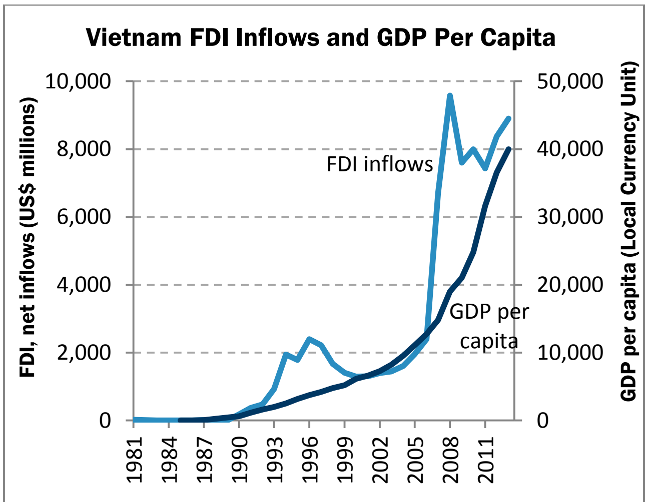
Vietnam: The Ascending Dragon

Ongoing reforms to state-owned enterprises and the banking sector are much-needed to address the structural weaknesses which have contributed to Vietnam's prolonged economic malaise. While significant progress has been made in recent times, the country will need to continue on this trajectory to reap the potential benefits of the ASEAN Economic Community ("AEC").

The Market Economy on a Leash

The sole communist-run state examined in this ASEAN Way series, Vietnam, has been the second-best performing economy in the region for the past two decades. Vietnam's economic growth has averaged 6.8% per annum since 1994. Much of the country's rapid growth since the mid-to-late 1980s is attributable to the *doi moi* reforms from 1986 onwards. The reforms initiated by the Communist Party of Vietnam ("CPV") — the only party in the one-party state — aimed to transform the economy from a centrally-planned system to a "socialist-oriented market economy." The *doi moi* program has been successful in raising incomes as well as in bringing foreign direct investment ("FDI") into the country; income levels have increased exponentially since the 1990s and FDI inflows increased rapidly in the mid-2000s (Vietnam joined the World Trade Organization in 2007), although this growth has since moderated.



Source: World Bank Databank

Other factors which fed into growth include the country's large, young and relatively well-educated workforce which has struck a balance between low cost and skill levels. Vietnam has the third largest population in the region and its labour force grew at an annual rate of 2.8% from 2000 until 2010.

Despite these relatively strong figures, growth has slowed in recent years as the gains from economic liberalisation, the shift from an agriculture-based economy to one based on services and manufacturing and demographic dividends from a youthful population have gradually faded. From a peak of 7.5% annual growth in the 1990s, average economic growth slowed to 6.6% in the 2000s and has been recorded at 5.6% in the present decade. The prolonged slowdown is a result of both external conditions and structural problems in the country's state-owned enterprises (SOEs) and the banking sector.

Reforming Giants

The behemoths that dominate the Vietnamese economy (the remaining 400 plus SOEs slated for equitization by end-2015) account for 35% of Vietnam's GDP. They are also notorious for their poor investment choices, corruption and overall bad management. In 2012, the government announced that SOEs had "wrongfully spent" some US$1.5 billion. The need to reform these giants is particularly acute considering their links to the banking sector; SOE borrowings are widely believed to have contributed to the non-performing loan ("NPL") ratio in Vietnamese banks, which have the highest bad debt ratio in the region. Vietnamese SOEs now owe banks and foreign donors US$71 billion, an amount equivalent to 1.45 times their equity.

SOE reform has focused on equitization, a process that has been underway for over two decades. Progress to date has been both encouraging and frustrating. Since the start of the equitization drive in 1992, some 4,000 SOEs have been equitized, merged or restructured. Recent regulations have removed one of the main obstacles towards equitization by allowing the sale of shares below book value and relaxing foreign ownership limits in some sectors. However, the state has been reluctant to release substantial stakes in its largest and most prized companies. For instance, the much-anticipated IPO of Vietnam Airlines saw only a 3.5% stake up for sale. The reluctance to diminish the state's control over these companies is linked to the central role they play within the CPV; SOEs have formed the backbone of the party's unofficial patronage networks and are a valuable resource in preserving stability.

Debts for Bonds

While the official NPL ratio is stated at 6-8% of bank assets, observers and credit ratings agencies believe that the actual ratio is much higher, at 15% or more. Many of the NPLs in local banks were a result of expansive macroeconomic policies pursued by the Vietnamese government in response to the global economic slowdown of the late 2000s. During this time, state-owned banks provided loans to investors and property developers linked to SOEs, creating a real estate bubble that duly burst in 2010. As a percentage of GDP, domestic credit increased by more than 300% between 2001 and 2010.

The government attempted to address the banking sector's woes by launching a debt asset management company named Vietnam Asset Management Co. ("VAMC") in 2013. VAMC purchases NPLs from banks in exchange for special bonds, which can then be used to obtain central bank loans. The NPLs may then be sold to investors, but little progress has been made in this regard. Investors have offered market prices for the assets but this is often a mere fraction of the price paid for the NPLs by the central bank and the offers made have been considered inadequate. As a result, of the VND100 trillion in bad debt purchased by VAMC in 2013 and 2014, only VND4 trillion were sold by end 2014.

While VAMC is helping to remove bad debts from the banks' balance sheets, it is far from being a total solution to the problems in the banking sector. Domestic banks do not meet Basel II standards on capital and risk management, although a pilot program is underway to bring local banks up to the mark. Resolving the underlying causes of weaknesses in the banking sector will require, among other measures, dealing with special interest groups, cross-ownership and connected lending.

Accountability in a One-Party State

Prime Minister Nguyen Tan Dung has borne much of the blame for the performance of SOEs and the banking sector's troubles. Appointed in 2006, he has had the unenviable task of steering the country through the global recession and the domestic economic slowdown.

While Dung's responsibility for Vietnam's troubles should not be overstated — many of the weaknesses which have come to light in recent years have deep roots — he pursued a strategy of SOE-led growth and promised to turn these companies into global players along the lines of South Korea's *chaebols*, with state-owned shipbuilder Vinashin leading the charge. Within this context, the CPV agreed to let Dung reorganise SOEs and they were placed directly under his office. It was under his leadership that these enterprises were provided with ready access to credit and as a result spiralled into debt.

Dung's favourite project, Vinashin, suffered the most and almost brought about his downfall in 2010. Dung's allies were placed in the top echelons of the shipbuilder and the company benefited extensively from the state's largesse; it received US$750 million in proceeds from Vietnam's first international sovereign bond issue and a US$600 million syndicated loan arranged by Credit Suisse. Easy access to credit could not offset bad management and Vinashin almost collapsed under the weight of debts totalling US$4 billion in 2010.

The fallout of this near-default extended beyond the financial sector and threatened Dung's political career. A decision by the Politburo to discipline Dung for his mismanagement of the economy and SOEs would have removed him from office if the CPV's Central Committee had not intervened to reverse the decision. In 2013, Dung was then subjected to the National Assembly's first-ever confidence vote where he received a low confidence vote from one-third of its members. To his credit, Dung has survived these challenges relatively intact.

The actions by the National Assembly, while mild in comparison to other countries, are remarkable for a body that previously served simply to rubber-stamp government policies. Recent developments in Vietnam's political sphere, including public consultation on constitutional reform, show that while it may be a one-party state, that one party is not a monolith and is instead seeking incremental reforms to manage societal changes, not unlike its counterpart in China. The next CPV Congress in January 2016 will renew the party's leadership and provide an update on the party's plans for the country.

Rocking the Boat

With Vietnam's large market, strong growth and relative political stability, the country is a serious option for businesses looking to expand in the Mekong sub-region. Investment in Vietnam is expected to spike once its AEC commitments are fully met, meaning that domestic manufacturers will need to compete against their peers from other countries as barriers to trade and investments are lifted.

Therefore one measure of Vietnam's commitment to the principles of the AEC will be its willingness to not just equitize its beloved SOEs, but also to place these entities on a level playing-field with the private sector. While this would remove the market distortions created by these large enterprises, it could also destabilise the CPV's unofficial power structure. Whether the CPV has the stomach for such a move remains to be seen.

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