INTERNATIONALIZATION AND MACROECONOMIC MANAGEMENT IN VIETNAM: SOME LESSONS FROM SWEDISH EXPERIENCES

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Abstract

The main macroeconomic challenges at the early stages of Vietnam's economic reforms were related to stability and growth. The main achievements of *Doi Moi* are also related to the success in meeting these two challenges: Vietnam has managed to combine high growth with reasonable price stability since the early 1990s. However, meeting these challenges has become more difficult over time as new challenges have emerged. In the mid-1990s, economic structure and external balance entered the policy debate. In the late 1990s, the Asian crisis created further problems. In recent years, issues related to social and regional development gaps and investment quality have become important policy objectives. At the same time, it is clear that the instruments for economic policy making have changed. While the challenges of the early 1990s could be handled with various direct interventions like credit ceilings and quantitative trade restrictions, indirect instruments for macroeconomic management are gradually becoming more important. For instance, the choice of exchange rate regime is becoming much more important than in the past. This paper summarizes Vietnam's macroeconomic development, and illustrates some of the alternative approaches to macroeconomic management in an increasingly internationalized and deregulated environment by recounting some experiences from Swedish macroeconomic management during the past three decades.

Key Words: Vietnam, internationalization, macroeconomic management, growth, stability

JEL Codes: E60, F40, O11

1. Introduction

Some of the most impressive achievements during the first two decades of Doi Moi have arguably been related to macroeconomic management. Although the challenges facing the Vietnamese economy have varied over time, and although the past decades have included severe external shocks – for instance, the Asian financial crisis – it has been possible to combine high growth with reasonable macroeconomic stability. At the earliest stages of the reform process, stability was arguably the main policy goals: the economic reform program that was introduced at the Sixth Party Congress in 1986 was directly motivated by the severe inflation that paralyzed the Vietnamese economy. By the early 1990s, when inflation had been brought down to an acceptable level, the policy focus shifted to achieving a high rate of economic growth. This was necessary not only to improve the standard of living and sustain the public sector, but also to justify one-party rule in an international context where many other former command economies underwent both economic and political reforms. The public legitimacy of the Vietnamese Communist Party (VCP) was (and continues to be) to some extent related to its ability to provide satisfactory results in terms of growth, poverty reduction, and convergence towards the income and development levels of the richer East Asian economies.

Price stability and growth – with some bias towards growth – have remained priority objectives since then, but other policy challenges have been added over time. In the mid-1990s, industrial structure and external balance emerged as causes of concern. Industrial development was largely based on import-substitution through state-owned enterprises (SOEs), although future reductions in import barriers seemed unavoidable. The question was whether the current account deficits generated during this period were sustainable – apart from the possible efficiency problems related to heavy investments in SOEs, it was also known that the trade regime would have to be liberalized following Vietnam's accession to ASEAN and the application for WTO membership in 1995. Questions related to the macroeconomic effects of internationalization attracted even more attention a couple of years later, when the Asian crisis demonstrated some of the risks connected to international capital flows. By the end of the 1990s, employment generation was recognized as yet another major challenge. With over one million new entrants to the labor market every year and an SOE sector that had not created any new jobs since the early 1990s, it was necessary to establish other sources of employment. The answer was a recognition of the central role of the private sector, expressed e.g. in the form of the new Enterprise Law that came into force in 2000. During the last few years, social and regional development gaps have also been identified as important problems that need to be taken into account in the formulation of development strategies and policies.

One way to summarize this development is to note that the challenges facing the Vietnamese economy have become increasingly complex and sophisticated over time, and in many ways similar to those in much more developed countries. In today's rapidly globalizing environment, macroeconomic management aims to achieve internal as well as external balance – essentially, stable prices and exchange rates – at a level of growth that is sufficiently high to meet the specific political requirements of the economy in question. In Sweden, these political requirements are related to maintaining the welfare state and keeping the rate of unemployment low. In Vietnam, growth must be high enough to facilitate convergence to the more developed neighbors in the region, and to allow all segments of the population to improve their welfare and standard of living.

However, Vietnam differs from more developed economies when it comes to the instruments available for macroeconomic management. At the early stages of Doi Moi, Vietnamese authorities could rely on a multitude of tools and policies to reach their objectives, including radical interventions like import bans and other discretionary trade restrictions, direct price controls, and administrative orders to state-owned enterprises and banks. The scope for direct intervention has diminished as a result of domestic reforms and international agreements, but the system of indirect policy instruments is still weakly developed. For instance, Vietnamese monetary policy relies largely on changes in reserve requirements and discount rates, while the possibilities to engage in open market operations are very limited. Hence, while the macroeconomic challenges facing Vietnam have become more complex, the government's ability to control and direct the economy has evidently become weaker.

The purpose of this paper is to review some of Vietnam's experiences regarding macroeconomic management and to discuss the challenges that lie ahead. The next section will provide a summary of the main stages of macroeconomic development since the mid-1980s, with some focus on how Vietnam responded to the main problems emerging in the course of transition and development. Section 3 will turn to a discussion of the current situation and the requirements for the future. While it is impossible to predict in detail what kinds of problems Vietnam is likely to face during the coming decades, much can be gleaned from the experiences of other countries. Section 4 will therefore summarize some elements of Swedish macroeconomic development during the past decades, when the country experimented with several different policy regimes in an attempt to adjust to an increasingly competitive and internationalized environment: Vietnam is likely to go though some of the same stages of development. Section 5 summarizes and provides some concluding comments.

2. Macroeconomic developments since 1986

The shift from the war economy to peacetime production after the unification of North and South Vietnam in 1975 was not any great success. The Vietnamese economy suffered from the standard incentive and information problems connected to central planning, and industrial production stagnated in spite of a heavy investment emphasis on industrial development. Moreover, the collectivization of the southern half of the country was problematic: the most serious consequence was a fall in food production that forced the country to import large amounts of rice. After the involvement in the Cambodian conflict in 1978, Vietnam also lost most of the Western development aid that had started flowing in after the end of the war. Instead, the economy became heavily dependent on the trade and aid relations with the Soviet Union.

By the early 1980s, Vietnam had introduced several reforms that aimed to "perfect" the centrally planned economy. In the agricultural sector, many farmers had spontaneously left the collectives and returned to household production. These households were allowed to sell part of their output – above and beyond what the collective required – in the parallel markets, at market prices. Simultaneously, official prices were adjusted upwards, to provide stronger incentives for production. In industry, a "three-plan" system was introduced to strengthen the incentives for state-owned enterprises (SOEs). The first "plan" covered production for the state at pre-determined prices using inputs supplied by the state. Under the second plan, enterprises were allowed to produce additional output for the state at predetermined prices using any inputs they could source outside the formal plans. The third plan, finally, allowed enterprises to produce and sell additional unplanned output at market prices (Leung and Vo Tri Thanh 1996). The supply response was initially positive, but the gains were only temporary. One reason was an increase in inflation, which quickly eroded the initial improvements in the farmers' terms-of-trade. Another reason was the response from the central planners. When it was obvious that farm households and SOEs had the capacity to produce more, they aimed to raise the plan targets in order to appropriate a larger share of the production surplus – however, this reduced the autonomy of farms and SOEs, and weakened their production incentives. Although these early reforms were not sufficient to reverse the decline of central planning, they were important because they introduced an awareness of markets even in an overall context of central planning (Fforde 2005). The market experiments helped farmers and SOEs react positively to the new opportunities that opened up some years later, when more fundamental reforms marked the beginning of the transition from central planning towards a market economy.

2.1 Growth and stabilization

The decisive steps in the move away from central planning were taken in the mid-1980s, with the reform package that became known as *doi moi* at the Sixth Party Congress of the VCP in late 1986. By the time the Congress announced that a multi-sector economy with decentralized decision-making, markets, and prices would replace the central plan, several important reforms had already been implemented. For instance, the state subsidies for consumption goods had been abolished and SOEs had been given the right to set most of their prices. They were also permitted to finance their investment and working capital needs by borrowing from the State Bank instead of relying on support from the state budget. Nominal real wages and pensions had been raised, to compensate for the increases in consumer goods prices. A monetary reform – exchanging one new Dong for ten old ones – was also implemented to stabilize the economy and absorb the excess liquidity that had accumulated in the parallel markets. However, this stabilization effort was largely a failure. Private holders of currency managed to shift into gold and foreign exchange, and the main impact of the reform was instead to wipe out the currency holdings of SOEs, which were essential to purchase inputs from the parallel markets (Leung and Vo Tri Thanh 1996). As a result, many SOEs required subsidies to compensate for the losses caused by the currency reform. Other types of government expenditures were also high, and the government budget deficit reached 12 percent of GDP in 1985. This was financed mainly with loans from the central bank. The rate of domestic credit expansion reached 300 percent in 1985 and 430 percent in 1986. High inflation could not be avoided. Official prices increased by more than 400 percent in 1986; the rate of increase in free market prices was nearly 600 percent the same year (Leung and Vo Tri Thanh 1996). The inflation rate remained above 300 percent in 1987 and 1988, with severe negative effects on economic activity, particularly in the agricultural sector.

Overall growth in 1987 and 1988 was still positive, in spite of the high inflation: the increasing autonomy of state enterprises in combination with continued aid inflows from the Soviet Union was sufficient to generate GDP growth rates reaching 6 percent in 1988. However, when it became evident in early 1989 that the Soviet Union was close to a collapse and the flow of Soviet aid would end, Vietnam was forced to deepen its reform program. The main macroeconomic problem since the announcement of *doi moi* had clearly been the high rate of inflation, so stabilization became the primary objective of the 1989 reforms. Three important measures formed the core of the program. Firstly, real interest rates were raised to very high levels – this was easy since the banking system was fully state-owned and interest rates were set administratively. In early 1989, when the monthly inflation rate was about 6 percent, the corresponding bank interest rate was set at 12 percent. This led to a rapid increase in bank deposits, particularly in the private sector: the households' holdings of bank deposits grew by over 600 percent between March and December the same year (Montes 1995). At the same time, credit expansion was kept low: apart from the high nominal interest rates, the State Bank imposed strict credit ceilings. Inflation expectations diminished rapidly, and the monthly inflation rate dropped below 3 percent by the end of the year. Interest rates fell as well, but much more slowly. Secondly, the government budget deficit was reduced. Public investment expenditures were held back. Schools and hospitals were allowed to charge formal user fees to compensate for lower contributions from the state budget (see Kokko and Tingvall 2007). More than 500,000 soldiers were released from the military, reducing public expenditures notably. Thirdly, harder budget constraints were imposed on SOEs. Direct budget support was abolished and the withdrawal of Soviet assistance ended the provision of imported inputs at artificially low prices. By 1992, the provision of subsidized credit to SOEs through the banking system was also halted. As a result, some 800,000 workers were laid off from state enterprises between 1989 and 1992 (Dollar 1994). By that time, the state budget deficit had been reduced to less than 4 percent of GDP, from over 11 percent in 1989. The inflation rate was gradually brought down to manageable levels after 1992.

Simultaneously, strong measures were implemented to promote economic growth. Most importantly, the agricultural collectives were largely abolished and production decisions were moved to the level of the individual household or family farm. The households' land holdings were protected with long-term user rights. The remaining price controls were abolished and SOEs were given full nominal autonomy for investment, production, and pricing decisions. The exchange rate was unified and the VND was sharply devalued. Trade restrictions were eased and the rules for inward foreign direct investment (FDI) were liberalized. The combination of these deregulations and the macroeconomic stabilization generated a strong positive output response. Although industrial output contracted in 1989 because of the SOEs' harder budget constraints, agriculture and services grew rapidly, resulting in an overall GDP growth rate of 8 percent that year. The turnaround in the agricultural sector was particularly notable: Vietnam transformed from a heavy importer of rice in the mid-1980s to one of the world's largest rice exporters half a decade later.

By 1991, when the strict credit restrictions introduced as part of the stabilization package had been eased, the SOE sector had also recovered and was rapidly moving to take advantage of the new opportunities that had opened up as a result of the liberalization and increasing openness of the Vietnamese economy. Although the SOE sector was helped by contacts with foreign investors and the emergence of Vietnam as a notable oil producer, there is no doubt that state enterprises had largely managed to "commercialize" their operations. To some extent, this was related to the experiments undertaken since the early 1980s. Another explanation was the relative fragmentation of the Vietnamese SOE sector. There were few large SOEs owned and controlled by an anonymous "state": instead, most SOEs had an identifiable owner within the state who had some influence over management and an interest in the profits generated by the enterprise. In this sense, many SOEs were a type of hybrid firms where the distinction between public and private was not always entirely clear. In any case, by 1992 Vietnam had established a growth standard of 7-8 percent per year, which was sufficient not only to achieve some convergence to the level of the richer regional neighbors, but also enough to improve the living standard of most population groups. It was also high enough to allow the government to raise the investments in social sectors like health and education, which had been partly abandoned because of the large budget deficits of the mid-1980s. Table 1 illustrates the transition resulting from the reform program, and shows how Vietnam has been able to maintain a reasonable balance between growth and price stability since the early 1990s – the only notable dents in the growth trend were seen in 1998 and 1999, when the fallout from the Asian crisis led to somewhat lower growth rates also in Vietnam.

Table 1. Growth and Inflation in Vietnam 1986-2005 (percent).

	1986	**1987**	**1988**	**1989**	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**
GDP growth	2.8	3.6	6.0	4.7	5.1	5.8	8.7	8.1	8.8	9.5
Inflation rate*	398	362	407	74.0	42.1	72.8	32.6	17.1	17.0	8.7
	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
GDP growth	9.3	8.2	5.8	4.8	6.8	6.9	7.1	7.3	7.8	8.4
Inflation rate*	5.7	3.2	7.3	4.1	-1.7	-0.4	3.8	3.1	7.8	8.2

Sources: *East Asian Economic Perspectives*, Vol. 17, No. 1, 2006, Chapter 12.
Note: * The inflation rate for 1986-1995 refers to the change in the GDP deflator. For 1996-2005, it is the change in the consumer price index.

The 1989 reforms also had a political dimension. This did not entail much domestic political liberalization, but rather a normalization of Vietnam's external relations. An important step in this process was the withdrawal of troops from Cambodia in 1989, which facilitated the rebuilding of relations with China, ASEAN, and many Western countries. The normalization process was not only politically important, but also of great economic value. Apart from the increase in inflows of development assistance, it contributed to the increase in FDI inflows that had slowly started growing after 1989.

2.2 Economic structure and external balance

By the mid-1990s, Vietnam had emerged as one of the most promising markets and investment locations in East Asia. The macroeconomic stabilization and gradual shift towards a market oriented economy had led to dramatic improvements in the Vietnamese economy and triggered a growth boom. The GDP growth rate averaged almost 8 percent per year during the period 1990-1995, with over 9 percent recorded in 1995. Domestic savings and investment increased, both in absolute amounts and as shares of GDP. International trade expanded, with rapid growth in exports as well as imports. Foreign direct investment emerged as an important source of capital and technology, with the inflow of FDI reaching USD 2.3 billion in 1995 (corresponding to 11 percent of GDP, more than anywhere else in the region).

Moreover, Vietnam's integration into the world economy had deepened. Several bilateral trade agreements with foreign countries were established, the US embargo was lifted in early 1994, Vietnam submitted an application for WTO membership in January 1995 (only days after the formal inauguration of the organization) and joined the ASEAN in July 1995. As part of the membership in ASEAN, Vietnam also joined AFTA, ASEAN's free trade agreement, and promised to reduce tariffs on intra-regional trade to below 5 percent by 2006. Vietnam's relations with multilateral financial institutions such as the World Bank, the Asian Development Bank and the International Monetary Fund were also normalized, and by 1995, Vietnam held structural adjustment credits from the World Bank and the IMF. These credits were important not only because they provided financial resources for development, but perhaps mainly because they signaled that Vietnam's economic development was progressing in a satisfactory manner. The structural adjustment credits were normally granted under the condition that the recipient country pursued ”appropriate” policies in the area of structural reform and fiscal and monetary management. Another consequence of the strength of the reform process was that the Vietnamese authorities revised their economic targets for the ten-year plan period 1991-2000. Instead of aiming for a doubling of the country’s GDP over this period, as was originally intended in the ten-year plan adopted at the Seventh Party Congress in 1991, the target was changed to a doubling of GDP per capita (SRV 1994). Assessing the achievements of *doi moi*, many foreign observers concurred, concluding, for example, that “Vietnam appears well-positioned to become a new East Asian ‘dragon’” (Irvin 1995:725).

However, these impressive achievements could not completely hide the fact that the economy was burdened by some structural and systemic weaknesses. In particular, donors and foreign observers had called attention to several problems related to the import substituting trade regime and the continuing reliance on state-owned enterprises as the main vehicle of development (Kokko and Zejan 1996, Ljunggren 1996, Mallon 1996, UNDP 1996). Regarding trade policy, the concerns focused on the distorted incentives provided by the complex, non-transparent, and highly restrictive trade regime (Kokko 1997). Various import barriers created strong incentives in favor of import-substitution in consumer goods and selected heavy industries, as well as a bias against export-oriented production (not least because the interventions tended to overvalue the exchange rate). One paradoxical result was that imports were increasing faster than exports: import-substituting industry in Vietnam, as elsewhere, was heavily dependent on imported machinery, raw materials, and intermediates. Consequently, the trade and current account deficits were widening. In 1995, the current account deficit exceeded USD 2.6 billion, or 13 percent of GDP. The large imbalances raised questions about Vietnam’s ability to finance the large deficits without endangering macroeconomic stability, as well as doubts about how the far-reaching commitments to liberalize trade would be realized. In particular, there were fears that the plans to reform the trade regime and the production structure might be neutralized by the emergence of strong interest groups benefiting from, and therefore lobbying for, continued protectionism.

These questions were intimately related to concerns about the role of state-owned enterprises. They were the main beneficiaries of Vietnamese import substitution, in many cases in joint ventures with foreign investors. Although the foreign joint venture partners provided badly needed technology and skills, it was clear that most SOEs operated with obsolete machinery and equipment, with some estimates suggesting that one-third of the capital stock was completely useless (Le Dang Doanh 1996). In combination with weak incentive structures and poor management practices, the result was low technical efficiency: their financial performance was heavily dependent on protection from foreign (or domestic) competition. CIEM (1997) reported that most state enterprises were running at a loss and that only 300 enterprises accounted for 80 percent of the SOE sector’s contributions to the state budget. Many SOEs were also forced to borrow capital from other state enterprises, the banking sector (which provided preferential credits to SOEs), and other capital sources, creating a significant debt burden (although the absence of transparent accounting practices still makes it impossible to quantify the total amount of SOE debt).[1] Donors were not only skeptical about

[1] At the end of 1995, unpublished data from the Ministry of Finance estimated the aggregate debt of the SOE sector at a staggering VND 279,000 billion, or about 20 percent above the country’s GDP (MoF 1997). It is likely that this figure included non-convertible debt (to the former CMEA area), but it is not known what transferable ruble exchange rate the estimate was based on. The civilian debt obligations to the former Soviet Union alone amounted to over 9,400 million transferable rubles in 1994 (IMF 1995). IMF (1999) reported total

the reliance on state-owned industry, but also about the additional problems caused by the combination of import substitution and SOE dominance. The concern was that isolation from international markets would allow the SOEs to survive without having to undertake necessary reforms. This was a particularly sensitive problem since the SOEs and their foreign joint venture partners were not only economically important, but also intimately connected with various levels of political decision making. In many cases, they were in a position to use their political influence to oppose trade liberalization or other reforms that might reduce their privileges. In addition, they could to some extent influence future policy decisions through their own investment behavior, by influencing the costs for liberalization. The more resources the SOEs invested in import substitution before the removal or reduction of trade barriers, the higher would be the cost for future trade liberalization. Hence, they could force the government into a difficult time inconsistency problem. While a commitment to trade reform was desirable *ex ante*, it might also be optimal to default on some or all of these commitments *ex post* if enough resources were sunk into the old production structure between announcement and implementation of trade reforms. The lack of a detailed publicized time plan for promised, future tariff reductions increased the risk for this kind of backlash, since it implied that the scheme for trade reform was still open for negotiation. The public investment plans discussed in the mid-1990s clearly revealed that these worries were relevant. More than half of the planned investment spending for the period 1996-2000 was expected to be connected with SOEs, often in import substituting industries (UNDP 1996:20ff).

The development of the Vietnamese private sector was stunted by the complex regulatory environment and the competition from SOEs benefiting from political contacts and privileged access to capital, land, and other resources. The GDP share of the domestic private sector, excluding farmers and informal household enterprises, reached only about 7.5 percent in 1995, while the "modern" private sector, consisting of limited liability companies and shareholding companies, accounted for at most one percent of GDP (Webster 1999, Kokko 2000). The lack of a dynamic private sector was worrying, particularly since it was becoming increasingly clear that the SOE sector would not be able to generate enough jobs for the rapidly growing labor force. In 1995, the SOEs employed only 1.8 million people out of a total labor force of nearly 35 million, with over one million new entrants to the labor force each year.

These structural problems and contradictions in economic policy were by no means unknown to Vietnamese authorities. On the contrary, the agenda for development cooperation between Vietnam and the donor community included the concerns discussed above, and both trade reform, SOE reform, and private sector promotion were addressed in the government's reform plans already in the mid-1990s (PFP 1994, SRV 1995, PFP 1996). In the area of international trade and investment, the primary aim was to simplify trade regulations. The ambition to abolish import permits and import shipment licenses and to allow all enterprises to engage in international trade was particularly important. Initially, the overall level of protection was not considered a major problem, and the only concrete policy ambitions were to reduce the number of tariff lines and to cut the maximum tariff from 100 percent to 60 percent. Other measures focused on the foreign exchange market, aiming to eliminate restrictions on current account transactions. In the area of FDI, there did not seem to be any need for radical reform: the inward FDI commitments in 1996 summed to more than USD 8.6 billion, which was considered sufficient for reaching the economy's development goals. The objectives for SOE reform were more far-reaching, presumably because both the World Bank and the IMF

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debt of VND 101,439 billion in the SOE sector in 1997, to be compared with total state capital assets of VND 73,079 billion in the sector.

considered this a priority area (World Bank 1995). The SOE Action Plan was expected to stipulate a clear timetable for the restructuring of the SOE sector, including the identification of strategic enterprises to be retained under government ownership and program for the divestiture of non-strategic SOEs. Other elements of the plan focused on modern accounting rules and reforms in SOE management and governance. These measures did not only aim to improve the efficiency of the SOE sector, but they were also important to level the playing field for firms from different ownership categories. In addition, the plans included substantial legal reform, with revisions of the Commercial Law, Company Law, and Private Enterprise Law intended to create a simpler regulatory framework for private enterprise.

All three reform areas have figured prominent in the Vietnamese policy agenda during the past decade, but the success in reaching the policy objectives has varied. Trade policy is the area where reforms have arguably been most successful. Some progress was made already in 1995-1997, even though the reform plans met with opposition from interest groups lobbying for continued protection. For instance, most domestic firms were given export rights in January 1997, at the same time as import licensing requirements for a large number of consumer goods were eliminated.[2] The Asian financial crisis in 1997 resulted in a temporary backlash, as the reform program was put on hold – in fact, many trade restrictions were tightened between 1997 and 1999. The reason was that the crisis led to a fall in the export growth rate and the inflow of FDI, forcing authorities to restrict imports of "non-essential" goods in order to allocate scarce foreign exchange to the import-dependent industrial sector. However, by the end of the 1990s, concerns about the detrimental long-term effects of trade restrictions had grown strong enough to motivate further reform. Moreover, the Asian crisis had changed the views regarding the possibility to finance investment and imports with foreign capital inflows. As noted above, the current account deficits in the mid-1990s had exceeded 10 percent of GDP, and the expectation at the time was that these deficits would be sustainable (SRV 1995). One of the short and medium term consequences of the Asian crisis was a reduction of capital flows to emerging markets: this meant that a larger share of Vietnam's import requirements would have to be financed without foreign assistance, from export revenues.

An additional concern in the late 1990s was the need to meet the trade liberalization targets set up by AFTA. Until about 1999, Vietnam had been able to fulfill its formal annual tariff reduction commitments by listing goods that were either exported or that already met the 5 percent maximum tariff requirement. Real tariff reductions were required from 2000. At the same time, Vietnam also found an opportunity to deepen the relation with the US: the Clinton administration was willing to conclude a bilateral trade agreement at terms that were relatively favorable for Vietnam. In particular, the agreement promised immediate access to the US market, but a gradual liberalization and adjustment of Vietnamese trade policies. The agreement was also seen as a stepping stone for future WTO membership – many of the US requirements coincided with measures that Vietnam would need to undertake anyway prior to WTO accession. Hence, the Bilateral Trade Agreement (BTA) between Vietnam and the US was signed in July 2000, institutionalizing the increasing outward orientation in Vietnam's development strategy. Unlike the AFTA agreement, which is based on consensus and does not prescribe severe sanctions against member countries that do not fulfill their commitments, both the BTA and WTO membership come with stricter conditions, enforcement, and sanctions.

[2] See Decision 28/TTg of January 13, 1997. Trading enterprises were required to hold a minimum working capital of USD 200,000, which was a substantial obstacle for private sector participation in international trade.

Looking at the trade policy environment in general, it is clear that Vietnam has addressed many of the weaknesses that were identified in the mid-1990s (CIE 1997, Kokko 1997). Foreign trade rights have been expanded, the tariff structure has been simplified and tariffs have been reduced, many quantitative restrictions and other non-tariff barriers have been removed, and the foreign exchange market has been deregulated. For instance, all domestic enterprises have been allowed to engage in exporting since 1998. A similar liberalization for import rights was introduced with the new Enterprise Law that came into force in 2000. The average tariff has been reduced to around 15 percent, which is not remarkably high for a developing country. All exchange restrictions on current account transactions were removed in 2005. The issue that remains most problematic is the relatively extensive use of quantitative restrictions. As late as 2000, quantitative restrictions were in effective for 11 imported items: petroleum, oil, motor cycles and components, automobiles, construction steel and iron, cement, vegetable oil, sugar, paper, alcoholic beverages and construction glass. At that time, the plan was to gradually replace these quotas with tariffs, with quotas on fertilizers, cars, and cement to be lifted in 2005, construction steel and iron quotas to be lifted in 2007, and those for sugar in 2010. However, these plans have not been realized. Instead, the coverage of the quota system has varied rather unpredictably over time, with some quotas removed earlier and new ones added, e.g. quotas on selected agricultural products in 2003. In early 2006, quotas were in place for petroleum products, sugar, salt, and tobacco. Even taking these problems into account, the overall assessment of Vietnam’s trade reform program is very positive and it is clear that the Vietnamese trade regime does not appear to be more restrictive than the standard for low-income developing countries. The progress in the trade policy area has also allowed Vietnam to internationalize rapidly, and rate of export growth has consistently exceeded even the most ambitious plans. For instance, PFP (1996) assumed that Vietnam would be able to double its total exports between 1995 and 2000, from about USD 5 billion to USD 10 billion. In reality, the export volume in 2000 exceeded USD 14 billion. Similarly, the current 10-year plan for the period 2001-2010 sets the goal that the export growth rate should be twice as high as the GDP growth rate: this target will be exceeded by a large margin.

Table 2 summarizes the growth of Vietnam’s external trade during the past 20 years, and highlights the rapid increase in export and import volumes. The table also notes the large current account deficit, which was threatening to become a serious problem in the mid-1990s. It was temporarily reduced after the Asian Crisis in 1997-1998, but a substantial merchandise trade deficit has reappeared in recent years. The risks connected to trade and current account deficit are lower now than they were a decade ago, thanks to the comprehensive trade policy reforms – the incentives to invest in import substituting sectors are weaker than a decade ago. Moreover, there is a direct link between the current account deficits and the inflows of foreign capital in the form of FDI. New foreign direct investment projects are very import intensive in their earliest stages, since much of technology, machinery, and intermediates must be sourced outside the country. The resulting trade and current account deficits are sustainable if these projects raise the economy’s long-term export capacity (or capacity to compete with imports). It is therefore very positive that the structure of inward FDI has become increasingly export oriented, and foreign-invested firms are estimated to account for about half of Vietnam’s non-oil exports today. It is also important to note that substantial inflows of ODA and private transfers make it possible for Vietnam to finance much larger trade deficits than a decade ago. Yet, considering that the bulk of Vietnam’s total investment resources are used by the state sector, in infrastructure projects and SOEs, it is remains important to monitor the use of capital and the investment efficiency in this sector.

Table 2 Merchandise Trade, Current Account Balances and FDI in Vietnam 1986-2005

	1986	**1987**	**1988**	**1989**	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**
Exports	0.8	0.9	1.0	1.9	2.4	2.1	2.6	3.0	4.1	5.4
Imports	2.2	2.5	2.8	2.6	2.8	2.3	2.5	3.9	5.8	8.2
Current account	--	--	--	--	-4.0	-1.7	-0.1	-5.8	-7.2	-8.3
FDI	0	0	0	0.1	0.1	0.2	0.3	0.3	1.0	1.4
	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Exports	7.3	9.2	9.4	11.5	14.5	15.0	16.7	20.1	26.5	32.7
Imports	11.1	11.6	11.6	11.7	15.6	16.2	19.7	25.3	32.0	37.8
Current account	-8.2	-5.7	-4.0	4.1	3.6	2.1	-1.7	-4.9	-2.0	-1.5
FDI	2.4	2.2	1.7	1.4	1.3	1.3	1.4	1.4	1.6	--

Sources: *East Asian Economic Perspectives*, Vol. 17, No. 1, 2006, Chapter 12.
Notes: Merchandise exports, imports, and FDI are in billions of current USD. The current account balance is in percent of GDP. There are no reliable data to calculate the current account / GDP ratio for the period 1986-1988.

The continuing dominance of the SOE sector has also been one of the obstacles for even faster integration with the international economy, for instance through WTO membership. Although some technical issues related to market access, particularly in the service sectors, seem difficult to resolve, it appears that the main obstacles in the discussion about WTO membership in the most recent years have been connected to the extensive state involvement in industry. For instance, the US has insisted that Vietnam should be considered a "non-market economy", which makes it easier to impose anti-dumping tariffs and other temporary trade restrictions on Vietnamese exports. This is unfortunate, since an agreement with a "non-market economy" clause is likely to reduce the incentives for further market oriented reform. The WTO negotiations would undoubtedly have been much simpler if the SOE reform programs outlined in the mid-1990s had been realized.

However, the SOE reform program has not been very successful, and progress has fallen short of plans almost every year since 1996. The two main components of the program are equitization – a combination of corporatization and partial privatization – and management reform. The number of firms going through equitization was relatively small until 2000, but the process has accelerated after that time, and some 2,600 firms had been equitized by early 2005. However, most of these are relatively small firms, and few large and strategically important SOEs have been involved in the process. Moreover, the state remains the largest individual owner in most equitized companies. This, together with the fact that management reform has been slow, suggests that governance issues will remain on the list of challenges for Vietnamese economic development for the foreseeable future. Still, it appears that the SOE sector is in better condition today than a decade ago. In the mid-1990s, it was reported that the majority of Vietnamese SOEs were barely breaking even (CIEM 1997). In recent years, it appears that most SOEs are making some profit, although the bulk of tax contributions still originate from a few hundred firms. It remains to be seen how the SOE sector adjusts to the increasing competition from imports that follows from the continuing liberalization of the trade regulations, as well as the increasing competition from the domestic private sector.

In contrast to the SOEs, the measures to promote the private sector have been remarkably effective (see Hakkala and Kokko 2007). A key reform in this area was the new Enterprise Law from 2000 that transformed the complex business licensing procedure to a much simpler registration process. As a result, well over 100,000 new private firms have been registered during the past six years. Although some of these already existed in the informal sector prior to their registration, and although many have not managed to survive, the boom in the private enterprise sector has contributed strongly to the economy, not least regarding employment creation. It is estimated the private sector accounts for most of the 5 million new formal jobs that have been created in Vietnam during the past decade. It is also notable that the increasing prominence of the private sector has been beneficial from a structural perspective. Without access to substantial amounts of capital, most private firms have entered into relatively labor intensive sectors, where Vietnam has strong comparative advantages. The SOE sector, by contrast, has a bias toward capital intensive sectors and many SOEs are unlikely to survive in the long run without protection from foreign competition.

2.3 The Asian Crisis

The Asian crisis that erupted in Thailand in July 1997 had strong impact on the Vietnamese economy, both in real terms and through its effects on the economic reform program. Yet, in comparison with most of its ASEAN neighbors, it may appear that Vietnam weathered the Asian crisis quite well. Although the rapid growth of the preceding years slowed down, Vietnam did not experience any severe recession, Export growth remained. The exchange rate was adjusted several times in 1997-1998, but the depreciation of the VND with respect to the US dollar was limited to some 30 percent. The rate of inflation accelerated, but remained below 10 percent. The most significant negative developments were a substantial reduction in foreign direct investment and a decrease in employment. On balance, therefore, the official picture did not look very bad, particularly in comparison with the deep recession plaguing countries like Indonesia, Malaysia, Thailand, and South Korea.

The fact that Vietnam was relatively mildly affected by the Asian crisis, however, had more to do with controls and regulations than with sound economic fundamentals. The exchange rate was relatively stable because the VND was not freely convertible, and because both trade and foreign exchange transactions were strictly regulated. The withdrawal of foreign portfolio capital from Asia's emerging markets did not hurt Vietnam, because the weakly developed financial market did not attract much foreign capital in the first place. There was no stock market collapse, because there was no stock market. Aside from these features, the country shared many characteristics with the rest of the region. In fact, most of the structural weaknesses that contributed to the crisis in other Asian countries could be found in Vietnam as well. Many of the SOEs that dominate the manufacturing sector were inefficient and unprofitable. Due to their low profitability, many of them were forced to borrow capital from other state enterprises, the banking sector, and other capital sources, which created a complex maze of cross-subsidization and indebtedness. There were no reliable data on the aggregate debt of the SOE sector – in fact, Nguyen Minh Tu (1997) argued that the government itself did not have detailed knowledge of the financial situation of SOEs – but it is likely that many firm were technically bankrupt. In addition to domestic debt, some SOEs had been able to borrow in the international market, contributing to the country's growing external debt. At the end of 1996, the external debt in convertible currencies stood at about USD 8.3 billion, or 35 percent of GDP.[3]

The debt problems of the SOEs were not only a potential burden for the state budget, but they also weighed heavily on an already fragile financial sector. Although the banking sector comprised around 80 commercial banks in 1996, most were small and the four largest state-owned banks accounted for over 75 percent of assets and credits. Their operations were not only based on commercial decisions, but also influenced by political objectives. SOEs enjoyed various privileges, such as easier access to foreign currency loans, subsidized interest rates, and less stringent collateral requirements than private firms. Consequently, more than half of the banking systems' aggregate lending was directed to SOEs, and the banks were heavily exposed to the weaknesses of the SOEs.

In addition, because of their limited experience with market-based financial transactions, the banks were vulnerable to the kind of moral hazard problems that plagued other Asian countries. Leung and Le Dang Doanh (1998) suggested that the "mini" financial crisis of 1996-97 provided a good illustration of these weaknesses. In 1996, lending restrictions were liberalized and state-owned commercial banks were allowed to start issuing letters of credit to finance the international trade transactions of SOEs. In practice, this was equivalent to increasing short term lending in foreign currencies. The total amount of outstanding letters of credit grew to about 7.5 percent of GDP (over USD 1.5 billion) by the beginning of 1997. However, instead of using the credits for trade financing, a number of SOEs channeled the funds into real estate investments and other speculative uses.

Many of these investments failed, and an estimated 40 percent of the guaranteed letters of credit had become bad loans in early 1997. Several commercial banks defaulted on their letters of credit, which eventually necessitated a costly State Bank rescue operation that reduced the country's international reserves significantly. Another consequence was a downgrading of Vietnam's sovereign credit rating from Ba3 to C. By September 1997, before any real impact of the regional crisis had yet been felt, the overdue debts of Vietnamese banks had thus grown to 12.7 percent of their total lending, corresponding to over 100 percent of their capital and reserves (IMF 1998). The Vietnamese authorities responded by introducing various controls to avoid similar credit expansions in the future. Yet, serious problems remained and the banking system was probably in a worse condition than what its financial statements indicated (IMF 1998).

The development in the trade sector provided another reason for worry. Although exports had grown at an average annual rate of nearly 30 percent between 1991 and 1996, imports had increased even faster, with widening trade and current account deficits as a result. The trade deficit exceeded 10 percent of GDP already in 1994, and grew to about 15 percent of GDP in 1996. The acute problems concerned the financing of the deficit. Until 1996, it had appeared easy to finance the import surplus, since optimistic expectations about the future of the Vietnamese economy had generated large inflows of foreign assets in the form of ODA, private transfers, and FDI. However, the situation started to deteriorate in 1996. The growth in FDI inflows stagnated, and it was necessary to finance a large share of the current account deficit with increased borrowing. The disbursement of medium and long term loans almost doubled between 1995 and 1996, the rapid expansion in the amount of outstanding letters of credit discussed above provided easy – but temporary – short term financing, and arrears on

[3] In addition, Vietnam owed about 10 billion rubles to the former Soviet Union. At the time, it was not known how this would be valued.

scheduled repayments began to accumulate. At the beginning of 1997, it was understood that a serious balance-of-payments (BoP) crisis could emerge unless the current account deficit was contained.

The response was a combination of a very severe tightening of import controls and gradual devaluations, to promote exports. Strict quantitative restrictions and temporary import prohibitions were introduced to limit imports of consumer goods (including cars, motorcycles, bicycles, beverages, sugar, and confectioneries) and commodities such as cement, glass, paper, and steel. Apart from reducing the import surplus, it appears that the import bans also aimed to help local firms, mainly joint ventures and affiliates of foreign multinationals, reduce their large inventories (CIEM 1998, IMF 1998). In the first quarter of 1997, the target exchange rate was VND 11,175 per USD, with a narrow fluctuation band of only +/- 1 percent. The band was widened to 5 percent in March 1997 and further to 10 percent in October 1997. Since the market rate immediately moved to the upper end of the band, these adjustments constituted *de facto* devaluations of the currency. During 1998, the target rate was changed several times, with the exchange rate depreciating to about VND 13,940 per USD in early 1998. Overall, this constituted a depreciation of about 20 percent. In addition to formal trade policy measures and devaluation, currency controls were also used to curb imports. Firms were obliged to deposit their foreign exchange earnings in designated commercial banks and the allocation of foreign exchange to potential importers was subject to a licensing procedure managed by the State Bank. Export oriented companies and "strategic" SOEs and foreign investors had privileged access to foreign exchange (although foreign investors were obliged to be self-sufficient in foreign currency), but the imports of all other companies were easily controlled through the licensing system. For instance, restrictions in the allocation of foreign currency and letters of credit were among the main instruments used to uphold the "consumer goods import restriction list" announced in February 1997.[4] This way, import growth was restricted to only a few percent in 1997. Since exports continued growing at a rate of about 20 percent, the trade deficit shrank to between 8 and 10 percent.[5] However, the severe trade restrictions undermined investor confidence. For instance, there was a 50 percent drop in applications for FDI licenses in 1997. Reports in the international press suggested that many foreign investors were scaling down their operations or closing altogether. For instance, in the first two months of 1998, 176 representative offices in Ho Chi Minh City were closed (Marshall 1998).

In spite of these responses, the growth rate fell from over 8 percent in 1997 to about half of that in 1998 and 1999.[6] By 2000, growth recovered to nearly 7 percent, helped by increasing oil revenues and stronger export performance, driven largely by the increasing outward orientation of the economy, manifested e.g. by the bilateral trade agreement with the US. In retrospect, it seems that the most important consequence of the Asian crisis was the insight

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[4] This list included most consumer goods, from food products to chemicals and electronic equipment. See *Viet Nam News*, February 28, 1997.

[5] The imprecise figure on the trade deficit motivates a comment on the lack of transparency. Reliable data on economic fundamentals are hard to come by, although newspapers and government reports overflow with seemingly precise statistics. One problem that data from various sources are seldom consistent. Another problem is that some information – e.g. details on the government budget - is not published. It is hardly necessary to add a caveat about data quality.

[6] The data on Vietnamese growth rates (as well as other statistics) differ substantially by source, and it is difficult to obtain complete data sets from the same source. For example, while official Vietnamese data indicate a growth rate of nearly 5 percent in 1998 and nearly 6 percent in 1999 (see Table 1), the corresponding estimates presented by IMF (2003) are 3.5 and 4.2 percent. In particualar, there is reason to be cautious in the interpretation of older data.

that external balance is an important component of successful economic development. The developments during the late 1980s and early 1990s had clearly demonstrated the importance of internal balance, with a reasonably combination of growth and price stability. The development experiences from the region – summarized in the excitement about the *Asian Miracle* – had also demonstrated the potential growth benefits of outward orientation. However, the extraordinarily easy access to foreign capital during the early 1990s may have given the impression that external balance would not be any cause for concern: capital inflows were expected to adjust to fill the needs identified by the policy makers. However, the crisis showed that external balance does not only matter in the abstract long term, but that it is also a short term concern. Economic policies need to be designed with attention to internal as well as external balance. In this respect, Vietnam has become more similar to other small open economies that have for a long time struggled with similar policy challenges.

2.4 Today: growth, stability, and social concerns

Vietnam's economic development during the last few years has been favorable, and several of the problems that were discussed a decade ago seem to be under control. Real annual GDP growth has averaged over 7 percent since 2000, with a growth rate of around 7.5 percent reported both for 2004 and 2005. In real terms, this corresponds to a 40 percent increase in average per capita income since the turn of the century. Growth has been fuelled mainly by high investment rates – in the past two years, over 36 percent of GDP has been devoted to investment – and rapid export expansion. Vietnam's export volume has more than doubled since 2001. In 2004 alone, export revenue increased by almost 30 percent, reaching a total value of over USD 26 billion or 56 percent of GDP. In 2005, the export volume continued expanding well above the USD 30 billion mark.

Foreign investors have been important both for investments and export growth. The inflows of FDI have recovered strongly after the slump following the Asian crisis, and actual investments grew from around USD 3 billion in 2000 to nearly USD 4 billion in 2004 (Nguyen Thi Tue Anh et al. 2005).[7] Foreign-invested enterprises account for over 15 percent of GDP, nearly one-fifth of total investment, and more than half of total exports including crude oil (excluding crude oil, the FDI share of exports is about one-third). The development of the private sector has also been encouraging, and private firms account for an increasing share of employment and investment. Yet, the state sector still dominates, controlling 55-60 percent of total investment and nearly 40 percent of GDP. In fact, the state's share of GDP has increased somewhat since 2000, which may be appear contradictory taking into account the progress of the private sector. However, the GDP share of the non-state sector includes agriculture, where growth rates are substantially lower than the average – the private sector's shares of industrial output and employment are growing steadily.

The one macroeconomic indicator that is slightly worrying is the inflation rate. The rate of price increases stayed low until 2003, but inflation has accelerated during the past two years – this applies both for products like oil and steel, where the international price level has increased steeply, as well as domestic food products, where prices did not recede after the customary pre-*Tet* price increases. According to official statistics, the rate of inflation remained slightly below 10 percent in both 2004 and 2005, although there are large variations

[7] The data on implemented FDI from the Ministry of Planning and Investment are systematically higher than the data on FDI disbursements from the State Bank of Vietnam. One reason is that the MPI figures include the local capital shares, but the difference is still disturbingly large. In 2004, the SBV reported FDI disbursements of USD 1.6 billion, as seen in Table 2.

across product groups. The problem is that it may be difficult to maintain a stable exchange rate to the USD if Vietnam's inflation rate is substantially higher than that in the US: a higher inflation rate tends to reduce the competitiveness of Vietnamese firms, worsening the current account imbalances and creating pressures for devaluations. At the same time, there is a risk that a devaluation of the currency may create macroeconomic uncertainty, causing increases in import prices and further inflationary pressures. These concerns are increasingly important for Vietnam. One reason is the increasing trade ratio. A decade ago, exports plus imports accounted for 70-80 percent of GDP, but the same ratio today exceeds 130 percent of GDP. This means that small variations in competitiveness have much larger effects on the macroeconomy today than ten years ago. Another reason is the liberalization of the trade regime. A decade ago, Vietnam could respond to external shocks by tightening or introducing various quantitative restrictions on trade and foreign exchange transactions. These instruments are out of bounds for today's decisionmakers, which means that the exchange rate plays a more important role for the economy. The concern for price stability, exchange rate stability, and growth is, of course, not unique to Vietnam but a standard challenge for well known in other open economies as well, developed as well as developing.

Moreover, Vietnam continues to put heavy emphasis on economic growth for political reasons, and it is not likely that the government is prepared to take strong measures to reduce aggregate demand. One strong reason is the increasing demand for public social services, in particular health and education. During the past decades, Vietnam has chosen to shift a large share of the financing burden for health and education from the state budget to individual households in process that is somewhat paradoxically called *socialization* – the various social groups and communities are expected to take the responsibility for financing. This has created substantial social gaps in access to health and education, and the strong concern for equity and social stability is likely to result in demands for increased state investment in these sectors (see Kokko and Tingvall in the present volume). Another reason to expect demands for expansionary rather than contractionary policies is the uneven regional development in Vietnam. Although the past 20 years have witnessed a remarkable reduction in poverty incidence, with the share of the population living in absolute poverty falling by well over half during the past decades, the gains have been unevenly distributed. Growth has been concentrated to Hanoi and Ho Chi Minh City with surrounding provinces, and there are no clear signs of convergence in provincial income and development levels (Kokko and Tingvall 2005). One determinant of the provincial development gaps is the uneven distribution of infrastructure: the demands on regional development policy and broad infrastructure programs are likely to increase in the future. Hence, fiscal policy is not likely to contribute much to reducing aggregate demand.

The continuing dominance of the state sector is another cause for concern. Although the private sector is expanding, the state sector still controls most of the country's investment resources and there are worries that the investments are not efficient. The direct employment generated through state investment is small – the total employment in the state sector amounts to about 10 percent of the labor force, and has barely increased during the past decade – and there are frequent complaints about problems at all stages in the public investment process, ranging from planning to implementation (CIEM 2005). The concerns apply both for investments in SOEs and public infrastructure. These investments are expected to raise future production capacity, and it is assumed that the investment resources are used for projects that yield a high social return. For investments in industry, a key question is whether the enterprise will be able to survive in the more competitive climate that is expected as Vietnam joins the WTO in the near future. For infrastructure projects, the requirements are related to how well public investments are able to "crowd in" private investments. The fact that domestic savings and capital inflows to Vietnam are presently at a high level – roughly comparable to those in China[8] – does not reduce these concerns. On the contrary, the availability of large amounts of capital makes it important to invest these funds efficiently, since there are often important lock-in effects of investments. Once large amounts of funds are committed to specific projects, they create interest groups that benefit from these investments and that are likely to try to maintain *status quo* even when it would be socially beneficial to change the direction of policies. Hence, establishing effective mechanisms for allocating public investment resources to the most efficient uses should be a priority.

However, on this point, the current developments in Vietnam appear uncertain. Although management practices and other skills in the banking sector have improved over time, it seems clear that an increasing share of government controlled lending is finding other outlets where management and decision making is less transparent and less rigorous. Part of this process is intentional and follows from decisions in 1999 to move all policy lending from the state-owned commercial banks to the Development Assistance Fund (DAF). Since policy lending is often based on other determinants than economic performance, it is reasonable to transfer it away from commercial banks that face strong demands to become more business oriented and to improve their lending practices and skills in project assessment and risk management. However, it seems that many SOEs that are not directly subject to policy lending have also moved from commercial banks to other sources of financing. This is likely to be a partial explanation for the falling share of SOEs in the lending operations of the formal bank sector.

The motive to move from formal banks to other financing institutes is probably related to the less stringent requirements for financial information, business plans, and collateral in these institutes. There are two or three of these alternative sources of financing that have emerged in Vietnam in recent years. The most prominent is the DAF, which channels funds from ODA and other sources (such as government bonds) to infrastructure and SOE investments. The total amount of resources available for this kind of off-budget public investment exceeds 10 percent of GDP, and is likely to increase in the future. Discussing the sustainability of the DAF, IMF (2006) notes the substantial risks involved in its operations, and calls for increasing accountability and transparency in the use of funds. Moreover, IMF (2006) also argues that the liabilities of the DAF should be incorporated in public debt statistics to make it possible to correctly assess the country's fiscal position.

A substantial share of the DAF's funding is drawn from the Social Insurance Fund (SIF), which administrates the pension and health insurance contributions of all Vietnamese formal sector employees. Given the all formal employees are mandated to pay 18 percent of their gross salary to the SIF – at the same time as the pension payments from the Fund will not start growing rapidly for another 5 to 10 years (since at least 15 years of contributions are required to qualify for full pensions) – it seems clear that the total value of the Fund will grow very substantially in coming years. At present, the SIF is investing mainly in government bonds and DAF bonds, which are considered very safe but have low yields, but there is pressure to raise yields by taking on more risky investments. The most likely investment objects in that

[8] The capital inflows to Vietnam in 2004 included FDI valued at between USD 1.5 billion (according to SBV) and USD 4 billion (according to MPI), officially recorded overseas remittances of USD 2.4 billion, and ODA inflows of about USD 2 billion (in 2003). To reach an equally large inflow of foreign capital per capita, China would require between USD 85 billion and USD 115 billion per year, which is roughly in line with the capital account balance of the Chinese balance of payments in recent years (Prasad and Wei 2005, Table 6).

case are SOEs. The concerns regarding accountability and transparency obviously apply for the SIF as well: taking into account that it manages pension funds, it may be appropriate to require even stricter regulation and supervision than for the DAF.

A third source of non-bank financing for Vietnam's SOEs has recently been introduced in the form of government guaranteed bonds issued in the international market. The first major example is from late 2005, when the Ministry of Finance floated a USD 750 million bond in the US market, and channeled the proceeds to Vinashin, Vietnam's state-owned shipbuilding company. The bond issue was considered successful since it was fully subscribed, but is clear that this was largely due to the government guarantee: a corporate bond issued directly by Vinashin would have been classified as a junk bond, and would have been difficult to sell even with a very substantial risk premium. However, it is still unknown how the funds will be used, and there are question marks regarding the efficiency of the planned investments. Moreover, the decision to issue a foreign bond seems somewhat at odds with the objective to maintain price stability. A domestically issued USD bond would probably have been less costly, and it would not have added to aggregate demand in a situation where inflation is already a problem.

This illustrates some of the problems connected to monetary policy in Vietnam. Apart from the fact that Vietnam's money market is weakly developed, meaning that open market operations are inefficient, there does not seem to be much coordination between the State Bank and the Ministry of Finance. This is particularly problematic since the volume of government bonds issued by the Treasury is substantially larger than volume of the State Bank's open market operations. Instead, the main instruments for monetary policy are the State Bank's refinancing rate and the reserve requirement. However, the efficiency of these instruments is weak: Vietnam applies a fixed exchange rate regime, which essentially shifts the responsibility for price stability from monetary policy to fiscal policy. Apart from the inherent tension between growth and price stability, it can therefore be argued that Vietnam faces an additional restriction through the fixed exchange regime.

As noted earlier, these challenges for macroeconomic policy are not unique to Vietnam, but rather endemic to all small, open economies. The key components of the macroeconomic stability equation are related to the determinants of fiscal and monetary policy, with particular emphasis on the exchange rate. In the Vietnamese case, these issues have not moved to the top of the policy agenda yet, which is partly explained by the remaining regulations and restrictions for trade and capital flow and partly related to luck. More specifically, Vietnam has maintained a fixed exchange rate to the USD, which has depreciated substantially since 2002, and allowed Vietnam to some extent to brush aside the debate about the exchange rate regime. However, with systematically higher Vietnamese inflation, it will be hard to avoid pressure on the exchange rate and discussions about policy alternatives in these areas.

What are then Vietnam's options, and what institutional developments will be required in fiscal policy, monetary policy, and exchange rate management. Some elements are easy to identify, such as closer collaboration between the State Bank and the Ministry of Finance, development of money markets and the financial sector in general, and stricter regulation and supervision of the policy lending that is channeled through the DAF, the SIF, and government guaranteed bond issues. Other decisions – in particular regarding major questions like the exchange rate regime – are more difficult, since they have very far-reaching effects for public governance and macroeconomic management in general. One way to approach these very substantial questions is to examine the experiences of other countries, to identify where the major challenges are likely to occur once some specific institutional solution has been chosen. The following sections will therefore discuss some of the features of Swedish macroeconomic development during the past 20 or 25 years: during this relatively short period, Sweden has gone through a spectrum of different regimes and cumulated more experiences than most other countries.

3. Experiences from Sweden

During the decade from the early 1980s to the beginning of the 1990s, Sweden went through a transition from a closely regulated to a fully deregulated economy where most decisions are made in the market place. This transition episode includes a number of mistakes that resulted in a financial crisis in the early 1990s, with severe macroeconomic costs. When the deregulation commenced, neither households, firms, banks, nor the state were prepared to operate effectively in a deregulated economy. Since there were few countries that had liberalized their financial markets earlier, the possibilities to learn from others were limited. However, the Swedish experiences may be useful for other small, open economies searching for ways to combine internal and external balance in an increasingly internationalized business environment. This section therefore reviews the Swedish macroeconomic experiences during the last decades in the wake of the extensive de- and re-regulations that took place in the economy.

3.1 The regulatory environment before the 1980s

Since the 1930s, the Swedish macroeconomy had been subject to far-reaching regulations in many areas and forms, particularly in the financial sector. For example, on the domestic side almost half of Swedish banks' lending was reserved by the government for two specific purposes; to finance the construction of housing and to finance fiscal budget deficits. Lending for these purposes had to be at low and fixed interest rates so that the fiscal budget would be able to finance the growing welfare state and to make it possible for low and medium income households to afford good housing.

For the other half of the lending, banks could decide to whom they wanted to lend. However, the Riksbank (the Swedish central bank) set quantitative credit ceilings for each bank. The aim was mainly to prevent excessive inflation. Moreover, there were rules for banks´ interest rates on the deposit as well as the lending side. Cash reserve requirements were also applied to give the Riksbank an instrument to influence liquidity and interest rates.

In addition, international capital movements were heavily restricted. The krona – the Swedish currency – had a fixed exchange rate. Extensive capital regulations aimed at maintaining the fixed exchange rate and to protect the domestic credit market from international capital flows. For example, Swedish export companies' earnings in foreign currencies had to be exchanged to kronor. Corporations were thus not allowed to hold accounts in foreign currencies. Furthermore, investment abroad required permission from the Riksbank. Swedish households were not allowed to buy shares in companies outside Sweden and borrowing in foreign currency was restricted. There were also restrictions on foreign investment in Sweden.

Despite all these measures, the Swedish krona was devalued several times during the first 10 years after the collapse of the Bretton-Woods system. The Swedish currency appreciated throughout the 1970s because Swedish inflation rate was higher than the average among

Sweden's trade partners, leading to real appreciation, loss of competitiveness, and current account deficits. Ambitious employment targets contributed to fiscal deficits and excessive wage rates. Regular devaluations became the favored way to avoid unemployment. The devaluations led to lack of confidence in the stability of the exchange rate. This in turn caused high inflation expectations and high wage demands in a vicious circle.

The regulations aiming at stabilizing the GDP growth rate and the welfare state served the economy well in many ways, but precluded it from taking advantage of the rapidly growing international financial markets. Moreover, in the 1970s and 1980s, the efficiency of the regulations began to erode as the financial sector found ways to circumvent various restrictions.

The regulations also created other incentives and skills than those in demand in liberalized markets. For example, the credit ceilings and the lack of differentiation in lending rates reduced competition in the banking sector. The establishment of new banks and bank branches required permissions from the authorities, which also reduced competition. The lending ceilings and low real interest rates led to a substantial unsatisfied demand for borrowing by companies and households, which created incentives for banks to lend to the lowest risks in order to minimize losses. Hence, the banks did not have to develop skills and methods for dealing with risk.

3.2 The 1980s: deregulations and their macroeconomic impact

In the period 1980-1985, the domestic quantitative restrictions were gradually abolished. The foreign exchange restrictions did however remain until 1989. Technical innovations and growth in the financial markets – domestic as well as international – gradually reduced the efficiency of the regulations and were important reasons for the liberalization.

During the 1980s, the krona was tied to a trade-weighted basket of currencies allowing for fluctuations within a band of +/- 1.5 percent. A large devaluation of the krona in 1982 was intended to be a starting point for developing the krona into a hard currency. The Riksbank and the Treasury emphasized that this would be the last devaluation, after a period between 1976 and 1982 when there had been a number of devaluations accumulating to a XX percent lower value of the krona. In contrast to the previous devaluations, the objective of the 1982 devaluation was not only to restore Swedish competitiveness after a period of higher inflation than in neighboring countries, but also to rectify structural imbalances in the economy. It was believed that that too small a part of the economy was exposed to competition. This imbalance was reflected in more or less permanent deficits in public finances and in the current account balance.

By starting the reorientation with a large devaluation, the government wanted to stimulate the sector that was exposed to competition. It was also of great importance to demonstrate clearly and unambiguously that there was political support for the new "hard line" exchange rate policy. In part this was done through a rule that prohibited the government from increasing the borrowing in foreign currencies. The motivation was that an isolated domestic credit market was expected to be self-regulating: if fiscal policy became too expansive it would result in higher domestic interest rates, partly discouraging the government from further borrowing.

Government Treasury bills were introduced in 1982 for sale to non-bank buyers in order to stimulate both a money market and a secondary market. Two years earlier, banks had been allowed to emit short term bank certificates for the same reason. Well functioning bond and money markets were important when regulations for lending and deposit rates were abolished. After these events the Riksbank could affect the market interest rate mainly by liquidity management and the prime rate.

However, inflation expectations remained high, partly due to Sweden's long history of devaluations. Coupled with the expansion of credit following the full deregulation of the credit market in 1985, this caused wages and inflation to rise steeply. Private consumption expanded rapidly after the abolition of the quantitative regulations of the credit market. During the period 1985 to 1990, the credit volume increased by an average of 16 percent each year, which was a very high rate considering that the average increase in real GDP was only a couple of percent per year. Heavy borrowing from both households and firms and a booming international economy led to sharp price increases in the equity and real estate markets. In addition, when the credit market was deregulated the prevailing tax system was still structured in such a way that it favored accumulation of debt. Nominal interest expenditures in the late 1980s produced tax relief of approximately 50 percent. This meant that the real rate of interest after tax was negative. Despite these unattractive characteristics, reform of the tax system was not politically feasible at the time the credit market was deregulated.

At the same time banks were in a completely new situation following the credit market deregulation, and they did not have internal systems for controlling new risk. They focused more on market shares than on risk, which exacerbated the increase in credit volume. A large part of loans was investment in housing or commercial real estate and most of this was collateralized by real estate, which put upward pressure on real estate prices. High real estate prices lead to higher asset prices. This in turn raised collateral values, which facilitated further borrowing, which consequently increased the upward pressure on asset prices. Especially in metropolitan areas, real estate prices skyrocketed. Capital requirements were gradually increased during the 1980s and harmonized among different institutions. Sweden introduced the Basle I capital requirement 1990, which resulted in higher requirements especially for mortgage institutions.

With a fixed exchange rate, the possibilities to employ monetary policy in areas other than managing the exchange rate were severely limited. Meanwhile, the international mobility of capital increased steadily during the 1980s. Combined with the undermining and eventually formal termination of the domestic credit market regulations, this meant that the Riksbank had limited scope for increasing domestic interest rates in order to dampen the demand for credit. In addition, low sensitivity to interest rates due to the tax system, notably in the household sector, further reduced the effectiveness of monetary policy.

It thereby became the task of fiscal policy to offset the strong inflationary pressures created by the expansion of credit. This assignment failed. The government budget did show small surpluses during the second half of the 1980s, but the economy was overheated and a progressive tax system without indexation contributed to the surplus. Adjusted for cyclical factors, fiscal policy was actually expansive. Viewed in relation to the overheating, with open unemployment below 2 percent and private consumption at an historically high level, public finances should have shown considerably greater surpluses.

At the same time, responsibility for price and wage formation primarily rested on the social partners – the labor unions and the employers' federation. It had been made clear at the time of the devaluation in 1982 that the exchange rate would be maintained. Consequently, price and pay increases that were far higher than the surrounding world would lead to an undermining of competitiveness and reduced employment.

Despite a long period of real appreciation of the currency caused by higher inflation than abroad, the credibility for the fixed exchange rate seemed to be high during the overheated period in the second half of the 1980s. Currency outflows from the current account deficit and investment in real estate abroad were met by borrowing from foreign banks in foreign currency, which was attractive because foreign interest rates were lower than the Swedish ones. Half of the commercial banks' lending volume at the end of the 1980s was denominated in foreign currency. Borrowing in foreign currency often financed real investments in Sweden which made Swedish companies as well as the banks exposed to changes in the exchange rate.

Despite substantial decreases in competitiveness, the unemployment rate was low. A strong international economy and strong growth in sectors that were not exposed to competition, such as the service sector and the construction sector, offset the negative effects of losses in export market shares.

3.3 From overheating to depression – the crisis years 1991-93

At the beginning of the 1990s, the economy was still in an upswing. Open unemployment was approximately 1.5 percent and GDP growth was above its trend level. The government budget was in surplus. Yet there were clear indications of internal imbalances, in addition to the external imbalance characterized by large current account deficits. The rate of inflation was approximately 7 per cent and nominal wages were increasing by almost 10 percent per year. Pushed by a rapid expansion of credit, prices of commercial real estate had risen rapidly.

The turn in the course of development of the economy during the following years was both swift and strong. At the end of 1993, open unemployment had increased to almost 9 per cent. The government deficit reached 12 percent of GDP and government debt grew rapidly. In 1991-1993, GDP declined for three consecutive years and the economy shrank by 6 percentage points. This development forced Sweden to abandon the fixed exchange rate in fall of 1992. Instead, the krona got a floating exchange rate for the first time since the 1930s. A bank crisis and fiscal crisis forced the government to make major commitments to restore confidence in the bank sector and to prevent a systemic crisis.

The crises developed gradually. During the winter of 1989-1990, the government proposed statutory interventions in price and wage formation to contain the cost and price pressures caused by the overheated economy: the measures included a pay freeze, a rental freeze, a freeze on increases in local government taxes, restrictions in the right to take industrial action, and increased penalties for illegal strikes. But the government lost the vote in the parliament, the Riksdag. The political uncertainty in early 1990 spread to the foreign exchange market. A strong outflow of currency took place for the first time since 1985. The Riksbank was obliged to make purchases to support the krona to defend the exchange rate.

This eroded the credibility and sustainability of the fixed exchange rate. One explanation was that there were clear indications of an imminent financial downturn. This was due both to external and internal factors. The international business cycle slackened and Sweden lost market shares because of the eroding competitiveness that was caused by high price and wage increases. When growth diminished and unemployment started to increase, the Swedish economy was once again in the kind of situation that had traditionally resulted in a devaluation of the krona..

In the fall of 1990, the lack of confidence spread rapidly throughout the Swedish financial market. Credit losses in finance companies spread to the banks. The situation in the banking sector turned worse when interest rates were raised to very high levels in order to combat the pressure on the fixed exchange rate. The Riksbank gave loans on special terms to banks and mortgage institutions to soften the impact of the high interest rate, although it was clear that the risk for credit losses was rising. In the previously hot market for commercial property, rental levels fell, leading to a fall in both prices and turnover in the property market. In the same way as lending and property prices were driven upwards in the 1980s in a self-reinforcing spiral, they now both turned downwards. The stock market fell in response to the dawning recession. In combination with the ongoing economic downturn, this meant that the Swedish banks' financing, in particular in foreign currency, was threatened: the banks' foreign lenders began to call into question their payment capacity and solvency. Sweden was threatened by a financial system crisis, and it was feared that this could seriously damage the national economy in a situation that was already considered critical.

The effect was a swift decline in both private consumption and capital expenditure, in particular in real estate investment. The Swedish commercial paper market ceased to function. Asset prices and saving were also affected by a tax reform that was carried out in stages in 1990–91. A central idea in the reform was to encourage savings and discourage borrowing. Other key principles were uniformity and a striving for low tax rates and broad tax bases. This meant among other things that a separate uniform tax on capital income was introduced, with a flat tax rate of 30 percent. Earlier, capital income had been added to other types of incomes and taxed at substantially higher rates – for many middle class income earners, well over 50 percent. Similarly, interest payments had been deducted from aggregate income, reducing tax obligations by more than 50 percent on the margin. One result of the reform was therefore that the value of interest deductions was reduced, which increased the real cost of borrowing after tax. This contributed to reducing the price of houses and tenant-owned housing. This also contributed indirectly to increased saving. The real debt ratio of households increased which strengthened the motivation to reduce loans, i.e. to save by amortization. The tax reform contributed to reinforcing the downturn in the economy: the restraining effect on private consumption via reduced asset values dominated the effect on disposable incomes of the initial underfinancing.[9]

Up until the abandonment of the fixed exchange rate regime in fall of 1992, the government repeated the objective of a fixed exchange rate as a basis for monetary and foreign exchange policy. The division of responsibility in economic policy was clearly expressed:

The Swedish credit market is practically wholly integrated with the surrounding world. In the light of this, the Riksbank's monetary policy has become increasingly focused on balancing currency outflows by adaptations to the domestic level of interest rates. Monetary policy can

[9] According to the calculation reported by KUSK, an estimated approximately one percentage point of a total fall in real GDP from 1991-93 of 5 per cent can be derived from the tax reform. A summary of KUSK and the government's evaluation of the tax reform, including its effects on cyclical developments, are reported in Government Bill 1997/98:1, Annex 6.

thereby not be used to affect domestic demand. Fiscal and structural policy bears the main responsibility for creating the prerequisites for low inflation and stable growth.[10]

In only a couple of years time, the Swedish economy had ended up in a situation which was a mirror image of the 1980s. Then it was not possible to increase real interest rates since the fixed exchange rate was perceived as credible. Now it could not be reduced despite the economy going steeply downwards, since the credibility of the exchange rate regime was weak. At the same time, public finances continued to worsen. Every third krona of expenditure in the central government budget was borrowed and approximately a third of expenditure was for interest payments on central government debt. Public finances were thereby not sustainable in the long term. The increasingly poor development of the Swedish economy led to the krona being sensitive to disturbances. An extensive outflow of currency took place.

The government faced a troublesome trade-off. On the one hand, there was a risk that continued high interest rates caused by the imbalance in public finances would delay the economic recovery. On the other hand, there was a risk that rapid and extensive budget reinforcements would result in an excessively strong tightening, which could also delay or interrupt the expected cyclical upswing.

In the Budget Bill in 1993, the government stated consolidation of public finances as a main task of economic policy. This was described as a condition to "increase confidence in economic policy and make a sustainably lower interest rate level possible".[11]

Half a year earlier, the fixed exchange regime had come to an end as the Riksbank gave up its defence of the krona. Once free to float, the krona depreciated by 25 percent. In January 1993, the Riksbank set itself a new monetary policy: the objective was to aim at an inflation rate (measured with CPI) of 2 percent with a symmetric interval of ± 1 percentage point.

3.4 After the crises: a new playing field for economic policy

A substantial consolidation program was carried out between 1994 and 1998. The program entailed a permanent reinforcement of public finances equivalent to 8 percent of GDP. It was designed according to three basic principles. Firstly, it was to take effect swiftly so that the increase in central government debt was checked at an early stage, although the effects were to be distributed over a number of years so that the effect on demand would not be too great. Secondly, it was designed from the point of view of distribution policy, so that those with high incomes contributed most. Thirdly, priority was given to public activities such as education, health care and social services above transfers to households.

The measures to achieve credible, long-term sustainable public finances also entailed a clearer target formulation for budget policy by introduction of targets for the public financial balance and expenditure ceilings. Work on the budget was also given a firmer regulatory framework through a new budget act and through changes in the budget process in the government and the Riksdag. These institutional changes were as important for the consolidation work as the exact design and distribution over time of the measures in the Consolidation Program.

[10] Government Bill 1991/92:100.
[11] Government Bill 1992/93:100, Annex 1, p. 1.

The public finances, measured by the general government financial balance, were to be in balance by 1998 and central government debt as a proportion of GDP to be stabilized by 1996.[12] It was moreover stated that the deficit in the public sector should not exceed 3 percent of GDP in 1997, which was one of the criteria for entry into the European Union's monetary union. The objective of stabilizing central government debt by 1996 was achieved. Central government debt peaked at 81 per cent of GDP in 1995 and was thereafter successively reduced. The consolidation of public finances laid the basis for a credible low inflation policy with a monetary policy that could be carried out in an expansive direction without price and wage increases accelerating.

In 1997, a new budget act came into effect. Its main characteristic is what is called an expenditure limit decision model. This means that the Riksdag makes decisions on the budget in two steps. In the first step, the Riksdag sets the overall budget space and distributes this to individual expenditure areas. The Riksdag also establishes an estimate of revenue in the budget. The limits set for the respective expenditure area in the first step thereby forms a binding restriction. After consideration by its various committees, the Riksdag makes the final decision on the various appropriations. All appropriations within an expenditure area are distributed in a single decision. From having one of the weakest budget processes in Europe, the new set up resulted in Sweden having a considerably more stringent budget process, well on a par with comparable European countries.[13]

In addition to the new budget act, a long-term surplus target was established. The government decided that the general government financial balance should have a surplus amounting to 2 percent of GDP on average over a business cycle. The government had a number of motives for this surplus target:

- Public finances will be exposed to considerable pressure some way into the 21st century, not least because of the increasing number of elderly people. The surplus target plays an important role for equipping the public sector to meet this development.

- The prospects for pursuing a cyclical policy were improving. With a surplus of 2 percent of GDP as a starting point, there was a margin for actively counteracting cyclical slowdowns without the deficit in public finances threatening to become too large.

- A surplus in public finances promotes and makes possible high private investments without Sweden's foreign debt increasing.

The basis is that a 2 percent surplus should be achieved when the use of resources in the Swedish economy is at a level that is possible to maintain without accelerating inflation. In a downturn, the surplus should consequently be less than 2 percent and in an upswing more than 2 percent.

In 1999, the new monetary policy regime based on an explicit inflation target and a floating exchange rate received legal backing, as it was written into the Riksbank Act. Since then, the Riksbank has the statutory target of maintaining price stability. In addition, the Riksbank has an obligation to support general economic policy, promoting sustainable growth and high

[12] Government Bill 1994/95: 150.
[13] Central government debt and the budget process , Government report Ds 1992:16.

employment to the extent that this does not conflict with the price stability objective. In the new legislation, it was clarified that the Riksbank may not accept instructions from outside on the conduct of monetary policy. The obligation of the Riksbank to consult with the parliament before taking important monetary policy decisions was thus changed to a duty to inform. In the sphere of foreign exchange policy, the new legislation meant that responsibility for overall foreign exchange policy issues was transferred from the Riksbank to the government. The Riksbank on the other hand decides on the practical application of foreign exchange policy in a system with a floating exchange rate.

In all, these institutional reforms have meant that the economic playing field in Sweden has changed dramatically in the last two decades. In the past, households and firms operated in a heavily regulated environment with government controlled interest rates and a fixed exchange rate; today, they act in a liberalized and internationalized environment where decisions are based on prices that are freely determined in the market place. Consequently, resource allocation is more efficient than before the 1980s. In addition, fiscal policy is on a substantially firmer footing thanks to a more rigorous framework in which Sweden's historical tendency for fiscal deficits has been mitigated. Monetary policy has been substantially transformed, shifting from a fixed exchange rate regime to an inflation targeting regime.

One important result of these institutional changes is that issues related to macroeconomic stabilization require less policy attention than some decades ago. Instead, the focus in the policy debate has largely shifted to two other areas. On the hand, there is a lively discussion about the determinants of growth and innovation; on the other hand, the nature and sustainability of the welfare state has a more prominent position on the policy agenda. It is possible that this shift in policy priorities is at least a partial explanation for the improving performance of the Swedish economy. In the 1970s and 1980s, when all attention was required to achieve macroeconomic stability, questions related to long term growth and sustainability were arguably neglected. As a result, Sweden lost positions in the international incomes league, falling from third or fourth in the early 1970s to somewhere around 20th position in the early 1990s. Since the mid-1990s, the economy has recovered and Sweden is again a position in the top-10.

4. Concluding comments

While the main priorities in Vietnamese macroeconomic management have arguably remained the same throughout the past two decades – high growth and reasonable stability – it is clear that it has become increasingly difficult to reach these objectives. On the one hand, new problems and new policy challenges have emerged in the course of the country's development and internationalization. In the mid-1990s, economic structure and external balance emerged on the policy agenda. In the late 1990s, new problems were created by the Asian crisis. In recent years, issues related to social and regional development gaps and investment quality have become important policy objectives. At the same time, growth and stability remain core priorities, which means that the equation to be solved by policy makers is increasingly complex. On the other hand, it is clear that the instruments for economic policy making have changed. While the challenges in the early 1990s could be handled with various direct interventions, like credit ceilings and quantitative trade restrictions, there is less room for such interventions in today's more internationalized policy environment. For instance, Vietnam's various trade agreements, including the WTO in the near future, restrict the scope for discretionary policy making. Similarly, the liberalization of the financial sector means that interest rates are increasingly determined by the market rather than by government officials. Instead, the policy focus is shifting to creating and overseeing the institutions that determine the behavior of the market. Rules and incentives are becoming more important than direct interventions, and when interventions do occur, they are typically executed through the market, e.g. in the form of open market operations. One consequence is that the choice of exchange rate regime is becoming a much more important decision than in the past.

It is difficult to foresee the next stage of development in the Vietnamese macroeconomy, but some of the challenges are easy to foresee. External balance and international competitiveness are definitely two areas that will figure prominently in the Vietnamese macroeconomic balancing equation in the future. In this paper, we have illustrated some of the alternative approaches to macroeconomic management in an increasingly internationalized and deregulated environment by recounting some experiences from Swedish macroeconomic management during the past three decades. Although Sweden and Vietnam differ in many respects, they are both relatively small open economies that are highly dependent on international trade and other kinds of international contacts. Like Vietnam, Sweden has also undergone a dramatic internationalization during the past decades. In the Swedish case, this process involved not only increased imports and export, but perhaps mainly an internationalization of the financial market, with substantial consequences for macroeconomic management. A similar development is not unlikely for Vietnam. With increasingly open markets and a rapidly growing trade share, it will be difficult for Vietnam to maintain strict controls in the financial market. In a more internationalized economy, the actors will gradually find ways to bypass those controls that are contrary to their interest: at that stage, at the latest, it will be in the interest of authorities to adjust the formal rules to what is already a reality.

The Swedish experiences of this adjustment process suggest that there are many pitfalls in the liberalization and internationalization process. A first lesson concerns the liberalization of the financial sector, and has been emphasized also in connection with the Asian crisis. In Sweden, the deregulation of credit markets took place before sufficient formal financial surveillance by government was in place. In the early stages of deregulation, this meant that banks and other financial institutions took on excessive risk. With limited experience of how to compete in a liberalized financial market, and with weak skills regarding risk management, the individual actors were lured to focus more on credit volumes and market shares than on the quality of their credit portfolios.

A second lesson concerns the instruments for macroeconomic stabilization. The Swedish experience demonstrates clearly how external and internal balance rests on fiscal policy under a fixed exchange rate. When fiscal policy is too expansive – i.e. when economic growth is a policy priority that cannot be compromised – the likely result is internal overheating and high inflation, risking real appreciation of the exchange rate. In such a situation, there is a risk that continuous current account deficits are financed by increased borrowing in foreign currency, since the overheated domestic market will result in high real interest rates. If so, short term foreign capital may finance domestic investment, with creates severe dependence on foreign creditors. The situation is particularly sensitive if the banking sector finances itself abroad to invest domestically.

The current account deficits can be remedied in the short run through a devaluation of the currency, but there are several risks connected to this. One problem is related to the foreign currency borrowing that typically occurs during times of current account deficits. When the exchange rate is devalued, the burden of foreign debt will increase. This is a particularly severe problem if the banking sector holds substantial foreign debt: the increasing debt burden may result in financial instability and serious credit restrictions when banks adjust to their higher debt. Another problem has to do with expectations. Firms and households may learn to expect regular devaluations, and may adjust their behavior to these expectations. One consequence is high inflation expectations, since the devaluation will restore external balance even if domestic price increases are higher than those in the rest of the world. A more serious consequence may be the expectation that long term growth strategies are unnecessary if regular devaluations are available as a response to competitiveness problems.

With a floating exchange rate, it may be possible to resolve some of these concerns. In particular, there is a stronger potential for efficient monetary policy, although it should be noted that a strong institutional environment is required to create a credible policy environment. In the Swedish cases, this has required an independent Riksbank with very substantial autonomy and a clear mandate to maintain price stability. At present, Vietnam lacks both the monetary policy tools and the State Bank independence to follow this example.

A third lesson concerns the character of economic policy in different institutional settings. It is clear that Swedish policy makers paid much attention to stabilization issues during the transition from the fixed exchange rate regime in the 1970s and 1980s to the present setup. This meant that long term growth and innovation issues and discussions about the sustainability of the welfare state were less prominent. To some extent, the ambitions in these policy areas were instead adjusted to the current macroeconomic conditions. In times of relative stability, the welfare state was more generous; in times of turbulence, welfare benefits had to be reduced. The present macroeconomic regime is to a large extent an institutionalization of policy that is likely to remain successful as long as the credibility of the Riksbank is maintained, and as long as there is no obvious conflict between the price stability requirements and real variables, such as employment and income growth. This setup has allowed policy makers to focus their attention on long term issues like growth and welfare. The result has arguably been an improvement in the Swedish policy environment, reflected e.g. in improved economic performance. In Vietnam, policy makers have been able to focus much on growth and related long term issues thanks to the reasonably stable macroeconomic environment since the early 1990s. The internationalization of the Vietnamese economy is likely to require a regime shift in macroeconomic management. This transition from a strictly controlled environment to a more market-based regime will probably be accompanied by increasing instability: a period of trials and errors is likely when Vietnam searches for a model that is suited to the specific features of the economy. While this process will require the attention of Vietnam’s policy makers, it is important that it does not divert attention from the long term priorities related to growth and welfare.

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