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Reform of State Owned Enterprises: A Big Challenge to the Vietnamese Economy

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Introduction

For many years Vietnam has made strenuous efforts to improve infrastructure actively using the ODA funds and to attract foreign companies. Specifically since 2007 when it joined the World Trade Organization (WTO), the economy has continue to perform well with its trade flows and inflow of foreign investment increasing and it rose from a low income country to a lower middle income country. However, the economic development mechanism that relies on foreign assistance funds (loans) has put a burden on the Vietnamese fiscal balance, making the fiscal consolidation an urgent task. As in China, Vietnam maintains a dictatorial political regime controlled by a single party of the Communist Party, and the market economy that works on competition principles has been underdeveloped. Especially, state owned enterprises (SOEs), not only place a heavy burden on finance, but also they might pose an impediment in maintaining the current high economic growth. Despite its long efforts on the reform of SOEs, Vietnam has not achieved visible results, and it is required that the country finally works on the reform seriously.

This article reviews the situation of the Vietnamese economy and after reviewing the necessity of fiscal consolidation, I explore the present situation of the reform of SOEs and agendas for it.

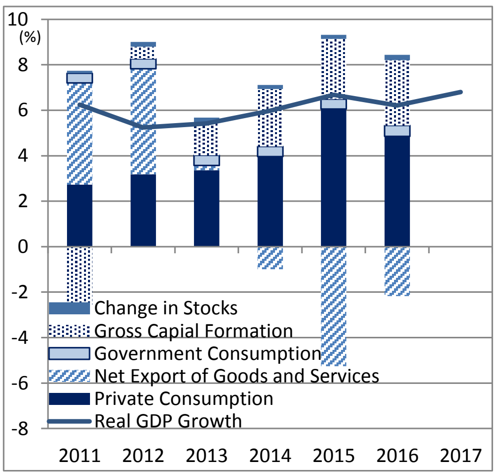
1. Overview of the Vietnamese Economy

(1) Economic growth

Vietnam's real GDP growth has exceeded 6% year over year in the past few years (Figure 1). As compared to other ASEAN countries, Vietnam continues to grow relatively at a higher rate than other countries (Figure 2). In the background of this high growth, there are increase in domestic demand supported by income rise and population growth as well as an increase of exports centering on electronics supported by the recovery of the world economy.

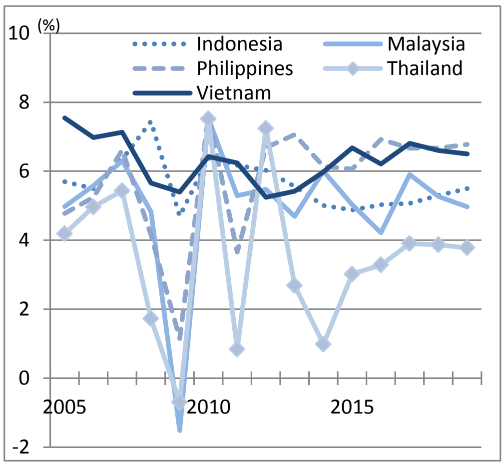
Looking ahead, the high growth is expected to continue as private consumption will grow aided by rising wages, migration of workers from rural to urban areas and an increase of middle class. In addition, Vietnamese exports (Figure 3) are rapidly increasing as compared to other ASEAN countries and expected to pull the whole economic growth also helped by the conclusion of Trans Pacific Partnership Treaty (TPP).

Figure 1 Real GDP Growth (by contribution)



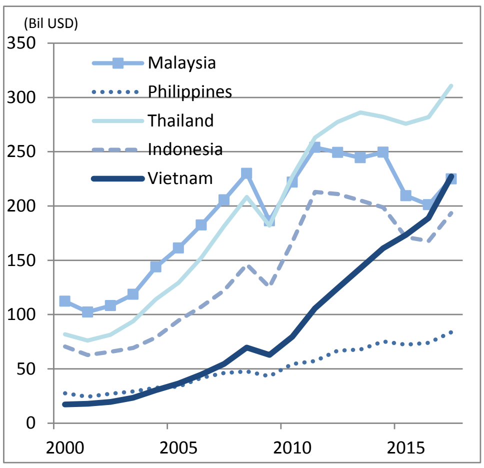
(Source) State Bank of Vietnam

Figure 2 Real GDP Growth in ASEAN Countries



(Source) IMF, and IMF Staff estimates after 2018

Figure 3: Export Volume of ASEAN Countries



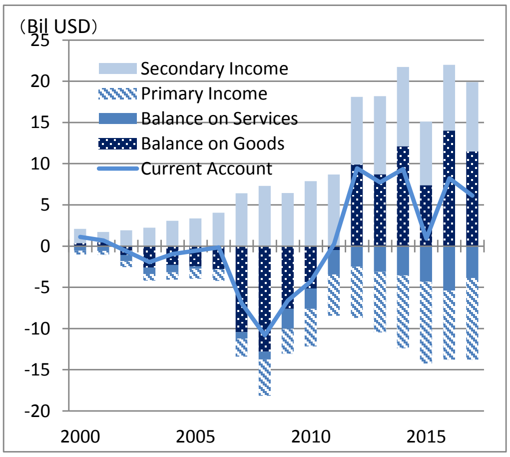
(Source) IMF

(2) Balance of Payments

Until 2010 the current account was mainly composed of a continued trade deficits partly covered by the secondary income surplus through remittances of overseas migrant workers (Figure 4). Since 2012, however, the current account shifted to a large surplus at a stroke, mainly due to a turn of trade balance into a surplus. This change resulted from a successful attraction of foreign manufacturers which contributed to an increase of exports of electronics products, in addition to traditional export items like oil and textiles.

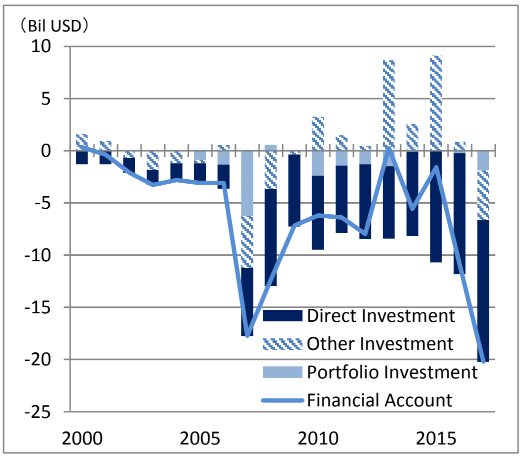
Inflow of foreign capital started to increase in the middle of the 2000s, resulting in net inflows in the financial account (Figure 5). Specifically after 2007, Vietnam has steadily attracted direct investments from abroad. On the other hand, there is little progress in the inflow of portfolio investments. This is mainly because the domestic securities market has not been fully activated as the delayed improvement of securities investment system has impeded the widespread participation of domestic financial institutions in securities investment and the reform of the SOEs has been delayed, as is discussed below.

Figure 4 Current Account by components



(Source) State Bank of Vietnam

Figure 5 Financial Account by components



(Source) State Bank of Vietnam

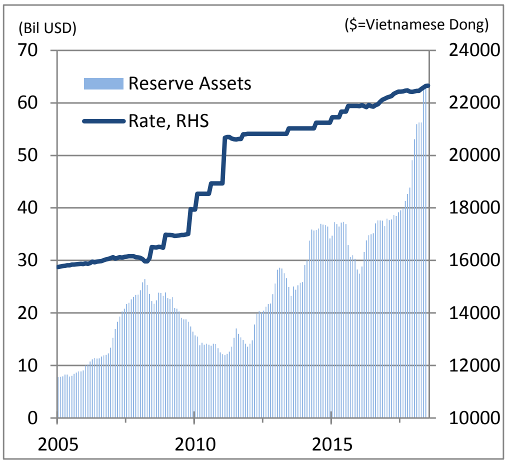
Following the turn of the current account into surplus, foreign exchange reserves increased to $63.5 billion by June 2018 (Figure 6). The ratio of the reserves to monthly imports stood at 3.8 months as of June 2018, exceeding 3 months that is generally regarded as a necessary minimum. The risk of running dry of foreign exchanges has been declining. According to the IMF, however, the ratio of Vietnam's foreign exchange reserves to the Assessing Reserve Adequacy (ARA) metric[1] remains at 77%, much lower than the level of 100～150% which is

[1] An indicator that the IMF sets for the emerging economies to show the appropriate level of their foreign exchange reserves. It is calculated by the formula of aggregating 5% of exports+5% of broad money＋30% of short-term debts +15% of other debts. The 100 to 150 % of actual reserves to the aggregation is considered to be an adequate level for the country's preparedness to external shocks.

considered to be adequate and safe. This is the point that needs to be kept watching.

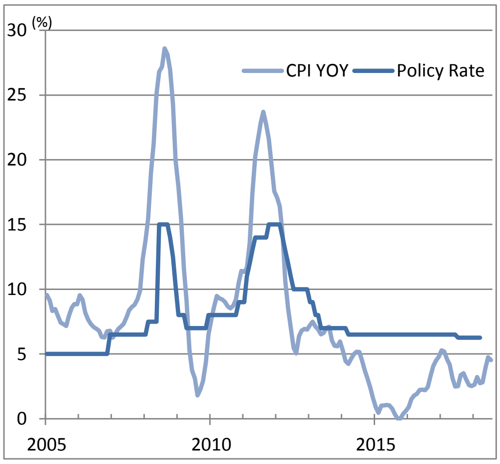
The exchange rate of the Vietnamese Dong to the dollar is maintained within a fixed range by the intervention of the central bank. The policy rate remains stable at a low level since 2014 (figure 7). In July 2017, the State Bank cut the policy rate by 0.25 % point to stimulate the economy but with no rate change thereafter. Inflation (consumer price) continues to rise below 5% over the previous year helped by the stable food prices. Yet there remains a risk that inflation may rise due to a rise of oil prices.

Figure 6 International Reserves and Exchange rates



(Source) State Bank of Vietnam, Reuters

Figure 7 Policy Rates and CPI

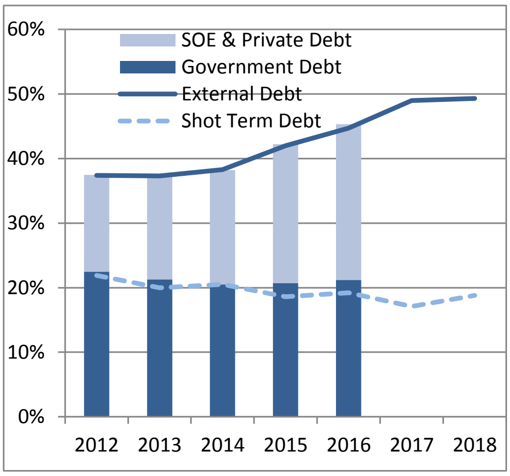


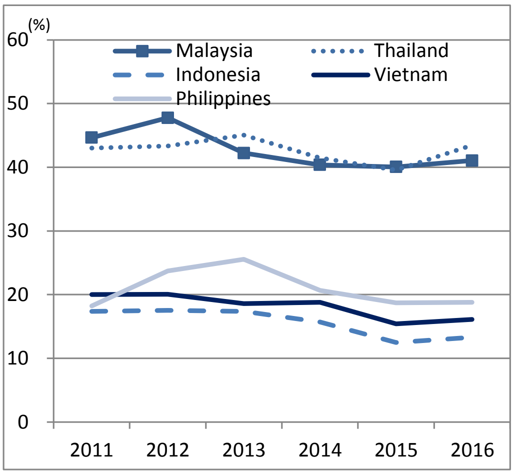
(Source) State Bank of Vietnam, IMF

Vietnam has positively introduced foreign aids and investment, by placing emphasis on the improvement of infrastructures aiming at attracting foreign companies. As a result, the external debt outstanding expanded to around 50% of GDP in 2017(Figure 8). As 70% of the outstanding is accounted for by loans with longer maturity and lower interest rates, short-term, external debt outstanding remains at around 20% of GDP, lower than in other ASEAN countries (Figure 9). In case the privatization of the SOEs accelerates in the future, however, some caution will be required to the expansion of external debts of the private sector.[2]

[2] As explained later in this paper, foreign acquisition of stocks of Vietnamese SOEs has been slow, but in 2017 Thai Beverage of Thailand extended a short-term loan to its subsidiary in Vietnam to acquire the stocks of SABECO, a state owned alcoholic drinks company in its conversion into a joint stock company.

Figure 8 Vietnam's External Debts by components Figure 9 Short-term External Debts of ASEAN countries





(Source) State Bank of Vietnam and its Estimates for 2018 (Source) World Bank

(3) Current Situation of the Fiscal Balance

The fiscal situation of Vietnam shows a higher ratio of expenditures relative to GDP compared to other ASEAN countries, with continuous deficits as a stable revenue structure including tax revenues has not been fully established (Figure 10 and 11). Specifically, since 2012, the government continues to face a difficult situation to secure adequate revenues reflecting the loss of import tariffs on 1600 items that were abolished based on the ASEAN Free Trade Agreement (AFTA) and decrease of oil revenues due to stagnant oil prices.

The government has promoted public investment to improve infrastructures, but the public debts outstanding[3] has increased as a ratio of GDP year by year as the country has largely relied on the development assistance funds from Japan and other countries (Figure 12), At present, the required annual gross financing needs (GFN[4]) for the Vietnamese government stays below 15% of GDP, a level that is believed to start to put the government a heavy burden to repay, so the scale of debts has not reached a critical stage yet.

However, there is a risk that the fiscal deficit will increase in the future due to an increase of interest payments and repayments of debt principals associated with an expansion of debts. In this regard, the National Assembly took a decision in November 2016 that reset the ceilings on the debts of 65% as a ratio of GDP for the public debt outstanding, 54% for the government debt outstanding, and 50% for the government external debts, and that strengthened the debt control measures further. As the public debt outstanding increased to 63.3%, as close as to the ceiling, at the end of 2016, the government has come to postpone the infrastructure payments

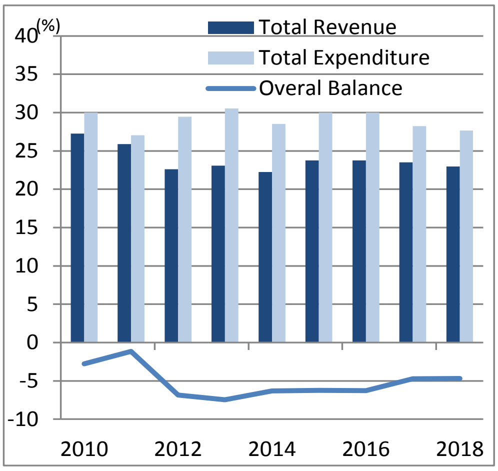
[3] Aggregates of the debts of the central government and those of the public sector.

[4] Gross Financing Needs (GFN) consist of the fiscal deficit and amount of required principal repayment.

including the ODA projects from Japan since 2017[5]. It has also made an effort to further control the public debts especially by stopping issuing government guarantees to new borrowings by SOEs (which account for 20% of total government guaranteed debts). Together with the efforts taken to improve the primary balance, the public debt outstanding decreased to 61.3% of GDP at the end of 2017 (Figure 13).

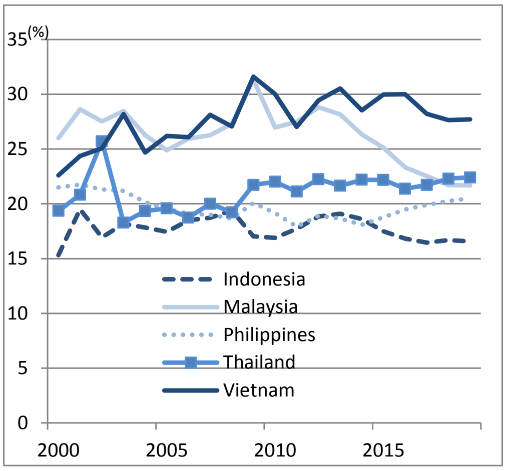
Also in November 2017, the amendment to the Public Debt Management Law was enacted to be implemented on July 1 2018. This amendment clearly stated that the debts of SOEs without government guarantees are not included in the public debts and defined their equal treatment as private companies that go through the same bankruptcy procedures. Further, although the public debt management was formerly administered with an ambiguous division of roles among three agencies of the Ministry of Finance, State Bank of Vietnam and the Planning and Investment Ministry, it was centralized to the Ministry of Finance to improve the efficiency and transparency.

Figure 10 Fiscal Balance, (% of GDP)



(Source) IMF, with its staff estimate for 2018

Figure 11 Expenditures of ASEAN countries (% of GDP)



(Source) IMF

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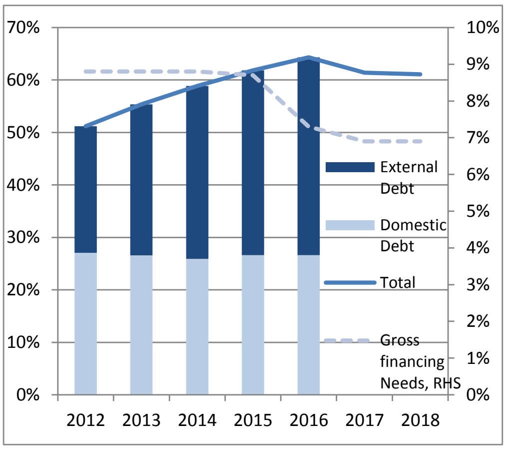
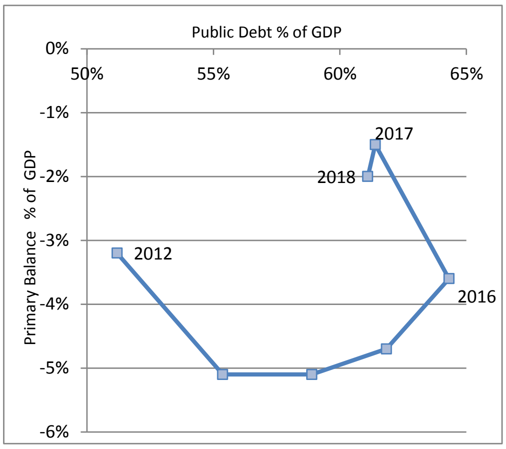
5 Regarding the infrastructure construction works financed by ODA funds, builders charge the construction cost to the Vietnam government at every certain progress of the construction, to which the Japanese government makes a loan of equivalent amount to the cost. Since 2017, the Vietnamese government intentionally has delayed the payment process. As a result, the disbursement amount of new loans to the Vietnamese government from the Japanese government decreased to the level of around 30% in the fiscal year 2017 from the previous year.

Figure 12 Public Debts and GFN (% of GDP) **Figure 13 Public Debts and Primary Balance (% of GDP)**





(Source) State Bank of Vietnam, IMF with its staff estimate for 2018 (Source) AMRO with its estimate for 2018

(4) Reforms aimed at Fiscal Consolidation

The government of Vietnam makes it a goal to eliminate the fiscal deficit and promptly reduce the public debts. As is noted earlier, however, not a small part of its economic development was supported by its fiscal policy. The government has promoted infrastructure investment with assistance funds (loans) from abroad to attract foreign capital, and actively taken in foreign direct investment (FDI). Taking advantage of Vietnam's lower wages and more ample young labors than in Thailand, Malaysia and China which have achieved economic development prior to Vietnam, foreign affiliated manufacturers have concentrated their business in Vietnam and succeeded in expanding exports.

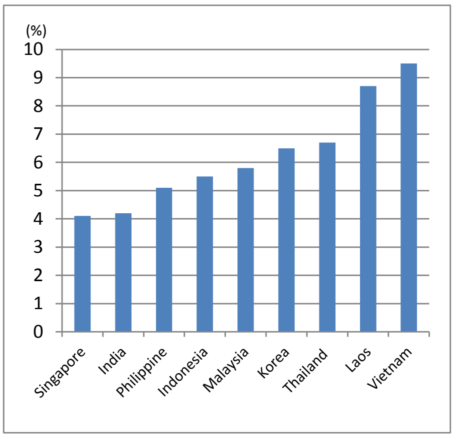
In the meantime, due to the accumulating fiscal deficits, the public debt outstanding expanded dramatically during these years. In addition, it is inconceivable that Vietnam can continue to receive aids on the same conditions as before as Vietnam has grown from a low income country to a lower middle income country. For instance, the World Bank and the Asian Development Bank have scheduled to reduce implementation of new loans and/or abolition of their preferential treatment. In other words, Vietnam is in a situation where it has to gradually break away from the economic development mechanism that largely depends on foreign aids. Given such conditions, in order to promote sustained economic development, it is considered necessary for Vietnam to make following reforms especially focusing on the fiscal consideration.

Firstly, in order to reduce fiscal deficits, it has to cut expenditures and increase revenues. The IMF report on the Article IV Consultation with Vietnam points out that Vietnam has a larger wage cost to government employees (in % of GDP) than other emerging countries (Figure 14). It is required to cut the number of government employees through restructuring of government offices and privatization of SOEs and restrain their wage levels. As a means to increase revenues, the government announced a five-year fiscal plan for 2016 to 2020, which will promote raising tax rates and broadening tax bases (Table 1). It also plans to utilize electronic invoices for tax collection.

Secondly, to reduce public debts, it should consider other financing methods that do not rely on foreign assistance. Vietnam's capital market is small in size compared to other ASEAN members, and the transactions in stocks and bonds are not active (Figure 15). This is mainly because in the past Vietnam easily could attract assistance funds and FDIs to finance infrastructure needs, but in the future it should diversify the financing methods by utilizing the stock and bond markets. Specifically, it is necessary to review regulations and red tapes to stimulate portfolio investment by foreign investors. It also should review the infrastructure projects implemented by local governments and government agencies and control public investment as well as shift the financing of infrastructure projects from public fund to private fund by constructing a new investment scheme that utilizes more private funds through Public-Private Partnership (PPP) programs and the like.

Thirdly, the reform of SOEs that have increased public debt through fiscal expenditures should be further promoted. Especially, it is necessary for the government to reduce the fiscal expenditures through dissolution or privatization of money-losing SOEs that are supported by the government while attracting more investments from foreign companies.

Figure 14 Wage bills of Emerging Economies (% of GDP)



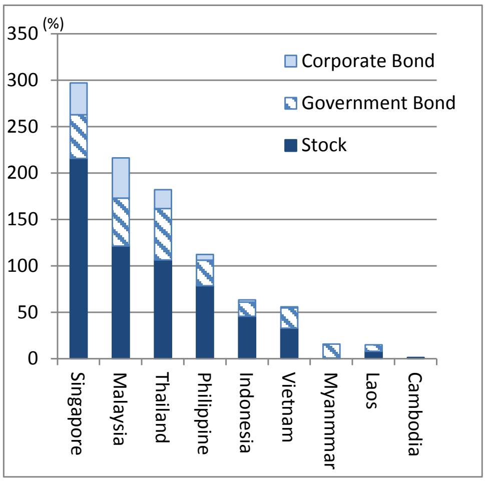
(Source) IMF

Table 1　Programs to Increase Revenues

VAT	・Raising the standard rate from 10 percent to 12 percent, effective since 2019 ・Broaden the tax base by including a number of goods and services which have been currently exemped from VAT
Excise tax	・Apply a 10 percent tax rate on sugary beverage, effective since 2019 ・Raise the excise tax rate on cigarettes and tobacco products from 70 percent to 75 percent from 2019 and levy some specific taxes additionally from 2020 onwards
Corporate income tax	・Review the current incentive system applicable to corporate income tax
Environment protection tax	・Review the maximum tax range, such as petrol and fuel products, from the currrent VND 1,000-4,000 to VND 3,000-8,000 per liter
Property tax	・Create a peoperty tax in replacement of the current complicated system of taxes and fees based on land

（Source）AMRO

Figure 15　Capital Markets of ASEAN Members (% of GDP)



（Source）Asia Bond Online, WB, Each Finance Ministry

2. Current Situation of SOE Reform in Vietnam and its Challenges

Vietnam has long tried to reform the SOEs with no visible results. However, as noted before, it is now faced with the need to break away from the economic growth mechanism that is more or less dependent on the foreign assistance funds. In such a situation, the country is required to make genuine efforts to reform the SOEs both to maintain the high growth rate seen thus far and further accelerate fiscal consolidation.

In the following sections, I would like to go into more detail about the SOE reforms which the government of Vietnam is going to step up.

(1) Historical background of SOE reform

As the Vietnamese economy stagnated after the Vietnamese war under the economic regime that demanded to change the infrastructure financing from public to private funds, a Doi moi policy was adopted at the Communist Party Congress in 1986, to promote a shift to market oriented economy and open-door policy. As a part of its policy, the government started to reform the SOEs in 1992. The reform included the implementation of privatization, mergers and acquisition, restructuring and dissolution of SOEs aiming at increasing efficiency of SOE management. In the 1990s, the early years of reform efforts, neither enterprise act nor environment of securities market was developed, and restructuring was implemented focusing on the small- and medium-sized SOEs that were administered by the governmental ministries and local governments. On the other hand, in the area of strategically important industries for the state[6], restructuring was made by integrating plural SOEs into groups.

From around 2005, SOEs in these important industries started to expand their business into non-core businesses, thus forming conglomerate groups. After the global financial crisis, large-scale monetary easing was implemented also in Vietnam, and in the easier financing climate, conglomerate groups evolved into even bigger ones by investing in real estates and stocks without paying due consideration to management efficiency. However, when the monetary policy turned to tightening to control inflation, their enormous non-performing assets came to the surface, with some of the groups falling into default or de fact bankruptcy.

It was in the 2000s that Vietnam began to try to privatize (sell their stocks to private sector) the SOEs after converting them into joint stock companies. It was because the country had to bring the SOEs to an international standard in order to become a member of the World Trade Organization (WTO)[7]. For that purpose, the government established a government investment company (the Vietnam State Capital Investment Corporation, SCIC) to supervise and manage the capital subscriptions of the government. Also the government tried to encourage the privatized enterprises to list on the stock exchange to help diversify their finance and improve their governance. However, the conversion to joint stock corporations and listings did not proceed as planned because SOEs had social roles like manipulation of the macro economy by the government through demand and price adjustment and job securities and therefore it faced with interventions on the management of SOEs from various governmental agencies both from central and local governments.

In 2011, the government changed its policy management stance from a growth-oriented economic management to a balanced one between stability and growth, and set the reform of

[6] Include telecommunication, retails, gas, infrastructure, energies, etc.

[7] Efforts were made to restore the health and efficiency of SOEs' management by abolishing preferential treatment to the SOEs.

SOEs as one of the high priority issues to be tackled by 2015. In 2014, it classified the SOEs into 3 groups based on the degree of need of capital subscription of the government, and listed the SOEs that are subject to conversion to joint stock companies together with planned ratios of their stocks to be sold. From around that time, the movement to sell parts of their stocks to private sector finally began to gain momentum.

The new government established in 2016 decided to accelerate the reform of SOEs and reviewed the classification standard of 2014 with a publication of a list of 137 enterprises to be converted to a joint stock company in the period of 2016 to 2020. In August 2017, it also published a sales plan of SOE stocks by 2020. The announcement not only disclosed the sales schedule and ratio to the capital of stocks to be sold, but also it required (obligated) the supervisory agencies to report to the Ministry of Finance the sales record in every quarter. Further, in February 2018, the government established the State Capital Administration Committee, a new organization to manage the SOEs as a whole. It aims at dissolving the situation that is prone to fall into sectionalism among government agencies, SCIC, and local governments, and accelerating the SOE reforms.

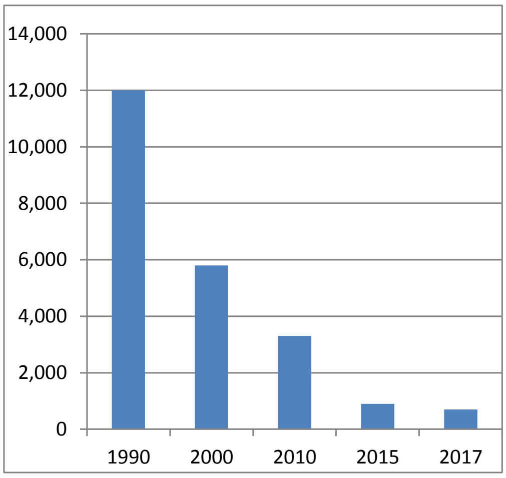
(2) Scale of SOEs

As described above, despite the government’s efforts of more than 20 years to reform the SOEs in Vietnam, the visible results are rather limited.

The number of SOEs[8] in Vietnam amounted to 12, 000 at the start of reform in 1990, but it was cut to 700 to date (Figure 16). The majority of the dissolved enterprises were those with little possibility to produce a profit or those of small business scale. Therefore the dissolution or reconstruction of such enterprises were possible to be promoted with relative ease. However, the current share of SOEs still accounts for about 30% in the annual distribution of GDP (Figure 17). It accounted for 40% in the 1990s, so it has not decreased so much since then. In other words, despite a large decline in the number of enterprises, the presence of SOEs still remains substantial. In fact, there remain many SOEs and their conglomerate in the key industries. Therefore, SOEs have more employees and capital with higher sales than the average values of enterprises in other sectors (Figure 18).

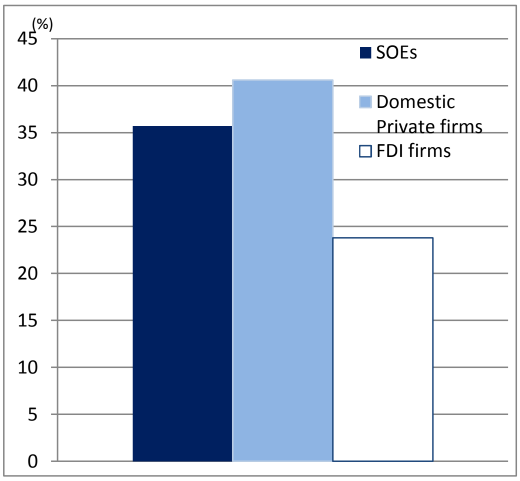
[8] SOEs are classified into three types, namely those with 100% stakes held by province and administered by the central or local governments, limited companies administered by the central or local governments, and joint stock enterprises with majority shares held by the government.

Figure 16　Number of SOEs



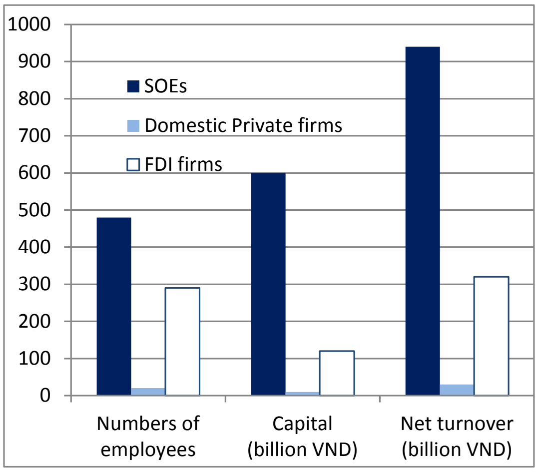
(Source) Various reports

Figure 17　Distribution of GDP by Sector



(Source) General Statistics Office Note: Figures for 2016

Figure 18　Average Corporate Scales by Sector



（Source）AMRO　Note：Figures for 2015

(3) Agendas for privatization of SOEs

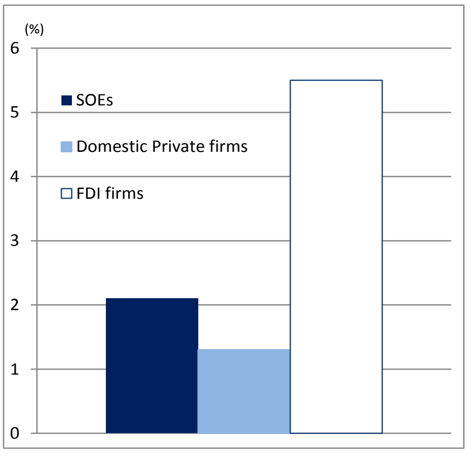
Vietnam decided in 2017 to participate in the TPP and it has to improve the market environment so that fair competition can be promoted at a higher level than with the WTO it joined in 2007. For this purpose, the government has been forced to finally complete the SOE reform by abolishing preferential treatment of SOEs and introducing company laws and accounting standard of an international level. As the fiscal balance has been deteriorating as was seen above, the government plans to sell money losing SOEs at the highest price possible to offset the fiscal deficits with the income.

Because of these situations, the government has actively been promoting the privatization of

SOEs as a compilation of long-standing efforts of SOE reform, but it is unclear whether it will proceed as scheduled. First of all, a big problem is that there are few capital investors to SOEs available. The domestic financial market has been less developed than the ASEAN neighbors, and institutional investors like insurance companies and pension funds are still to grow, with no individuals and companies available who can acquire a large lot of stocks of listed companies. Meanwhile, cash-rich foreign investors tend to avoid the investment in Vietnam due to complicated investment procedures for acquisition of stocks by nonresidents, coupled with insufficient disclosures of financial statements on enterprises. Further, since the SOEs have not been faced for many years with competitive environment, their return on asset (ROA) is lower than foreign companies, and given their high debt-to equity ratio, they do not look like a good investment opportunity for foreign investors to earn enough return for the risk (Figures 19 and 20). In addition, it is difficult for foreign investors to fully enjoy the benefit of investment since they cannot in principle have the whole management authority on their investment due to the ownership ratio restrictions while they are required by the government to guide the companies they invested with advanced technology and management techniques.

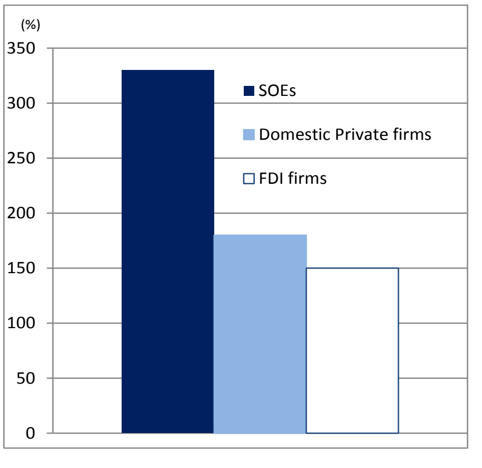
As we have seen before, the Vietnamese government has made efforts for several years to carry out through the reform process by setting a roadmap to promote the reform of SOEs. However, the reform of SOEs has entered the phase where it cannot be completed within the country. First of all, the country will be required to introduce regulations and systems to correct opaque financial situation and management techniques of SOEs and at the same time to establish a procedure for stock acquisition which is easy to understand to foreign investors.

Figure 19 ROAs of Enterprises by Sector



(Source) AMRO Note：figures are for 2015

Figure 20 Debt-to Equity Ratios by Sector



(Source) AMRO Note：Figures for 2015

Conclusion

Vietnam has so far achieved high economic growth by taking in foreign assistance funds. However, this economic development mechanism based on foreign aids has expanded its public debts and worsened the fiscal balance. It is time for a review. Also the current economic structure that much relies on the activities of SOEs has a limitation in activating free trade with foreign countries as it had decided to participate in the TPP. In such an environment, the government faces with a need to seriously carry out through the reform of SOEs that it has tackled for many years. Specifically it will be the challenge for the country to accelerate privatization of SOEs and improve the regulations and rules to an international level so that it can attract more foreign private investments.

The progress of SOE reform has the key to ensure a sustainable growth of the Vietnamese economy and its fiscal consolidation. Its development should be carefully watched.

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