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ENTERPRISE REFORM AND FOREIGN INVESTMENT IN VIETNAM

A conference on enterprise reform and foreign investment in Vietnam, jointly organised and sponsored by the Ministry of Planning and Investment of Vietnam, the Government of Japan and the OECD, was held at the Daewoo hotel in Hanoi on 19-20 January 1998.

The presidency of the conference was shared by the Vietnamese Government, represented by Mr. Trân Xuân Giá, Minister of Planning and Investment, and Mr. Nguyen Nhac, Vice-Minister of Planning and Investment, and the OECD, represented by Ambassador Marino Baldi, Chairman of the OECD Committee on International Investment and Multinational Enterprises.

The conference included four workshops. The following reports of these workshops were delivered at the concluding session of the conference.

Workshop A: The general policy framework for enterprise reform

- ***Moderator:*** *Dr. László Becker, Managing Director of International Privatisation Consulting, Hungarian Privatisation and State Holding Company, Budapest, Hungary*

Lead speakers:
- *Dr. Janusz Lewandowski, former Minister of Privatisation of Poland;*
- *Ms. Katharina Pistor, Development Associate, Harvard Institute for International Development, Cambridge MA, USA;*
- *Mr. Tran Ngoc Trang, First Vice-Chairman, Central Steering Committee for Enterprise Reform, Office of the Government, Vietnam.*

At this workshop, participants explored the main issues and areas of policy and regulation that a government of a country in economic transition needs to address with regards to enterprise reform.

1. Enhancing the efficiency of the corporate sector in transition economies

Participants were reminded that Eastern European countries started their transformation in circumstances that are not too different from those in Vietnam, with most of the productive sectors of the economy, being up 90 per cent or more, state-controlled.

Among the most important steps for a transition economy to generate enterprise development and growth, the first task is to ensure that the macroeconomic framework becomes stable and predictable. The second is to make sure that private economic initiative can be undertaken.

This implies the identification and subsequent elimination of all types of entry barriers in markets. In countries like Poland, Hungary and the Czech Republic, reform has ranged from the international trade liberalisation to the scrapping of all licensing and monopolies in many sectors of the economy. More importantly, state-owned enterprises have been put on exactly the same footing as private

firms in terms of access to both product and credit markets. Assets from liquidated state firms have been reallocated to new entrepreneurs who have made good use of them.

Taking Poland as an example, it was observed that external pressures alone could not reform the SOEs. During the 1980s, these had slowly drifted from total state control and were left with very weak governance structures. The Polish government recognised that it had to privatise and hence, it adopted a multitrack privatisation programme. This programme had to be massive, given the number of state-owned firms and rapid, given the deteriorating state of corporate governance. It had to address the issue of domestic capital shortage and the issue of depoliticisation of enterprises.

Apart from traditional methods of privatisation, such as tenders and offerings in the nascent equity markets, Polish privatisation closely involved the enterprise insiders with strong incentives for them to become the new owners. The general public was involved by offering them part of the enterprises via a free voucher scheme, comparable to other programmes adopted in many other countries.

The point was made that corporatisation of enterprises was very helpful since it renders their situation more transparent and focuses their managers on their commercial task. However, its benefits have been realised mainly because managers were already discounting privatisation of their enterprise down the road. If such a prospect is not within view, corporatisation might result instead in asset stripping and in a more problematic corporate governance environment for SOEs.

Enterprise restructuring in Poland had also been helped significantly by special re-organisation procedures that turned banks into restructuring agents for bad debtors. The banks themselves had been, at a relatively early stage, the target of important institutional reform in which the supervisory structure and prudential requirements were strengthened in parallel with a one-off recapitalisation exercises.

Finally, it was mentioned that the difference between gradualism and shock therapy in economic transition is, to a large extent, a political issue. If the political environment can tolerate spontaneous privatisation, a gradual approach might be as effective as any other to reallocate assets in the economy.

2. Legal systems in transition; implications for enterprise reform in Vietnam

The core function of the reform process was identified as the improvement of resource allocation. This function can be exercised by the state alone on one hand, a multitude of market participants on the other, or it can take the form of several in-between combinations. Economic transactions can be either rule-oriented or based upon the discretionary power of the administration.

Because in the first phases of economic transition, the latter is the usually the case, initial private sector growth takes place in a grey area outside the formal economy. While this is welcome as a first step, in the medium/long run it has some important social costs: it creates corruption by inviting private enforcement (*i.e.* protection/extortion), it creates a higher cost of capital because of the lack of clear property rights and it is a drain rather than a benefit to the budget.

Transition economies are faced with the difficult challenge of creating and enforcing complex property rights that in Western countries took centuries to develop. In most transition economies privatisation (and therefore the *de facto* creation of such rights), took place before a proper, enforceable legal system was put in place. This resulted in a protracted legal uncertainty.

An important lesson is that legal reform and economic policies have to be compatible and carefully sequenced. On the one hand, the establishment of a proper legal framework should not be postponed once the essential elements of economic reform are in place. On the other hand, adopting a complete rule book without the capacity to implement any of the new provisions will not do much good. Hence, there is a trade-off between the speed and irreversibility of reforms and the rule of law and, quite possibly, the right choice between the two has been made in many transition countries.

In the discussion of these subjects, the importance of developing the infrastructure for the protection of property rights was underlined. The development of a court system capable to implement the new legislation cannot be underestimated. Similarly, it was pointed out that in the case of land rights, developing adequate registries is of great importance.

Land rights were identified by many discussants as central to private enterprise development, both from the point of view of enterprise establishment and, more importantly, of enterprise financing. Pledges to establish a liberal real estate market were a central requirement for the accession of Poland, Hungary and the Czech republic to the OECD. On the other hand, the absence of real property rights in Vietnam is a great handicap for non-SOEs, since land use agreements can be arbitrarily changed or terminated.

3. Enterprise reform in Vietnam

On behalf of the Vietnamese Government, it was pointed out that Vietnam had to deal with market reforms in a different way because of its highly specific characteristics: it started off from a much poorer level than other CEECs; there is no experience with private enterprise and the people, after many decades of war, are poorly trained to undergo such a deep cultural transformation at once. There are very few economic agents that could take the place of the state if the latter decided to withdraw abruptly from the ownership of assets.

The Government acknowledges that a lot remains to be done in establishing a level playing field between state and non-state sectors, but it is of the view that this has to be done gradually. The same is true for the equitisation process, which at present is not very popular with workers or managers. Unfortunately, the Vietnamese effort to create a proper economic environment for enterprise development has stumbled upon the current financial crisis in Asia. Although Vietnam wants to join APEC and the WTO, it has infant industries to protect. It is not very easy either to envisage land privatisation and liberalisation, given the symbolic value of Vietnamese land to all those who fought for it.

During the discussion of these questions, it was pointed out that, in a number of areas, SOEs receive much more favourable treatment than private enterprises, to the detriment of private sector development and investment. These areas include the lack of secured lending possibilities for non-SOEs, their tax disadvantages and their discriminatory treatment when it comes to export/import licenses. It was argued that the actual increase in the number of SOEs and their role in the economy, combined with a decrease in the role of private (especially foreign) investment, was worrisome.

A number of participants noted that hiding unemployment by maintaining loss-making SOEs is not a sustainable solution. It is better to confront the problem directly by active labour market policies coupled with enterprise restructuring. Improving the bankruptcy framework is another prerequisite for allowing assets to be used efficiently. Current insolvency legislation is very difficult to implement. Only six enterprises have been declared bankrupt in spite of widespread insolvency in the economy.

Finally, it was pointed out that the widespread privatisation trend around the world is not an ideological phenomenon, but rather the consequence of a realisation by governments of the globalisation of capital markets and the inability to meet the SOEs' demand for risk capital and long-term finance from purely budgetary sources that results.

Workshop B: Regulation and promotion of foreign direct investment

Moderator and lead speaker: *Mr. Patrick J. Daly, Consultant on International Investment and former Executive Director of the Industrial Development Authority of Ireland.*

Other lead speakers:

- *Dr. Jürgen Voss, Consultant, OECD;*
- *Mr. Kazi Matin, Lead Specialist, World Bank Resident Mission, Hanoi;*
- *Mr. Toshio Asakura, Chief Representative, Hanoi, Japan External Trade Organisation;*
- *Mr. Đinh Van Ân, Director of Foreign Investment Legislation and Promotion, Ministry of Planning and Investment, Vietnam.*

This workshop dealt with two broad issues, the first one being the trends of foreign direct investment into Vietnam, including ways to improve these trends, and the second one the general principles of foreign direct investment policy.

1. Foreign direct investment in Vietnam

Recent trends

The importance of foreign investment to Vietnam is indicated by the statistical data, provided by the World Bank: FDI made up one-third of total investment in 1997, up from 15 per cent in 1992. Foreign-owned firms employ a total of 600 thousand workers. Foreign investment largely takes the form of joint ventures; there is a strong concentration in heavy industry, including oil and gas. There is relatively little export-oriented investment: the share of foreign-owned enterprises in exports is only just above 10 per cent, while their share in imports is 18 per cent. Finally, a rising share of FDI takes the form of loans.

Much of the approved FDI comes from other Asian countries, particularly Singapore, Hong Kong and Taiwan (42 per cent), 17 per cent from the four Asian countries in financial crisis (Korea, Thailand, Indonesia and the Philippines) and another 17 per cent from the OECD countries, excluding Korea. This concentration on Asia means that Vietnam will certainly feel the impact of the recent financial crisis: in particular there is reason for concern about the disbursement of the one-sixth of approved investment from the four Asian countries in crisis.

The ratio of FDI to GDP is in fact very high, but, on the other hand, research suggest a particularly low impact of foreign investment on GDP, which raises doubts about the efficiency of realised FDI. To this comes an unusually low rate of implementation of approved FDI, which several speakers identified as a reason for particular concern.

The recent decline of FDI into Vietnam did not go unnoticed. Among the causes mentioned were a general scaling back of the originally high expectations among foreign investors about the prospects in this country, a sluggish domestic market development (indeed, most FDI is oriented to serving the domestic market), generally lower outward investment from important investors such as Taiwan and Hong Kong, an oversupply of projects for large plant and property development.

Reference was often made to the intensified competition for FDI in the region. This is caused by several factors: firstly the improved performance of other emerging markets such as India and Myanmar, secondly the economic integration within ASEAN, which makes it less necessary for investors to supply the Vietnamese domestic market by an establishment in Vietnam itself instead of one in another ASEAN country and, thirdly, the lower supply of FDI from Asian countries. Vietnam may benefit in the short term from the fact that it appears less hard hit by the financial crisis than other countries in this region; however, the longer-term effect of this crisis seems to be that other Asian countries open up further to FDI; as a consequence, the intense competition for FDI may well mean that Vietnam suffers in the longer run, unless it too removes its barriers to foreign investment more expeditiously.

Policy recommendations

That leads to the specific policy recommendations for Vietnam. The maintenance of macroeconomic stabilisation as well as a competitive exchange rate and relative unit labour costs were mentioned. More in the microeconomic field, there is ample scope for lowering the costs of investing (by simplifying regulations and improving their transparency) and the costs of domestic production (*e.g.* by reducing the price of imports). From a sector point of view, the low incidence of export-oriented industries in foreign investment calls for urgent attention, as does the development of parts and components industries. Many investors in this field are small and medium-sized enterprises, which makes it all the more important that better information services are created.

This leads to the subject of investment promotion and hence to the broader field of general principles of FDI policy.

2. The general principles of FDI policy

Under this heading, the following subjects were discussed:

- investment promotion;
- the use of investment incentives;
- the need for specific FDI legislation: should there be an FDI law at all; and
- the internationalisation of FDI legislation.

Investment promotion

Many transition economies have endeavoured to create “one stop” agencies for foreign investors. Vietnam is lacking such a one-stop service and its establishment would be particularly helpful or foreign investors and not least for the country itself. While these are generally considered useful, although not always easy to implement, a word of caution is needed, since a one-stop shop risks raising too high expectations. In any event, these institutions should not be seen as all-powerful regulators, but rather as intermediaries between the investor and the various regulators.

Countries such as Singapore and Malaysia that have been very successful in attracting foreign investment are characteristically well-staffed and have the necessary clout to influence decision making. Their direct contact with investors makes investment promotion agencies well-placed to provide feedback to the authorities on investment conditions and there have been good examples of investment promotion agencies persuading the authorities of the need for specific policy changes.

Investment incentives

In general, speakers cautioned against the use of special incentives to lure foreign investors. Investors are more interested in a transparent tax regime than in tax incentives. Profit tax holidays will not work for newly established companies which rarely make profits in their first years anyway. The use of incentives can also lead to "incentive wars." The only two instances where incentives have been shown to work are in countries where the tax system is unreasonably burdensome (but then the best remedy would be to make it less burdensome across the board) and at subnational level: once an investor has chosen a country of establishment he may be swayed by incentives to establish in one location within that country and not at another one.

A specific form of incentive is to shelter investors against adverse amendments of laws and regulations, by providing specific exemptions, options to choose between old and new regulations, and grandfathering acquired rights. This option has been tried or contemplated and considered useful in a number of countries, including Vietnam. It should be added that such grandfathered rights can also be repealed, and this has sometimes actually happened, so not all investors take great confidence in this type of measure. However, the situation changes when guarantees are embodied in international agreements, which commonly take precedence over ordinary laws.

Yet another incentive is the creation of special economic zones, where foreign investors are insulated from much national legislation, *e.g.* in the field of taxes, or import duties. Such special zones can have their use in specific circumstances, such as in Latin America during the debt crisis, where the country as a whole is not creditworthy, but where foreign enterprises can be attracted by shielding them from the general economic and regulatory stance of the country.

The need for FDI legislation

A fundamental question is whether a country needs a foreign investment law at all. Indeed, most industrialised countries do not have such laws, simply because they do not treat foreign investors differently from domestic investors, often with a limited number of exceptions dealt with in sector-specific legislation. However, an FDI law can have its use in transition economies, especially those without a good track-record of treating foreign investors, by promoting transparency, formulating explicit guarantees and limiting the number of exceptions to national treatment. Furthermore, in economies dominated by SOEs and state monopolies, where thus no free competition exists, FDI laws are indeed necessary to create a somewhat more level playing field for foreign-owned enterprises.

Internationalisation of FDI regulation

In general, foreign investors consider guarantees provided by international law superior to those in national legislation, first of all for the obvious reason that international treaties take precedence over national laws and are not, or at least less easily, amendable. Moreover, international treaties often open

the way for international arbitration of investment disputes and international arbiters are usually, rightly or wrongly, seen as more independent than the national courts of justice. In this context, investment insurance programmes were mentioned, such as those offered by the Multilateral Investment Guarantee Agency.

A specific recommendation was that countries, including Vietnam, draft internationally enforceable investment contracts, not only for large projects, for which they are customary, but also for smaller projects. Such contracts can be standardised, not in the sense that they use a single model contract for all projects, in the sense that they consist of standardised elements, or incorporate standard terms of contract.

Finally, it was observed that there is an increasing tendency to provide multilateral investment protection, first of all by the existence of multilateral mechanisms such as MIGA, but also by the proliferation of bilateral treaties, namely because these usually offer most-favoured nation treatment. Of course, the MAI was mentioned in this context. It was observed that even countries that do not join the drive towards multilateral investment protection will feels its influence, because the mere existence of higher standards, such as those of the MAI, raises the standards of reference of investors, to the detriment of those countries that do not meet these standards. No country benefits from disgruntled investors. On the other hand, a satisfied investor is the best investment promoter a country can have.

Workshop C: Enterprise restructuring and state firms.

Moderator and lead speaker: *Mr. Stilpon Nestor, Head, Privatisation and Enterprise Reform Unit: Reforming the enterprise sector, the OECD experience*

Other lead speakers:

- *Prof. Michael G. Porter, Director, Tasman Asia Pacific Pty Ltd., Sydney, Australia*
- *Mr. Jean-Pierre Verbiest, Resident representative Asian Development Bank, Hanoi, Vietnam*
- *Mr. Đang Đúc Đam, Deputy Director, Central Institute for Economic Management, Ministry of Planning and Investment, Vietnam*

The panel addressed three central issues. First, the structural features of governing fully or partially state-owned firms; second, the implementation of reform measures and other state policies; and third, general policy issues, including the impact of the state-owned sector for private sector development.

1. Structural features of governance over state-owned firms

Who exercises ownership rights on behalf of the state?

During the discussion the importance of streamlining the governance structure for SOEs was repeatedly stressed. A clear allocation of decision making rights is important for enterprises as well as for their trading partners and potential investors. The allocation of formal title is only one aspect of this. Others include proper channels of communication and congruence between formal title and decision making rights.

Ownership rights in state-owned firms may be vested with a single state agency—either the Ministry of Finance or the Treasury. This is the case, for example, in the majority of OECD member countries. Alternatively, ownership rights may be exercised by line ministries or special agencies, such as property funds. Most transition economies have established such special agencies for the purpose of privatising state-owned enterprises and to exercise property rights during the transition period which often went through various stages; from full state ownership via majority control rights or golden shares to minority rights. To the extent policy makers contemplate privatisation as a reform measure, the establishment of a state agency whose task is to implement privatisation was regarded as beneficial by most panellists and discussants. The existence of such agency would alleviate potential conflicts of interest line ministries in particular might face, as the privatisation of enterprises under their control might endanger the purpose of their own existence.

How can the state exercise ownership rights?

A related question is how the state may exercise control rights over SOEs. Based on the experience of many transition economies, there was wide agreement that the incorporation of state-owned enterprises alone does not solve the issue of control. Different countries have experimented with different control structures. Lessons may be learned from closer examination of these experiences.

The incorporation of companies raises the issue of staffing the corporate boards with the right personnel. The pool of potential state representatives is typically limited. Lessons may be learned from Hungary, where the holding companies for SOEs conducted open tenders for potential candidates and created lists with people drawn from both the state and non-state sectors.

The selection of management is a critical issue. In most cases this involves the selection of individuals who will be authorised to conduct the day-to-day affairs of the company. However, in some cases, management may also be transferred to a legal entity, i.e. a company with limited liability. In either case additional control mechanisms are typically put in place. Possible devices are performance contracts.

A typical performance contract in a French SOE would include provisions on the following:

- return on equity;
- capital structure, including limits on debts;
- investment plans;
- restructuring plans;
- remuneration of management.

Hungary as well as other transition economies have adopted similar performance criteria. Even so, the enforcement of these contracts remains an issue.

Another control device is the *golden share*. It provides the state agency exercising ownership rights with veto rights on key issues that affect the state's control rights, including:

- sale of assets;
- establishment of subsidiaries;
- capital increase or decrease.

Although golden shares are quite common, the perception is that they are not used very often. This may be because the cases that give rise to the veto rights occur infrequently, or because this control device is rather ineffective.

Importance of the internal governance structure

Questions were raised about the importance of the internal organisation of a corporation. In particular, clarification was sought as to whether a two-tier management structure (the German corporate model) or a one-tier management structure (found in Anglo-American law) is more effective.

The consensus among Western experts was that these structural differences are only of marginal importance. Both systems have faced similar problems related to the competence of management and the willingness of those in charge of overseeing management to take the appropriate measures, including the replacement of management when needed. Thus, rather than worrying about two-tier or one-tier management structures, the focus of attention should be on the following issues:

- competence of management;
- independence of the board members overseeing the management;
- clear incentive structure for management to improve the company's performance;
- clear allocation of management rights vs. monitoring rights.

A regular (*i.e.* annual) review by an independent auditor who could hold management -- and/or members of the board in charge of supervising management -- accountable for their actions appears to be a particularly successful control device that ensures an impartial review process. This process is widely used by many OECD countries.

Problem areas

It was widely agreed that the various control devices discussed may enhance the state's control over companies it owns in full or in part. At the same time, it was stressed by the discussants and members of the panel that problem areas, which may be inherent to the state owned sector, still remain. They include the following.

- Appointment of management. Politics and networking often override concerns for the competence of management.
- Enforcement of performance contracts. In some countries, including France, performance contracts are not civil law contracts and therefore do not offer recourse to judicial review (i.e. it is not possible to enforce these contracts in the court system). Lack of compliance

with contractual requirements is dealt with through informal challenges. In transition countries in particular, performance contracts pose additional problems. As the transition process involves high levels of uncertainty due to the rapidly changing economic environment, criteria have to be loosely defined, which makes them difficult to enforce.

- Even the best contracts will face difficulties in dealing with the problem of diverting state assets for private benefits. The creation of subsidiaries, joint ventures, and other schemes have often been used by managers of state-owned companies to create profitable business operations, leaving the obligations, including employment obligations, to the state-owned enterprise. This process has become known as the “privatisation of revenue and the socialisation of risk”.
- Finally, while proper governance structure appears to be important in particular for companies that are being privatised in trenches (i.e. first a minority stake is sold, and several years later the remaining assets are transferred to a private investor), partial privatisation also involves specific risks. First, investors are unlikely to pay a substantial price for the first trench if they have doubts about the commitment of the state to privatise the remaining assets in the foreseeable future. Second, although in several transition economies the state had hoped to increase the price for the remaining assets once the company was allowed to operate as a partially privatised company for several years, in many instances the outcome has been just the opposite. This may be due to changes in market conditions, or the inability of the company to compete adequately in open markets.

2. Policy implementation

Panellists stressed the importance of adequate implementation of state policies. This should involve a clear division of labour between policy makers on the one hand and state officials who perform an executive function by implementing these policies on the other. Experiences by foreign investors in Vietnam suggest that the allocation of decision making rights is not always clearly demarcated among different state agencies. This creates backlogs in decision making and increases the costs of transacting with state-owned enterprises as investors need to confer with different state agencies whose respective jurisdictions are ill-specified. Moreover, policy making becomes cumbersome if those in charge of outlining general policies become involved in individual decisions.

To illustrate this matter, an example was given from New Zealand, where the Finance Minster was approached by a state official about whether or not he should take a decision to close a specific post office. The Finance Minister reportedly threw the state official out of his office and told him never to come back with such a request. He explained that he was in charge of making general policies. When policy changes were required, he could act. However, the implementation of these policies to specific cases was not within his jurisdiction. The New Zealand example, just as examples from other countries where reform processes had been stalled for years -- if not decades -- also suggests that leadership by the relevant policy makers is important for successful reforms and that successful leadership includes the delegation of decision making power.

In general, the decision making authority should be vested with state agencies that are closest to the matter at hand and have the best access to information. In the case of Vietnam, it was suggested, these are often the local Peoples’ Committees. Experiences by foreign investors show that the committees were often aware of the need for reform and willing to make important decisions, but lacked the authority from the centre to do so.

3. Policy issues

Finally, the panel addressed some general policy issues with respect to enterprise reform. Experts from Vietnam raised concerns about the competitiveness of the Vietnamese state-owned enterprise sector on world markets and about securing work places. As many state-owned enterprise in Vietnam are small, efforts have been made to establish holding structures, which SOEs are mandated to join. The purpose of these reforms is to gain synergy effects from various companies co-operating within a holding structure, to enhance the state's control over companies, and to enable Vietnamese SOEs to compete on international markets.

Several questions were raised with respect to effectiveness of these reform measures. First, it seemed unclear to what extent companies that had been mandated to join holding structures would actually collaborate with other firms under this structure. Without such collaboration, the claim that this would generate synergy effects appeared to be questionable. Second, the effectiveness of state controls rests on the assumption that the holding company effectively controls the various members of this structure. In light of the experience of some transition economies it was suggested that control over the various units may actually be weakened. Finally, it was reported that the general trend, in particular in OECD countries, is to divest state holding companies. Overall, their track record has not been very successful and the separation of different business activities appears to enhance the performance of these companies. It also facilitates the privatisation of state-owned enterprises.

The concern about employment was shared by all parties. However, it was pointed out that although unemployment increased initially in most transition economies after the introduction of economic reforms, new employment has been created by the private or the privatised sector, not by the state-owned sector. Moreover, it was suggested that enterprise reforms are unlikely to be successful unless social benefits, including employment, housing, health and other social services provided by SOEs, are addressed separately. This would include, among others issues, an expansion of the social safety net.

Finally, concerns were raised about the effects of the improved performance of the state enterprise sector on the development of the new private sector. SOEs in Vietnam currently seem to be privileged over other firms in several ways. It was suggested that they have better access to land use rights, export licenses, capital provided by the state-owned banks, and licenses to undertake certain businesses, and that they receive beneficial tax treatment. This skews economic development, as foreign investors who need access to land use rights or exports often do not have any other choice but to establish joint ventures with SOEs, rather than with non-state parties or establishing wholly foreign owned companies. The latest reform discussions in the government to allow non-state parties to contribute land use rights to joint ventures with foreign parties may alleviate some of these concerns.

Workshop D: The financial system, foreign investment and enterprise reform

Moderator and lead speaker: *Mr. Charles Kovacs, Director, Central European Operations Inc., Budapest, Hungary*

Other lead speakers:

- *Mr. Sadao Amano, Expert, Japan International Co-operation Agency, Hanoi, Vietnam*
- *Mr. Fumiya Yoshimura, Chief Representative, Nomura Securities, Hanoi, Vietnam*

The discussion at this workshop centred on the importance of financial sector reform, particularly in connection with enterprise reform and foreign investment. In addition to the designated lead speakers, Mr. Đang Đúc Đam, Deputy Director of the Central Institute for Economic Management at the Ministry of Planning and Investment of Vietnam, participated actively in the discussion, expressing the Vietnamese viewpoints.

The following three major issues were addressed: firstly, the linkages of banking sector reform with enterprise reform and foreign investment; secondly, the benefits of stock market development for enterprise reform and foreign investment; and lastly, the necessity of financial sector development for economic growth.

1. Links between banking sector reform, enterprise reform and foreign investment

At the beginning of the workshop, a comprehensive explanation about the experience of Hungary was presented. After reviewing the developments in the Hungarian financial sector since 1948, as well as their political and economic background, it was argued that most banks had not been restructured sufficiently, due to the decision against early privatisation of the banks, which in turn delayed enterprise reform and increased economic problems. Without early privatisation, the state-owned banks continued their substantial lending to state-owned enterprises, thereby diluting the fiscal discipline of the enterprises and resulting in the delay of their restructuring. As a result, most state-owned banks, which dominated the Hungarian market, were in trouble by the early 1990s. At that moment, the government was forced to implement the "Bank Consolidation Program" in order to avoid a serious systemic crisis. The program cost 1-2% of the GDP directly, but it had a much larger negative impact on the general economy.

The reference to the experience in Hungary led the participants to consider that good banks with sound banking policy act as a major catalyst for enterprise reform. This is because such banks will not lend without audited statements and confidence in the management of their borrowers, and then, such audited statements increase transparency, oblige companies to increase internal controls and reduce malfeasance by the management. Moreover, in order to develop good banks by increasing competition as well as encouraging innovation, it is essential to promote the privatisation of state-owned banks and the introduction of foreign banks. In Hungary, many foreign banks were established after the new legislation in the late 1980s, which ensured their national treatment, and almost all the state-owned banks had been privatised by the end of 1997. It was observed that these movements have led to Hungary's success in the process of economic transition.

It was also argued that a good banking system is important for the development of foreign investment. A sound banking system, especially with the participation of well-established foreign banks, can help build confidence among foreign investors. Such a banking system can also assure various kinds of advice, standard banking services and easier access to international credit markets. The point was made

that, unless a country is extremely attractive, foreign investment would be scarce without the active presence of foreign banks.

2. Benefits of stock market development for enterprise reform and foreign investment

In addition to banking sector reform, stock market development can also be an important vehicle for enterprise reform. For the current Vietnamese economy, improving the competitive power of state-owned enterprises would be the key issue. It was suggested in the workshop that this could be ensured through equitisation with foreign equity participation. The foreign equity participation would bring into the state-owned enterprises 1) well-developed management know-how, 2) an international distribution network, 3) advanced technology, and 4) funds for investment from the foreign partner, all of which are currently lacking in the state-owned enterprises of Vietnam. This should be treated as a very urgent issue by the Vietnamese Government, as state-owned enterprises are now facing severe competition from foreign companies and joint ventures, as well as from imported goods, which will no longer be restricted after 2003 or 2006, according to the ASEAN agreement.

The workshop then discussed what could be done to attract equity participation from abroad. Such a programme would require innovative solutions, since bringing foreign investment into the country is becoming more difficult as the world economy integrates, creating a situation of severe global competition for capital. The participants stressed that, from the foreign investors' viewpoint, transparency and transferability are the two most important factors in making investment decisions. High transparency, or in other words high predictability, helps investors to determine the risk/return profile which is prerequisite for their investment decision. High transparency, entailing the necessary sense of mutual co-operation between investors and local companies or banks, is vital to any serious influx of foreign investment. Disclosure and accounting/auditing practices have to be improved in order to enhance transparency in connection with foreign investment.

High transferability of the investments is another important factor for the foreign investors. Foreign investors need assurances that they can "exit" from their investment at the time they want to. In order to ensure high transferability for foreign investment, it was recommended to take measures such as standardisation of share certificates and the establishment of a stock exchange. It was argued that all these measures to improve transparency and transferability for foreign investment will be necessary to provide the basis for development of a securities industry, which is currently unavailable in Vietnam.

In relation to enterprise reform, there was a discussion about dealing with unwillingness among management and workers to accept equitisation. Some observed that such unwillingness is common to many countries preceding equitisation or privatisation of state-owned enterprises. One of the participants argued that, as in other transition economies, the respective groups of managers and workers may often be persuaded to accept such a situation by being provided eventually with shares in the company. Another asserted that it is important to start the equitisation program with the enterprises whose management and workers are not against its equitisation, and by initially leaving the difficult cases aside.

3. The necessity of financial sector development for economic growth

Lastly, the workshop discussed the importance of financial sector development in Vietnam in the context of sustaining its recent dramatic economic growth. Despite the remarkable developments since 1989, the Vietnamese economy still contains several frailties: an expanding trade deficit, stagnant domestic savings, and slow financial deepening, all of which are inter-related. Rapid economic growth

has to be supported by a high rate of domestic investment. This domestic investment should in turn be financed by either domestic savings or capital imports from abroad. The recent expansion of the trade deficit suggests that Vietnam is becoming more dependant on capital imports. Thus far, capital imports into Vietnam consist mainly of concessional official development assistance (ODA) and foreign direct investment (FDI). It was pointed out, however, that the growing requirement of additional capital might force Vietnam to attract short-term bank loans from abroad, which, because of their volatility, entail the risks of a financial crisis like that of Thailand. Therefore, financial market development is especially important for the current Vietnamese economy because it will help to mobilise domestic savings to finance investments, and also because developed financial markets may attract more foreign direct investment.

The financial market of Vietnam is still very small. Its M2/GDP ratio has been holding steady at around 25 per cent since the early 1990s. The low income level of the population should be one of the major reasons for this, but the underdeveloped capacities of the commercial banks for financial intermediation and banking services are also regarded as discouraging factors for financial market development. In this context, some options were suggested in the workshop for Vietnam to grow its financial market by diversifying financial assets and modernising financial systems. They include the following.

- Introduction of commercial bills. The commercial bills backed by commodities can not only serve as collateral for bank loans, but could also become the objects of interbank transactions, thereby developing a more effective and efficient money market.

- Creation of state bonds for construction. Long-term government bonds would provide households with an opportunity for long-term investment and banks with opportunities for investment diversification. The government may utilise the funds from the bonds for such long term investment as investment in infrastructure.

- Encouragement of syndicated loans. A syndicated loan system may be effective in utilising the advanced financial skills of the leading banks in the market.

- Creation of a long-term credit bank. A long-term credit bank would specialise in long-term credit and raise funds by issuing bank debentures with maturities that are longer than those of deposits. It may be efficiently operated without serious maturity mismatches between assets and liabilities which are a feature of the existing banks, such as the Bank for Investment and Development of Vietnam and Agribank.

- Introduction of postal savings. In order to enhance the accessibility to the basic financial services in the rural areas and to mobilise the savings there, the broad network of post offices may well be utilised. The system may also need to be developed to allow investment of the collected funds into variable projects.