved at the SBV, the lead agency in banking supervision, is complex and may need simplification. Enforcement mechanisms where banks violate prudential and other regulations need to be tightened. In addition, supervision by the central bank may be affected by the SBV's co-ownership function at the SOCBs.

### D. International Comparison Across Transition Economies

110. **Macroeconomic stability and rapid monetization have led to bank intermediation levels in Vietnam that are well above those in many other transition economies** (Figure VI.2). With more than 40 percent of GDP intermediated as credit to the economy, the banking system plays a key role in contributing to Vietnam's overall economic growth and stability.

111. **In terms of achieving financial deepening, bank restructuring has led to a wide range of results across transition economies in Eastern Europe, the Commonwealth of Independent States (CIS) and East Asia.** The more successful reformers, such as the Czech Republic, Poland and Hungary, after some decline in the transition, show relatively high levels of bank intermediation from households to the private sector. At the other end of the spectrum are the former CIS republics, where despite several years of reform, the role of the banking sector remains extremely limited. Output declines, a severe loss of confidence in the banking system and a shortage of creditworthy companies have all contributed to intermediation levels that are significantly below those of Vietnam.[49] One of the highest

[48] For example, neither some of the SOCBs nor supervisors have so far been able to quantify the impact of the new classification scheme on the amount of overdue loans.

[49] Another indicator of banking system performance, spreads between lending and deposit rates, may indicate that Vietnamese banks operate at relatively low margins. While this could point to relative efficiency, insufficient loan loss classification and provisioning requirements

(continued)

intermediation levels recorded is for China, which, like Vietnam, has been pursuing a gradual reform approach to transition.

112. **Regarding progress in addressing structural constraints, however, Vietnam appears to be much more similar to CIS countries than the more successful reformers of Eastern Europe** (Table VI.2). As in Vietnam, state-owned banks with weak lending practices subject to influence from privileged state-owned enterprises, continue to dominate the banking industries in many CIS countries. Moreover, accounting standards and disclosure requirements fall generally short of international best practice and banking supervision remains limited, in part owing to considerable constraints in human resources. By contrast, in Central Europe and the Baltics implementation of a strong regulatory and supervisory framework in compliance with international standards, and aggressive restructuring of state-owned enterprises, all have contributed to facilitating the transition to a commercially oriented banking system. In all these cases, opening the banking sector to foreign private investors was a key restructuring measure that contributed to success. [50]

113. **The cost of banking reform has varied substantially across transition economies and still appears to be relatively modest for Vietnam**. Apart from the size of the initial banking sector problem the cost of reform crucially depends on the credibility and timeliness of hard budget constraints imposed on both banks and the corporate sector, supported by needed reforms in bank management, in particular profit orientation and risk management, governance, and the regulatory framework. Based on international experience, delays in addressing structural weaknesses in Vietnam's financial system, in particular at the interface to the corporate sector, are likely to increase the ultimate cost of reform. [51]

114. **Vietnam's reform experience so far, appears to match most closely that of China.** In both cases, gradual reforms combined with strong economic growth and relative macroeconomic stability have led to some of the highest bank intermediation levels – significant NPLs notwithstanding - among transition economies. At the same time, the banking systems remain dominated by state-owned banks and internationally acceptable accounting standards are being gradually phased-in; in China's case with the adoption in 2002 of a 5-tier loan classification system and phased-in provisioning. An important difference between the two countries is that, in China a significant portion of NPLs were

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and ceilings on lending rates combined with limited commercial decision making, as mentioned above, make a comparison difficult.

[50] The accession process to the European Union (EU) has also provided a significant impetus to institutional reform. For an in-depth review of SOCB reforms in the transition economies of Eastern Europe and the CIS countries see Sherif et al. (2003).

[51] For a discussion of the intricate links between enterprise and bank reform in Eastern Europe see van Wijnbergen (1998) and Borish et al. (1996).

transferred to a centralized Asset Management Company (AMC), whereas NPL resolution remains the responsibility of individual banks in Vietnam. In terms of the cost of reform, tentative estimates suggest that the burden of NPLs and the need for recapitalization in Vietnam are modest compared with China, partly reflecting much lower intermediation levels in Vietnam.

### E. Challenges—Maintaining Reform Momentum

115. **Vietnam's banking sector, while already playing a more important role in financial intermediation than in many other transition economies, continues to face severe structural challenges.**[52] The transition towards a market-oriented two-tier commercial banking system is still incomplete. The existing approach relies on state-ownership of the four large SOCBs and their own capacity to reform. Within this framework more can be done to induce and enable banks to become commercially sound. Key elements to bring forward reforms include:

- ***Strengthening incentives for managers and staff to ensure commercially-based decision-making.*** The current compensation scheme of SOCB management rewards balance-sheet growth while not penalizing risky businesses.[53] The need to invest in training and technology, to provide for adequate loan loss reserves, and, above all to price credit risk adequately, should also become central objectives. Performance contracts of managers should reflect these factors and in particular profits after adequate provisioning for risks and non-performing loans.

- ***Simplifying SOCB's mandate.*** The phase-out of non-commercial lending operations should be accelerated. This would include the requirement that SOCBs make deposits at specialized policy-lending institutions at below-market interest rates.

- ***Building capabilities for sound commercial decision making, in particular improved credit risk management.*** Twinning arrangements with internationally reputable partners could prove particularly useful for transferring critical management know-how. In addition, efforts to train thousands of credit officers and managers need to be strengthened, including through increased technical assistance.

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[52] These challenges, including "poor financial capacity", "high non-performing debts", "low professional skills", and "poor supervision", are also noted in the SBV's "Plan on International Economic Integration of the Banking Sector in Vietnam" (Decision 663, June 23, 2003).

[53] SOCB managers' salary, like that of other SOEs, is tied to the size of their enterprise and some profit-related portion, which however is unadjusted for risks.

- ***Strengthening creditor rights by providing banks with more effective means to resolve NPLs, especially to loss-making SOEs.*** Approval of financial and operational restructuring plans for SOEs with NPLs should be streamlined. SOCBs should be able to initiate the process of SOE restructuring by calling to order a workout committee that is to agree on a restructuring plan within set deadlines. SOCBs should play a key role in these committees as they have access to critical information and they have already begun to develop relevant expertise in their respective loan workout units. To enhance effectiveness, SOCBs should first focus on the SOEs with the largest NPLs. [54]

116. **Providing banks both with incentives and key instruments to operate commercially would be supported by measures that create an environment more conducive to reforms, including:**

- ***Creating a level competitive playing field.*** The current framework still hampers competition, by practically prohibiting foreign bank branches to offer dong and foreign currency deposits to households,[55] increase their branch network and/or acquire domestic banks. While commitments under the USBTA would result in a phase-out of competitive restrictions on US banks, these should apply to all foreign banks to promote a more competitive domestic banking environment.[56]

- ***Strengthening bank supervision.*** Without improved supervision, progress in bank restructuring cannot be independently assessed, a necessary condition for reform incentives. To better monitor banks' performance, supervision will need to be strengthened, in particular in the area of risk assessments, and streamlined, including through consolidation of responsibilities.

117. **The existing incentives for reform provided through recapitalization, albeit limited, should be more fully exploited.** The incentives created by recapitalization may appear modest as long as banks are state-owned and thus are implicitly guaranteed to

[54] Bank-led restructuring efforts will also have to be coordinated with efforts to resolve inter-enterprise debt through a central Debt and Asset Management Trading Company (DATC) that is under development.

[55] Foreign bank branches are not permitted to offer FCDs to households. Further, their offering of dong deposits to non-borrowing customers is limited to 25 percent of their capital.

[56] The most important concessions under the USBTA include (1) phase-in of national treatment in the dong deposit market, (2) national treatment in equity participation in privatized SOCBs, and (3) majority foreign ownership of banking institution after 3 years of the agreement.

operate.[57] However, rewarding successful banks in a transparent and public manner could have a demonstration effect and limit moral hazard. Therefore, stricter enforcement of the eligibility criteria for public recapitalization funds would help limit the cost of the reform program.

118. **Beyond the existing approach, privatization could prove a valuable option to modernize the banking system.** As in other transition economies, a reputable foreign equity partner would help provide banks with critically needed management know-how to successfully restructure their operations; it would also reduce the cost to the state of adequately capitalizing the SOCBs.[58] Through a demonstration effect privatization of a large SOCB could also make the banking system as whole more competitive and efficient. The attractiveness of banks for foreign investors, however, will also depend on overall progress to commercialize Vietnam's banking system and create a level competitive playing field.

## F. Conclusion

119. **Vietnam's banking reform program needs to be pushed ahead.** Under the current approach the four large SOCBs remain wholly state-owned and their transition to commercially oriented banks relies entirely on their internal resources and the credibility of incentives set by the government. The existing approach to reform should be strengthened in three critical areas: (1) strengthening the incentives for reform of banks and their management, including through performance contracts and strict recapitalization conditions; (2) improving credit risk management in line with international practice, supported by substantial technical assistance (including through twinning arrangements); and (3) providing banks with more effective mechanisms to resolve NPLs. Moving beyond the existing approach would likely entail privatization of a large SOCB by seeking a strategic foreign equity partner.

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[57] See Neale and Bozsik (2001) who describe the case of Hungary where lack of credibility of incentives for government run banks led to several rounds of failed recapitalization with public funds.

[58] Illustrative scenarios based on 2000 IAS audits and assumptions on credit growth around 15 percent indicate that funds needed to restore SOCBs' capital adequacy would make up half of the recapitalization cost through 2005. More capital would be needed to support higher credit growth rates.

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**Table VI.1. Vietnam : Selected Banking Indicators**

| | 2000 | 2001 | 2002 | 2003 March |
|---|---|---|---|---|
| | (In percent) | | | |
| Share in total deposits | | | | |
| Four large SOCBs | 74.4 | 75.3 | 74.3 | 73.9 |
| Other | 25.6 | 24.7 | 25.7 | 26.1 |
| Share in total credit | | | | |
| Four large SOCBs | 73.3 | 75.8 | 75.9 | 75.9 |
| Other | 26.7 | 24.2 | 24.1 | 24.1 |
| Share in SOE credit | | | | |
| Four large SOCBs | 90.1 | 91.4 | 91.2 | 91.2 |
| Other | 9.9 | 8.6 | 8.8 | 8.8 |
| Share of SOE credit in total credit | | | | |
| Four large SOCBs | 56.3 | 53.6 | 49.1 | 47.9 |
| Other | 18.5 | 12.9 | 12.2 | 11.9 |
| | (In percent of total) | | | |
| Memorandum item: | | | | |
| Bank credit to SOEs | 44.9 | 42.2 | 38.7 | 37.8 |
| Bank and DAF credit to SOEs 1/ | 49.9 | 48.2 | 45.6 | 46.2 2/ |

Source: SBV; DAF; and Fund staff estimates.

1/ Assumes that share in outstanding loans equals average share of SOE loan commitments for state-investment credit during 2001-03.

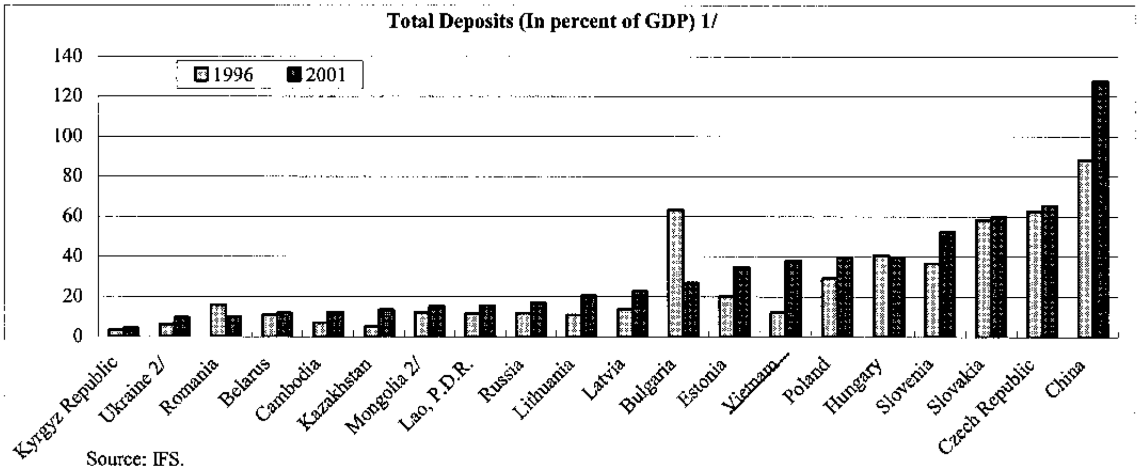
2/ Projection for 2003.

**Table VI.2. Banking Systems in Transition Economies - An Overview**

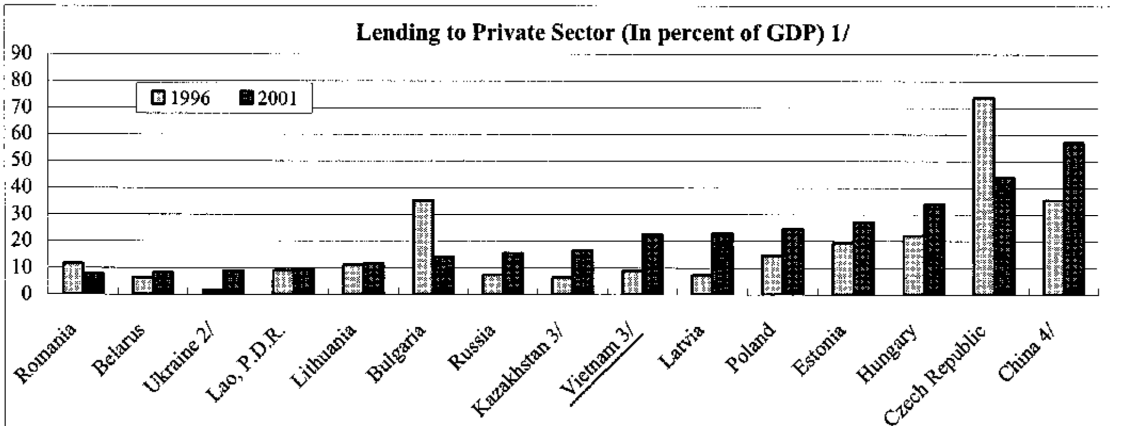
| | Incidence and nature of problems | Cost of bank restructuring (in percent of GDP) | Selected restructuring measures: Recapitalization | Selected restructuring measures: Privatization | Selected restructuring measures: Accounting and disclosure | Selected restructuring measures: Capital adequacy | State of transition to market-oriented banking |
|---|---|---|---|---|---|---|---|
| Baltic states | In early and mid 1990s insolvent banks represented about 40 percent of assets; several had to be closed. | Estonia: 1.9<br>Latvia: 2.7<br>Lithuania: 3.1 | Various rounds in Lithuania and Estonia; no government recapitalization in Latvia. | Foreign banks increased presence to about 85 percent of total assets in Estonia and Latvia (42 percent in Lithuania). | IAS adopted: Estonia (1995); Latvia (1992); and Lithuania (1997). | First adopted in mid 1990s, increased to 10 percent in 1999. | Completed. |
| Hungary | In late 1980s and early 1990s insolvency of 8 banks representing 25 percent of total assets; NPLs estimated at 30 percent of total loans. | 12.9 | Several rounds; first attempts considered to have failed due to insufficient amounts and moral hazard. | Share of private sector banks increased to more than 80 percent of bank equity; 60 percent of banks foreign owned. | IAS put in place in 1996. | 8 percent; adopted in 1992. | Completed. |
| Poland | Throughout 1990 state-owned banks and cooperatives became insolvent; in 1992 NPL ratio estimated at 30 percent. | 7.4 | Unrequited capital injections to prepare for privatization, conditional on bank audits and plans for NPL resolution. | Initial period of liberal entry for foreign banks. | IAS put in place in 1994. | 8 percent; adopted in 1993, risk-adjusted since 1999. New banks need 15 percent in first year, 12 percent thereafter. | Completed. |
| Russia | Loss of confidence; more than 1,300 banks closed/merged following stricter licensing requirements in 1995. | Not applicable. | Not applicable. | Formal privatization of branches from monobank system without recapitalization or operational restructuring. | IAS planned to be adopted in 2004. | Adopted in 1996 and gradually increase to a range between 9 percent and 11 percent (depending on bank size), risk-adjusted, but hampered by weak accounting standards. | Banking system dominated by state-owned banks (in particular Sberbank) benefitting from implicit government guarantees for deposits. |
| Ukraine | In mid to late 1990s central bank intervened to support 20 banks; 50 banks were liquidated; NPLs estimated at 40 percent of assets. | Not available. | Financial restructuring only by central bank through short-and long-term loans. | Limited; lax licensing requirements led to mushrooming of small private banks, often owned by SOEs; foreign equity participation mostly Russian. | IAS put in place in 1998, but banks reluctant to implement. | 8 percent adopted in 1999. | Banking system dominated by 7 banks of which two are state-owned. |
| China | At end-2001 NPLs of state-owned banks (two-thirds of the financial system) averaged more than 30 percent of total loans (excluding 14 percent of loans transferred to AMCs in 1999-2000). | Not available. | In 1999-2000 transfer of 14 percent of total (about 17 percent of GDP) loans to an AMCs. Other capital injections not strictly linked to improved efficiency. | Not applicable. | Adoption in 2002 of new loan classification and phased-in provisioning approaching international standards. | Adoption as targets (8 percent) with the Commercial Bank Law in 1995; riks weights generally consistent with the Basle capital accord except for treatment of large SOEs. | State-banks continue to dominate banking sector with gradual improvements in NPL resolution and operational efficiency, while interest rates remain partly administered. |
| Vietnam | Undercapitalized or insolvent banks; NPLs at 4 dominant SOCBs representing about 15 percent of loans in 2000, or about 5 percent of GDP. | Tentative estimates range between 4 and 7 percent of GDP. | In progress for SOCBs and conditional on NPL resolution and operational targets | Not applicable. | SOCBs subject to IAS audits; loan classification enhanced and adequate provisioning to be phased in. | 8 percent; adopted in 1999 but not enforced for SOCBs; supervisors unable to make risk-weighted assessment. | Dominated by 4 SOCBs representing about 3/4 of banking system credit and deposits. |

Sources: Borish et al. (1996), Karacadag (2003), Tang et al. (2002), Zoli (2001) ; and IMF country reports (various issues).

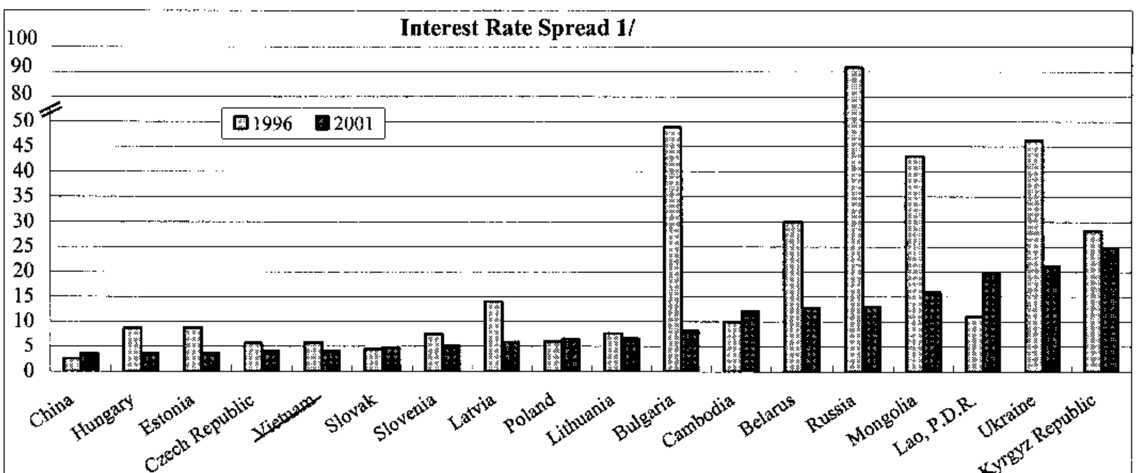
**Figure VI.2: Banking System Performance in Selected Transition Economies**




Source: IFS.
1/ As of year end. 2/ Latest available data pertains to 1999.




Source: IFS.
1/ As of year end. 2/ Latest available data pertain to 1999.
3/ Defined as lending to non SOEs. 4/ Credit of state-banks to non-SOEs in 1996 and 2000.




Source: IFS. 1/ Lending rate minus deposit rate in local currency.