TAKING STOCK DECEMBER 2019

FINANCE IN TRANSITION

Unlocking capital markets for Vietnam's future development

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ABBREVIATIONS

ADB	Asian Development Bank
ASEAN	Association of Southeast Asian Nations
CIT	Corporate income tax
CPI	Consumer Price Index
EAP	East Asia And Pacific
EVFTA	EU-Vietnam Free Trade Agreement
EU	European Union
GDC	General Department of Customs
GDP	Gross Domestic Product
GSO	General Statistics Office
HNX	Hanoi Stock Exchange
IMF	International Monetary Fund
M&A	Mergers and Acquisitions
MOF	Ministry of Finance
MPI	Ministry of Planning and Investment
MTIP	Medium-term Investment Plan
NPL	Non-performing loans
NTM	Non-tariff measures
ODA	Official Development Assistance
OOG	Office of Government
PIM	Public Investment Management
PIT	Personal Income Tax
R&D	Research and Development
SBV	State Bank of Vietnam
SMEs	Small and medium-sized enterprises
SOEs	State-owned enterprises
SPV	Special purpose vehicle
UPCOM	Unlisted Public Company Market
VAMC	Vietnam Asset Management Company
VAT	Value-added tax
VSSF	Vietnam Social Security Fund
VST	Vietnam State Treasury
WTO	World Trade Organization
y/y	year-over-year

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EXECUTIVE SUMMARY

Dark clouds continue to gather in the global economy with higher-than-anticipated sluggish economic growth and trade flows in 2019. However, the sun is still shinning on the Vietnamese economy, which is projected to expand by about 6.8 percent in 2019—only 0.3 percentage points slower than in 2018. Because the risks of bad weather cannot be ignored, the government has rightly focused on supporting the domestic private sector as a channel to compensate for a possible slowdown in the external demand. Yet, private firms operating in Vietnam are facing many obstacles, the most severe one being the difficulty of accessing long-term finance. For that reason, this report, after reviewing the recent developments of the Vietnamese economy, focuses on the challenge of long-term finance, arguing that the development of capital markets as a complement to the credit provided by commercial banks is an imperative.

Recent developments

The Vietnamese economy has done well in 2019. In the context of increasing global uncertainty, Vietnam will most certainly be among the fastest-growing economies in the world, with a GDP growth rate of approximately 6.8 percent. This rate is almost three times faster than the world average (2.6 percent) and 1.2 percentage points higher than the average in East Asia and Pacific, according to the latest estimates from the World Bank's *Global Economic Prospects*.

This robust growth performance was attained thanks to the contribution of two key factors: export growth and domestic demand from households and firms. The first factor reflects the performance of the exports sector, growing by about 8.4 percent between January and September 2019, which is lower than in the recent past (15.8 percent in the same period in 2018), but three times higher than the global average. However, this expansion can be short-lived as it captures to some extent the diversion of Chinese exports toward Vietnam due to the trade tensions between China and the United States. As a matter of fact, the value of exports toward non-U.S. markets increased by only 3.8 percent in 2019. The second contributing factor reflects the rapid expansion of the middle class, as the number of people living on more than US$15 per day increases by about 1 million every year. The demand of the burgeoning middle class has been met to a great extent by purchases of foreign products, as the imports of consumption goods have been rising by about 15 percent per year since 2015.

The contribution of exports and private demand to GDP growth has allowed the government to maintain its prudent fiscal and monetary policies. On the fiscal front, the authorities have managed to reduce their fiscal deficit (down by 0.1 percent of GDP) due to higher-than-expected revenues and a very low execution of capital investment expenditures; the latter has been persistently low since 2015. As a result, the debt-to-GDP ratio (the Ministry of Finance's definition) is estimated to have declined from 58.4 to 56.1 percent from 2018 and 2019. The authorities have thus been able to rebuild additional fiscal space by reducing public borrowing by almost 8 percentage points of GDP since 2016, though lower capital spending has also depressed potential growth.

Concurrently, the monetary authorities have managed the credit expansion (around 12.5 percent (y/y) over the first nine months of 2019), which should remain under the initial target set at 14 percent. It was only in September 2019 that the Central Bank opted to ease its monetary stance by cutting its rediscount and refinancing rates by 25 basis points due to the decline in the inflation rate (down from 3.5 to about 2.5 percent) and similar rate cuts in neighboring countries.

The balance of payments is expected to remain in surplus, with an increase in international reserves that were equivalent to 3.2 months of imports at end-June 2019. The current account surplus should slightly decline from 2.3 to 1.9 percent of GDP, while FDI inflows have remained at the same high level as in the past two years, averaging about US$3 billion per month.

Looking forward, the Vietnamese economy is projected to continue to expand at a robust 6.5 percent over the next three years. This baseline scenario assumes that Vietnam will offset the potential slowdown in its exports by higher domestic demand, possibly fueled by a more accommodating and efficient fiscal policy. Inflation should remain under control, as should the external balance.

Both domestic and external risks cannot and should not be ignored by policy makers. On the domestic front, the pace of reforms could decline during the preparation of the next Party Congress scheduled in early 2021. The privatization/equitization program and the restructuring of state-owned enterprises (SOEs), after a promising start in 2017, has slowed considerably in recent months. The risk of contagion from uncertain global markets could lead to a further decline in exports growth. The interest of foreign investors could also cool as many of them may postpone or cancel their projects. The level of greenfield investment has decreased in the last two years even if it has been offset by an increase in mergers and acquisitions by foreigners. If the export sector's growth was to slow more rapidly than anticipated, the Vietnamese economy would lose its main engine of growth. The government would then be forced to implement a fiscal stimulus.

The longer-term government response should be to accelerate the development of the domestic private sector. Such development would partly meet the growing demand by consumers over the next few years. However, many firms operating in the domestic market face severe obstacles preventing their expansion. The 2016 enterprise survey conducted by the World Bank revealed that access to finance was perceived as the most severe constraint (by over 22 percent of the firms), followed by informal competition (17 percent), and by poorly educated workers (10 percent). Therefore, addressing the financing constraint of firms should become a priority if the government wants to maintain the country on its trajectory of fast and inclusive growth.

Long-term finance through well-functioning capital markets

Both economic theory and empirical evidence demonstrate that economic growth and financial markets development are closely interconnected. Most of the high-income economies in the world are also those with the biggest credit-to-GDP ratio. Such correlation is also apparent in the recent history of Vietnam, as the rapid economic growth reported over the past 25 years has been accompanied by a surge in banking credit from 17 percent of GDP in 1996 to over 130 percent in 2018. Today, Vietnam has the highest credit-to-GDP ratio among the lower middle-income countries and is at par with some of the OECD countries. These comparisons suggest that the development of the banking sector may have been too rapid compared to the size of the economy.

Such a rapid development of the banking sector, albeit beneficial, has arguably created some challenges that may prevent the emergence of a dynamic private sector. The first challenge is that the allocation of credit by banks has traditionally been biased toward the public sector, including SOEs, which accounts for a significant share of total credit in the banks' portfolio. More recently, a disproportionate share of credit has been directed to real estate and housing, and to a lesser extent to durable consumer goods (for example, cars). These two categories have crowded out the credit available for private firms, particularly small and medium-sized enterprises (SMEs), which today represent only a marginal share of the credit market in Vietnam. The provision of long-term credit to firms is further constrained by the short nature of deposits (over 80 percent are one year or less) and by relatively high transactions costs due to the lack of information, weak collateral, and the poor functioning of the justice system.

The second challenge is that the financial market is highly concentrated around banking sector credit. Instruments such as bonds and equities finance approximately 40 percent of activities in Vietnam. When contrasted with other countries in the region, such as Thailand, the Philippines, and Indonesia, the size of the local bond market and of the market capitalization of listed companies is low despite rapid progress since 2011.

This report discusses why the development of capital markets has become so important for the future expansion of Vietnam's economy. By mobilizing domestic savings and foreign capital, these markets will enhance the diversification of the sources of financing for the firms, including SOEs, relaxing their main constraints, and allowing them to expand more rapidly. The emergence of long-term finance through capital markets would also help promote infrastructure spending, which is today almost exclusively funded by the government's budget. There is also a link between capital market finance and technology development, as these instruments are often aimed at new innovative sectors and research and development (R&D) activities. In short, SOEs, SMEs, corporates, infrastructure, and housing markets all stand to benefit significantly from the development of capital markets, which would enable a new pool of capital to be unlocked for unfunded productive projects.

The government has been active in the capital market over the past few years, leading to an increase in the volume and value of public bonds issuances (including guaranteed) from about 17 percent of GDP in 2011 to around 37 percent in 2019, with a significant improvement in yield curves, which have extended up to 30 years. The corporate bond market has also expanded, although not as rapidly, from about 4 percent of GDP to 9 percent between 2011 and 2019, while the listed stock market capitalization has jumped from 11 percent to 52 percent of GDP since 2011, but with relatively few active companies on the secondary market. Because the size of the domestic market is smaller than its peers, the Vietnamese authorities should recognize that further reforms are needed to encourage more issuances, introduce new products, and improve market functioning to provide long-time finance to a hungry private sector.

With this vision, this report suggests five areas policy makers should focus on.

1. **Modernizing the legal and regulatory foundation of the capital markets.** A strong and stable regulatory and legal framework and efficient market infrastructure are fundamental to provide market participants with the confidence to enter the market. Among priorities are the revisions of the Security Law and its implementation, as there is an urgent need to improve market and disclosure policy, conduct of market participants, institutional and operational arrangements, and market infrastructure to meet international standards.

2. **Improving governance and information dissemination*.*** A significant challenge in Vietnam is to build a robust credit culture where risks are measured and priced objectively through a high standard of information disclosure. Exposure to the corporate bond market remains extremely limited, in part due to the current lack of transparency and information available to prospective investors, but also due to the lack of sufficiently high-quality analysis. Credit rating agencies are needed to ensure that financial markets can function adequately, and bond issuances could be rated and priced accordingly. Ultimately, accessible and reliable information regarding the markets and the securities issued is necessary to increase investor confidence.

3. **Broadening the investor base*.*** Broadening the investor base, especially non-bank investors, will be key to the development of capital markets. A broader and diverse investor base is important not only to sustain market growth, but also to increase liquidity and reduce volatility. There has been a positive trend in recent years, but the Vietnam Social Security Fund (VSSF) should be allowed and encouraged to expand its investment expertise and diversify its investments beyond government securities

and high-yielding bank deposits. Such a move would not only improve the Fund's financial performance and enhance its ability to honor its long-term liabilities, but would also support the development of corporate bond and equity markets. The development and participation of insurance companies and of private pension funds would also create new long-term savings vehicles for individuals, which could further enhance the domestic capital markets. An upgrade to emerging market status in global stock and bond indexes will also attract international investors to Vietnam and support sustainable growth of the markets and diversified participation in the markets. Thus, reforms to support this effort must be prioritized.

4. **Developing innovative products.** Demands for long-term financing, particularly for infrastructure, will remain high as Vietnam continues its current growth trajectory, with rapid urbanization. Debt leveraged by banks is often insufficient to amortize infrastructure projects. Moreover, banks are unlikely to meet the full extent of this growing demand for long-term financing, due to the liquidity and capital constraints and maturity mismatches such lending would entail. In this context, new types of instruments—such as infrastructure bonds, asset-backed securities (including for mortgages), and other structured instruments are necessary to support infrastructure financing and other longer-term investments in Vietnam.

5. **Strengthening the government's role in building blocks for the development of long-term finance.** Given the weight of government bonds in emerging capital markets (more than twice the size of corporate bonds in Vietnam as of mid-2019), the way that the government conducts its operations exerts influence on multiple parameters such as maturities, liquidity, and risks. By improving the liquidity across the yield curve, it can create a reliable reference that can be used by other issuers from the corporate sector. The government can also impact the liquidity available in the market by guaranteeing predictable issuances so that potential investors can plan their investments well in advance. Further, the development of a liquid market for risk hedging instruments could help deepen and sustain the growth of the market, as foreign investors would be more interested in purchasing local securities. The development of money market and reliable short-term reference rates will help solidify the yield curve and indirectly facilitate the development of hedging instruments.

The policy options suggested above should be viewed as inputs for encouraging a larger debate on the role of capital markets in financing economic development. While Vietnam is still lagging most emerging and industrial countries in terms of capital market development, the government will have to carefully consider the balance between innovation and stability when moving forward. The experience has demonstrated that the rapid expansion of capital markets can boost financing opportunities for the economy, but it can also increase the risks of contagion. Moreover, developing capital markets will have implications for the banking sector, particularly with regard to banks' capital raising efforts. These important implications will need to be taken into account and stronger coordination among the key stakeholders, primarily the State Bank of Vietnam and the Ministry of Finance, will be required to ensure the development of a sound financial sector that includes viable capital markets and a sound banking system. The capacity of the government to respond to these challenges will ultimately determine to a large extent whether Vietnam will soon be capable of joining the group of most advanced economies.

SECTION I

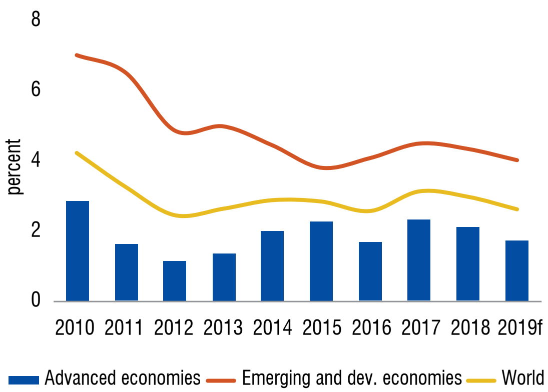
RECENT ECONOMIC DEVELOPMENTS

- Despite an increasingly uncertain global environment, Vietnam's economy has continued to report a robust growth rate that should reach 6.8 percent in 2019.
- Both monetary and fiscal policies have been prudent, leading to a decline in domestic inflation and a reduction in the public debt level, which should be around 56 percent of GDP at end-2019, down from 63.7 percent of GDP in 2016.
- The current account surplus has slightly deteriorated, but exports have continued to expand at a reasonable rate, partly as the result of the diversion effect due to trade tensions between China and the United States, and partly because, following the approval of Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), foreign investors have registered projects at an average of almost US$3 billion per month.
- Forecasts are positive for the next two to three years, with a GDP growth rate that should converge around 6.5 percent and with both fiscal and external accounts under control.
- Domestic and external risks are not marginal and, to mitigate them, the expansion of the private sector should become a priority, including through improvements in the business environment and in long-term financing options.

I.1. GLOBAL ECONOMIC ENVIRONMENT

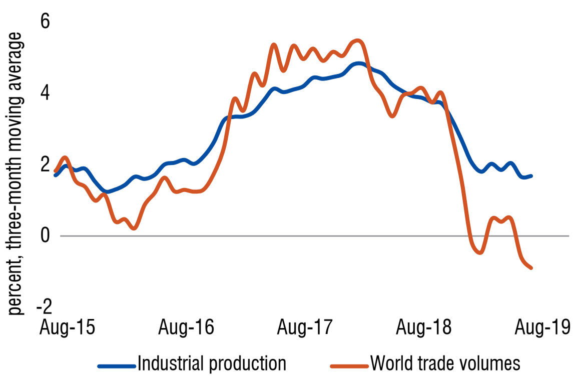
The global economy has continued to falter, with a bigger-than-expected decline in economic growth and trade flows. Incoming data confirm that activity remained subdued in world markets in the third quarter of 2019, with a sustained deterioration in both business confidence and in the global manufacturing Purchasing Managers' Index. In 2019, GDP growth should only reach 2.6 percent for the world and 4.0 percent for emerging countries, down, respectively, from 3.0 percent and 4.3 percent in 2018 (Figure I.1). The decline in economic activity has been accompanied by a sustained decrease in world trade volumes, which fell by 2 percent in August 2019 (Figure I.2). The slowdown in economic activity has persisted despite increasingly more accommodative monetary policy by almost all central banks. Such policy has not been able to compensate for the increasing uncertainty generated by the trade tensions between the United States and its major partners, or by the risks associated with Brexit.

Figure I.1. Global economic growth



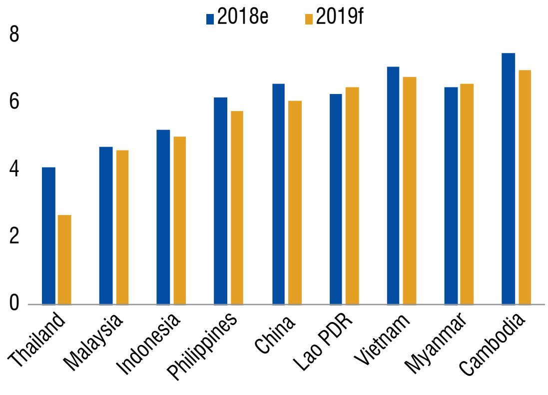
Source: World Bank.

Figure I.2. World trade and industrial production



Source: IMF.

Figure I.3. East Asia and Pacific GDP growth projections



Source: World Bank.

Regional growth in East Asia has followed the global declining trend as most economies are highly dependent on global markets. Growth in developing East Asia and Pacific economies slowed to 6.0 percent (y/y) in the first half of 2019, from 6.5 percent in the first half of 2018 (Figure I.3). Weakening external demand combined with global trade policy uncertainty have been weighing on the regional activity through declining exports, deteriorating business confidence, and weakening investment. In China, heightened trade tensions with the United States have contributed to the gradual economic slowdown. Growth in the region's other large economies has also moderated, and the recovery in manufacturing observed at the beginning of the year proved to be short-lived. Despite the overall deceleration, the region remains a key driver of global economic activity, due to its strong fundamentals, accounting for over one-third of global growth.

II.2. RECENT ECONOMIC DEVELOPMENTS IN VIETNAM

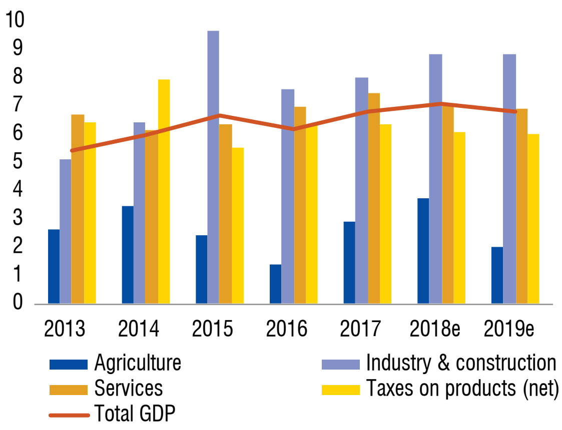
Amidst an unfavorable external environment, Vietnam's economy remains resilient

Despite a challenging global environment, Vietnam's economy has demonstrated its resilience, supported by robust private consumption and manufacturing exports. After a moderation in the second quarter, growth has rebounded by an estimated 7.3 percent in the third quarter, bringing y/y growth to nearly 7 percent in the first three quarters of 2019. The estimated GDP growth rate for 2019 should be around 6.8 percent, slightly lower than in 2018 and at par with the performance reported in 2017. This growth rate should be one of the fastest in the world and among the top two in East Asia, behind Cambodia but faster than China.

The robust GDP growth rate has been driven by the strong performance of the industrial sector (up by 9.6 percent in the first nine months of 2019), in line with the trend observed since 2015 (Figure I.4). Faster growth in manufacturing helped compensate for the relative slowdown in construction, the latter caused by the decline in the government's investment program. By contrast, the agricultural-forestry-fishery sector, which suffered from unfavorable climatic conditions, low world prices, and an outbreak of African swine fever virus, expanded by only 2 percent during the first nine months of 2019, with a relatively sharp decline in growth in agriculture output (only 0.7 percent compared to 2.9 percent a year ago). The service sector has continued to expand around 7.0 percent, fueled by relatively fast-growing domestic demand and urbanization, and by the good performance of modern sectors such as telecommunications, finance, and transport.

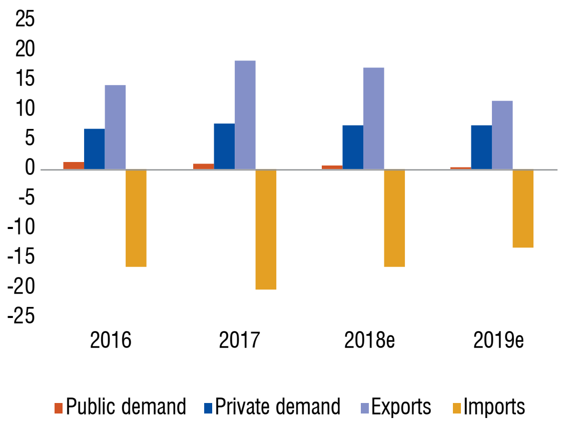
On the demand side, the GDP growth rate has been supported by both exports growth and domestic demand by the private sector (Figure I.5). The external sector has been the traditional driver over the past decade, and its role has been confirmed in 2019, with a relatively rapid expansion of exports and an estimated contribution to GDP growth of almost 12 percentage points. The contribution of private consumption has been an emerging trend in the last few years as the result of the growing middle class, which accounts for approximately 10 percent of the population. It is estimated that approximately 1 million people are moving into the middle-class category every year, boosting the demand for consumption goods and housing. Fueled by rising real income and subdued inflation, retail sales rose steadily by 11.8 percent in nominal terms (9.4 percent in real terms) in the first 10 months of 2019. Such demand has also been partly met by an increase in imports of consumption goods (up on average by 15 percent since 2015). The investment by the private sector also rose by almost 17 percent during the first three quarters of 2019, also contributing to the robust GDP growth rate.

Figure I.4. GDP and sector growth (%, y/y)



Source: GSO and World Bank estimates.

Figure I.5. Contribution to GDP growth (pps)

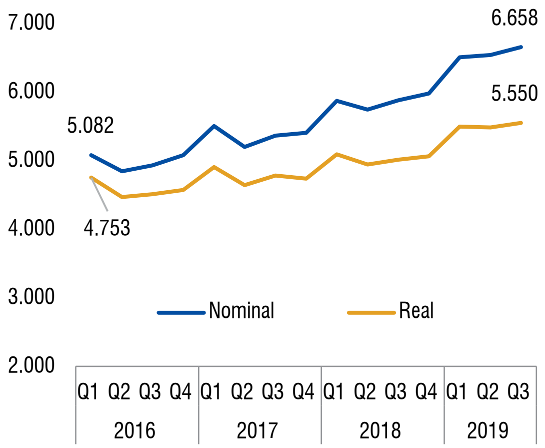


Source: GSO and World Bank estimates.

By contrast, the contribution of the public sector to GDP growth has continued to remain marginal due to the consolidation policy adopted by the government since 2015/16. The level of (net) spending has decreased as the result of higher-than-projected revenue and the slow execution of the investment budget (see fuller details in Box I.1). The estimated contribution of the public sector should only be 0.4 percentage points of GDP, three times lower than in 2016.

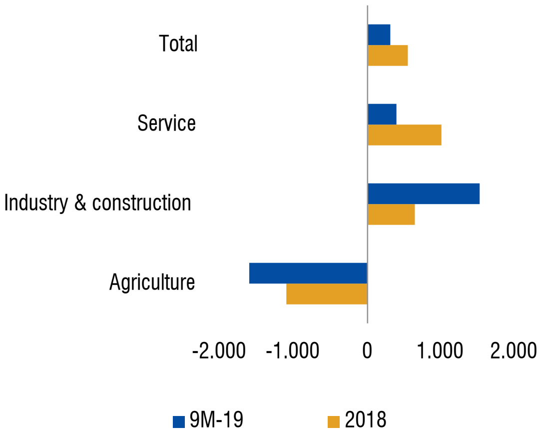
Vietnam's resilient economy continues to create new jobs and increase the real wage. Real disposable household incomes are benefiting from low inflation, an expanding wage sector, and a robust nominal wage growth, which reached 13.1 percent (10.5 percent in real terms) during the first nine months of 2019 (Figure I.6). The labor force has continued to move away from the agriculture sector (1.6 million jobs lost in the first nine months of 2019) toward industries and services (2.5 million new jobs) (Figure I.7). This shift has also contributed to higher wages as workers are moving from low to high productive activities. The combination of higher real wages and more productive jobs has led to a further decline in poverty rates, with extreme poverty now estimated to have fallen to less than 2 percent, using as a reference the international poverty line (US$1.90 per day).

Figure I.6. Monthly wage average
(thousand dong)



Source: GSO.

Figure I.7. Employment by sector
(net, thousand people)

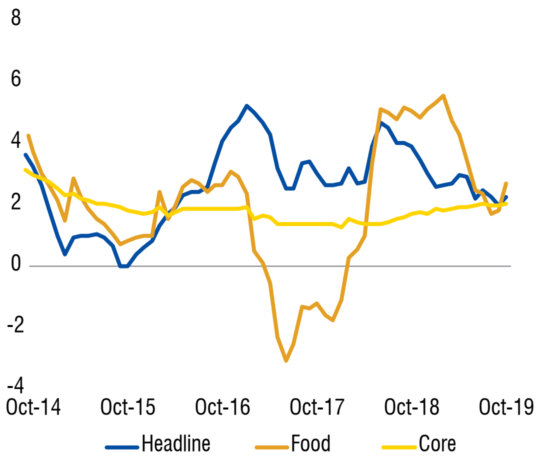


Source: GSO.

Subdued price pressures and easing monetary policy stance

Headline inflation remains subdued in 2019. Headline inflation (y/y) was at about 2.2 percent in October 2019, decelerating from 3 percent in December 2018 (Figure I.8). The outbreak of swine fever and unfavorable weather conditions have not led to higher food prices, which increased by only 2.7 percent in October 2019 compared to 5.1 percent in December 2018. Softening fuel prices helped maintain transportation costs over the past year. The main factor behind the inflation rate in 2019 (contributing to about a third) has been the adjustment in prices of health care and education services administered by the government, in an effort to bring them closer to cost recovery.

Figure I.8. Consumer price index (%, y/y)



Source: GSO.

Figure I.9. Credit growth (%, y/y)

Source: SBV.

Monetary policy continues to balance growth and stability objectives. Credit growth is estimated to have expanded by about 12.5 percent (y/y) as of September, which is below the State Bank of Vietnam (SBV) target of 14 percent for the entire year of 2019 (Figure I.9). In September 2019, amidst subdued inflation pressures, the State Bank of Vietnam eased its policy stance by cutting its rediscount rate and refinancing rate by 25 basis points to 4.0 and 6.0 percent, respectively—the first adjustment since July 2017. The decision, effective September 16, 2019, was prompted by the further slowdown in global markets, following the same move by many other central banks in the world and in the region. The cut of policy rates is expected to ease liquidity for banks, which could in turn provide more credit to the economy. Effective from November 19, 2019, the SBV cut interest-rate caps on dong deposits (by 0.2 and 0.5 percentage points on one-month and six months deposits). It also lowered the cap of short-term lending rate to 6 from 6.5 percent to support businesses, particularly in agriculture, small enterprises, high-tech industries and exporters. Given the weak monetary policy transmission in Vietnam, the SBV continues to manage financial risks through non-interest rate measures, such as caps on credit growth (for the entire banking system and each individual bank, as well), and other macroprudential measures. It has maintained regulations limiting loans to the real estate sector (chiefly for luxury apartment purchases where speculation occurs) or high-risk segments (for example, stocks and securities).

The SBV has continued to pursue its strategy aimed at further reducing the dollarization of the financial sector. According to SBV data, the share of foreign currency deposits in total deposits of the banking system has falling from 10.8 percent in December 2015 to about 7.7 percent in June 2019. Concurrently, the share of lending in foreign currency has also decreased from 9.1 percent to 6.5 percent. In addition to maintaining the zero-interest rate policy on US$ deposits (introduced in 2015), the SBV-issued Circular 42/2018/TT-NHNN has prohibited short-term foreign currency loans by the turn of 2019, and medium- and long-term foreign currency loans as of October 2019. Importers are now required to purchase foreign currencies. These measures are in line with the objective of eliminating all foreign currency borrowing and reducing foreign currency deposits/overall deposits to less than 5 percent by 2030, as set forth in the Banking Sector Strategy, promulgated by the Prime Minister's Decision 986 in 2018.

Overall banking sector stability has continued to improve, reflecting some progress with nonperforming loan (NPL) resolution and higher profitability in the banking sector. The reported NPL ratio was below 2 percent at the end of Q 3 (and below 5 percent when Vietnam Asset Management Company [VAMC] debts are accounted for). The implementation of Resolution 42 has significantly helped the credit institutions and VAMC accelerate bad debt resolution. According to SBV statistics, for two years (August 2017–August 2019), VND 9.6 trillion of bad debt was resolved per month, or VND 4.7 trillion higher than the monthly average in the pre-Resolution 42 period. Not only have reported NPLs been improved, but the hidden bad debts from SOEs and off-balance-sheet debts have also reported progress, as their weight in bank portfolios declined from 7.6 percent at end-2016 to 3.9 percent at end-Quarter 1 of 2019. Active measures including seizing and sales of collateral (land, buildings, and so forth), procyclical debt restructuring, and the sales of bad debts, have yielded these positive results.

Undercapitalization of the banking system remains a challenge as, at end-September 2019, only 12 of 45 banks operating in Vietnam reported a Capital Adequacy Ratio in line with the Basel II requirements (supported by Circular 41 issued in 2016 on prudential ratios, and Circular 23 issued in 2018 on internal audit). Attempts to raise capital by commercial banks have met challenges such as the cap on foreign ownership, high state ownership, and possible excessive exposure in high-risk sectors.

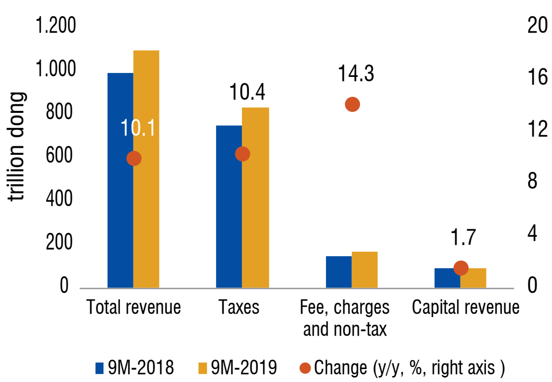
Fiscal consolidation in progress

The government has continued the consolidation of its fiscal accounts with the objective of further reducing the public debt. The level of public borrowing should reach about 56 percent at end-2019, almost 8 percentage point lower than the peak reported in 2016. By following a countercyclical fiscal policy, the authorities have not only sent a strong and positive signal to markets about their commitment to macroeconomic and debt sustainability, but they have also created additional fiscal space.

As Vietnam is one of the countries with the most important fiscal decentralizations in the world, it would be critical to better understand the fiscal accounts of local governments both at the consolidated and individual level. However, official data are only available for one year (2017), preventing an analysis of recent trends.[1] The 2017 information confirms that approximately 44 percent of total revenues and 58 percent of total expenditures were executed by local governments. The share of capital spending under the responsibility of local authorities reached 78 percent of the total public investment program.

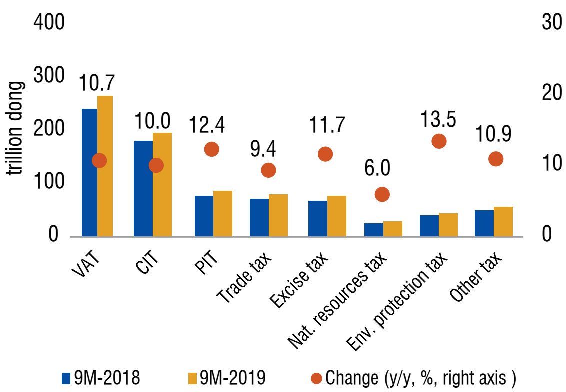
Revenue collection in the first nine months of 2019 is estimated to have increased by 10 percent (y/y), achieving 77.5 percent of the annual budget plan (Figure I.10). Revenue performance was the combination of higher non-tax (up by 9.4 percent) and tax revenues (up by 10.4 percent). Collection of the value-added tax (VAT) increased by 10.7 percent, while corporate income tax (CIT) and trade tax revenue rose by 10 percent and 9.4 percent, respectively. Revenue from the personal income tax (PIT) also strengthened, up 12.4 percent, thanks to a sustained effort to broaden the tax base (Figure I.11). These positive results are explained by recent administrative reforms including the introduction of transfer pricing audits and improved tax arrears management. While these reforms are useful, they appear insufficient to revert the declining tax revenue effort observed over the past few years (see Box I.1).

Figure I.10. State budget revenue by sources



Source: MOF.

Figure I.11. Tax collection by type



Source: MOF.

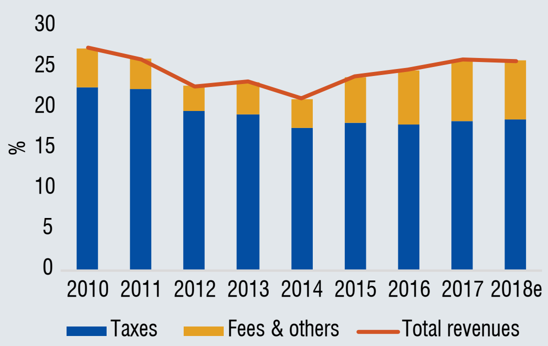
1 The Ministry of Finance started to report details of central and local fiscal outturns in 2017.

Box I.1. Tax reforms for sustainable growth

Over the past decade, Vietnam's tax effort has declined from 23 percent of GDP in 2010 to about 18 percent of GDP in 2018, even if a small rebound has occurred since 2015 (Figure I.12). This decline has resulted from the combination of lower trade tax revenue, mostly customs duties (due to Vietnam's international commitments), and declining revenue from the corporate income tax, as the government reduced the statutory rate with the aim of stimulating the economy (Figure I.13). If an increase in non-tax revenue has enabled the government to collect more revenue since 2015, this has been mainly the result of one-time transactions such as sales of land user rights, sales of state-owned houses, and dividends from and divestment of state-owned enterprises. It is also explained by the reclassification since 2017 of the revenue from the lottery as tax revenue, which contributed to the increase in tax revenue (0.6 percent and 0.5 percent of GDP in 2017 and 2018, respectively).

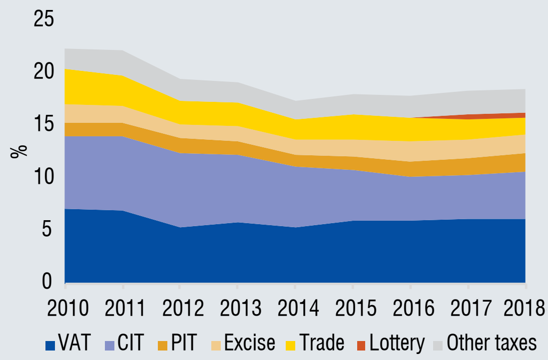
The declining trend in revenue collection is a source of concern as it has serious consequences for the fiscal policy conducted by the government, especially on its investment program. Unless the authorities opt to borrow more, additional domestic revenue will be needed to meet the country's ambitious targets in terms of infrastructure and social developments. In the short term, the government can continue to focus its attention on closing loopholes in the existing tax system. For example, the recent adoption of Decree 20 should help protect Vietnam against profit shifting by multinational firms, even though further clarification is needed over the application of the rules.

Figure I.12. Budget (% of GDP)



Source: MOF.

Figure I.13. Tax revenues (% of GDP)

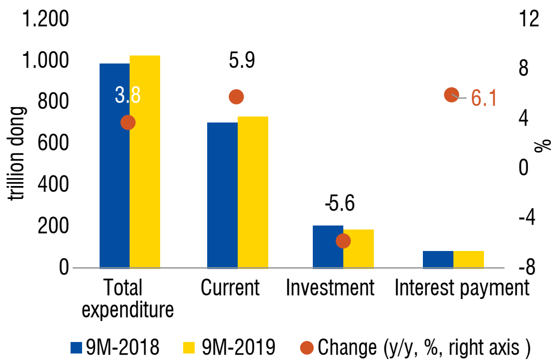


Source: MOF.

In the longer run, however, the government needs to consider a more ambitious tax reform program as part of its new national strategy for 2021–30. The reform strategy would guide the next phase of tax reforms to reverse the declining tax effort and stabilize it over the medium term, while attaining the desirable features of a good tax system. Vietnam should use the process to widely discuss key reform initiatives, such as rebalancing the tax mix for better growth and equity, considering the introduction of new tax instruments such as a property tax, and modernization of tax administration, including institutional reform, comprehensive compliance risk management, and further digitalization.

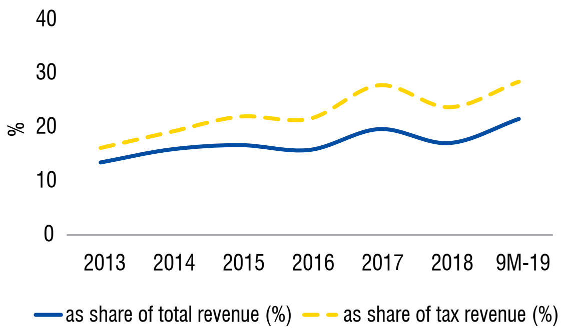
Public spending contracted, relative to GDP, in the first nine months of 2019 compared to the same period a year ago (Figure 1.14). Recurrent expenditure (including administration, wages and salaries, social security, and pensions) rose by 5.9 percent, while debt service payments (including interest payments and amortization) increased by 6.1 percent between 2018 and 2019. The debt service payments now account for nearly 22 percent of total revenue, which is not only more than double that in 2013, but relatively high by international standards (Figure I.15).

Figure I.14. Slowing budget expenditures



Source: MOF.

Figure I.15. Debt payment from state budget

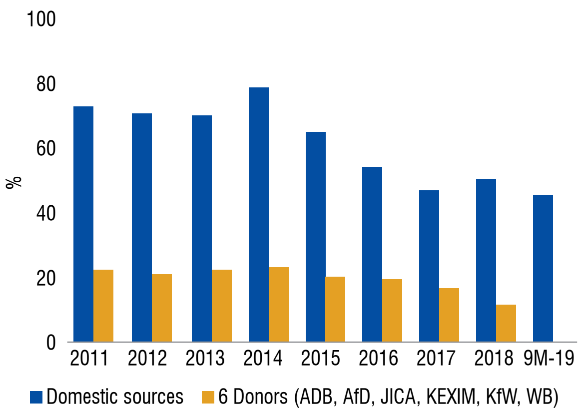


Source: MOF.

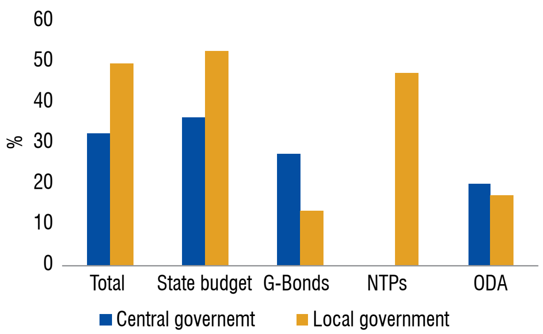
The low level of public expenditure in 2019 is mainly explained by capital spending, which declined by 5.6 percent between 2018 and 2019. While part of this decline is due to the consolidating fiscal policy followed by the government, it also reflects the low disbursement rate of the approved investment program by the Parliament. It is estimated that the execution rate of capital expenditures was only 49 percent during the first three quarters of 2019. This rate is low compared to the execution rates during 2011–14, but not far from the rates reported in 2017 and 2018. It also masks significant variations across ministries and agencies (from 0.2 percent to 100 percent) and among provinces (Figure I.16). The slow disbursement rate of the overall public investment program has become a major concern for the government, which took a series of remedy measures in June 2019 (see Box I.2).

Figure I.16. Public investment disbursement ratio, January–September 2019

Domestic sources compared to ODA



Central compared to local government



Sources: ADB, AFD, JICA, KEXIM, KfW, MOF, and World Bank.

Box I.2. Slow disbursements of public investment in Vietnam

While the government was able to disburse about 70 percent of its investment program during 2011–14, this rate declined to about 55 percent in 2017 and 2018, and was only equal to 49 percent during the first nine months of 2019. This decline is explained by the combination of three major factors:

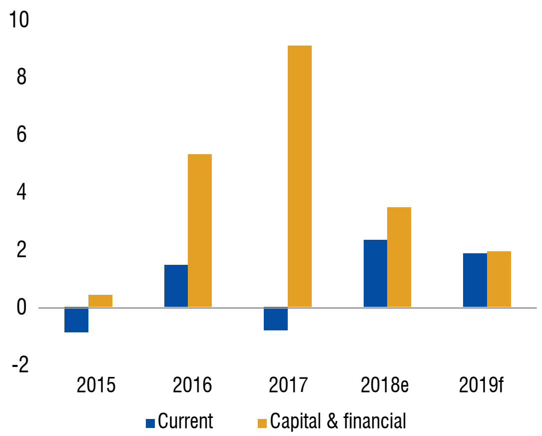
1. As part of the consolidated fiscal policy initiated in 2016, the authorities have set strict borrowing ceilings with the aim of reducing the debt-to-GDP ratio to more sustainable levels. As a result, the execution rate has been much lower for projects financed by borrowing than projects financed by domestic revenue. During the first nine months of 2019, only 18.8 percent of externally funded projects were executed, while the corresponding figure for domestically funded projects was over 50 percent.
2. The introduction of the new Public Investment Law (PIL) 2014 (in effect from January 2015) was accompanied by the first-ever medium-term investment plan (MTIP). While useful, the implementation of this plan was more complex than envisioned, leading to unexpected delays in the approval of investment projects, as their inclusion in the MTIP became mandatory for receiving funds. The approved MTIP (which was a top-down decision process) also led to a mismatch between the medium-term supply and the demand for investment capital requested by ministries on a yearly basis.
3. The substantial and increasing delays generated by the procedures to allocate and transfer funds also contributed to the decline in disbursements. The approval process starts with the National Assembly and then goes to the Office of the Prime Minister, the Ministry of Planning and Investment, and, ultimately, to implementing ministries and agencies. The new procedures incorporated in the Construction Law (2014) are also viewed as another important source of delay. As a result, in 2019, some key spending ministries received their funds only in June.

The government amended the PIL 2014 to address the above factors. The amended PIL, promulgated in June 2019, introduces some flexibility to the MTIP by allowing an annual update mechanism. It also introduces a mechanism to ensure the continuity of project preparation between consecutive MTIPs, by allowing each MTIP to commit up to 20 percent above the total estimated investment cost for projects implemented in the following MTIP. Additional important changes include the delegation of fund review authority from the Ministry of Planning and Investment (MPI) and MOF to provinces for projects using provincial funds, and the possibility for spending agencies to allocate funds among projects to facilitate their implementation.

Strong external position despite lackluster global demand

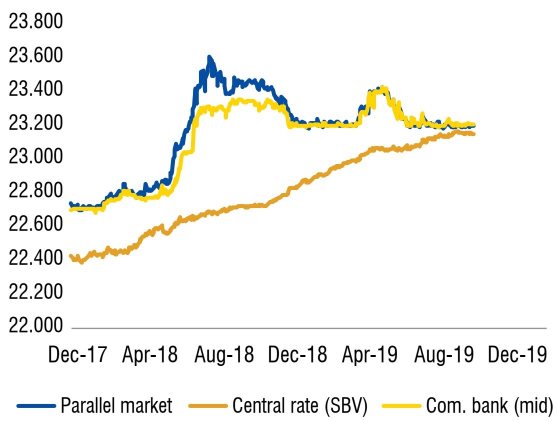
Vietnam's external position remains strong in 2019, with a current account surplus of approximately 2 percent of GDP, underpinned by a widening trade surplus and robust FDI inflows (Figure I.17). Such stability emphasizes Vietnam's external sector resilience at the time when global and emerging markets are suffering from declining trade and investment flows. Only a handful of East Asian countries have not reported a severe decline in their export growth and FDI inflows over the past 12 months. The stability of its external balance helped Vietnam accumulate more international reserves, which increased by 0.4 equivalent months of imports between December 2018 and June 2019. The value of the local currency has also remained stable on the commercial and parallel markets (around VND 23,200 per U.S. dollar), even though the SVB has devaluated its rate by about 3.5 percent since January 2018 (Figure I.18).

Figure I.17. Balance of payments (% of GDP)



Source: SBV.

Figure I.18. Nominal VND/US$ exchange rate



Source: SBV.

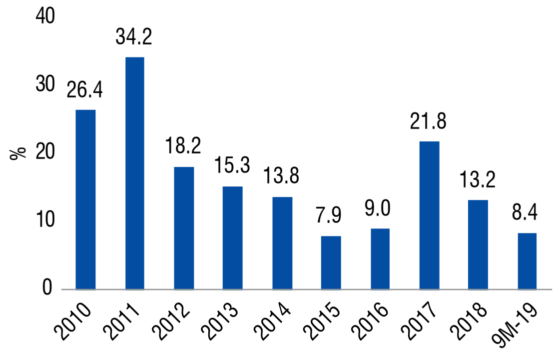
The SBV continues to carry out a market-driven management of the exchange rate-a key instrument to absorb the impact of external volatility on the domestic economy. While maintaining a crawling exchange rate peg, the SBV has been setting a daily reference rate in line with the market, instead of periodic one-off devaluations that were used in the past. Although the local currency has slightly depreciated compared to the U.S. dollar (in nominal terms) over the past 12 months, the real effective exchange rate has appreciated by about 2.8 percent since January 2019 and 4 percent since January 2015.[2] This real appreciation of the dong has been the market response to Vietnam's current account surplus but could create adverse impacts on Vietnam's export competitiveness in the longer term.

While Vietnam's export performance remains exceptionally strong, the sector has not been completely insulated from weak external demand and an uncertain global environment. Vietnam's total exports are estimated to have expanded by 8.4 percent in the first nine months of 2019 compared to 15.8 percent during the same period last year (Figure I.19). This slowdown partly reflects the impact of lower global oil prices on the value of crude oil exports, which declined by 10 percent between 2018 and 2019 (Figure I.20). Agricultural exports also declined by 6 percent, with a reduction in coffee and rice exports of 21 percent and 10 percent, respectively.

2 Based on World Bank data.

Figure I.19. Export growth

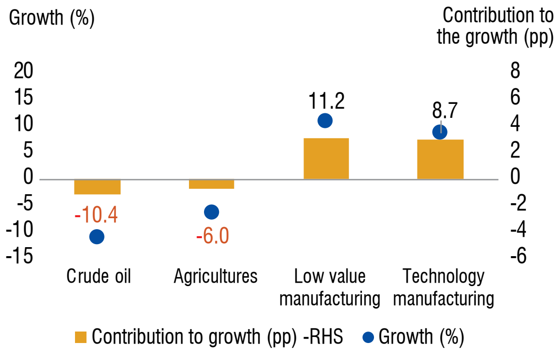
(%)



Source: Vietnam Customs.

Figure I.20. Contribution to export growth by sector

(percentage points, by export items)



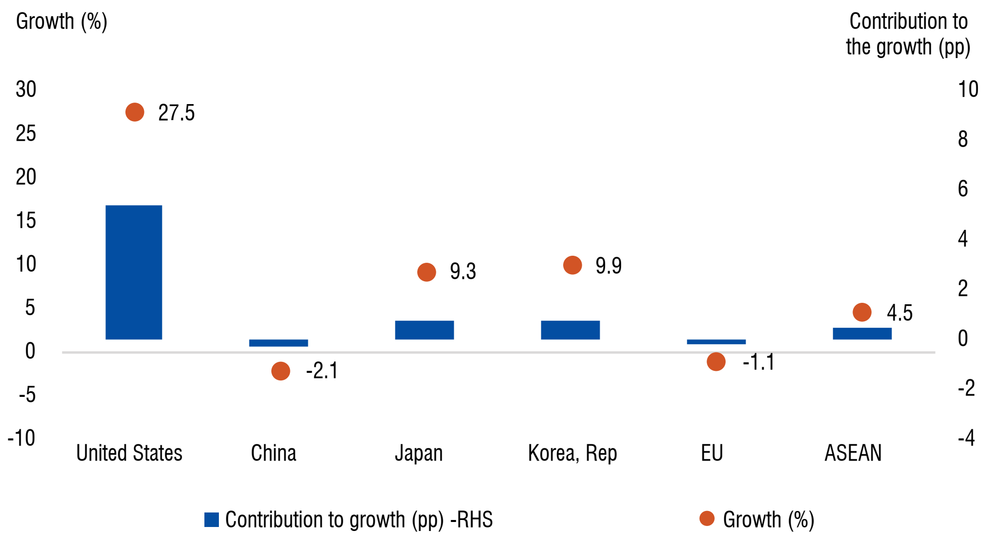
Source: Vietnam Customs.

Manufacturing continues to be the key driver of Vietnamese exports, expanding by over 10 percent between the first nine months of 2018 and the corresponding period in 2019. Low-value manufacturing exports (garments and textile, footwear, furniture, travel goods) expanded by 11.2 percent (y/y) compared to 13.7 percent a year earlier, while technology manufacturing exports (for example, smart phones, computers and electronics, cameras) rose by 8.7 percent compared to an increase of 17.7 percent in 2018.

The overall strong performance of Vietnam's manufacturing exports sector masks significant variation across destinations. Growth in exports to the U.S. market reported a jump of almost 28 percent during the first nine months of 2019), which is more than 10 points faster than in 2018 (Figure I.21). Concurrently, the growth of exports to non-U.S. markets fell to only 3.8 percent during the first nine months of 2019, down from 12 percent in 2018. This tends to suggest that Vietnam has benefited from export diversion following the escalating China-U.S. trade dispute rather than an overall improvement in its competitiveness in global markets (see Box I.3).

Figure I.21. Contribution to export growth, selected countries

(percentage points, by export markets)

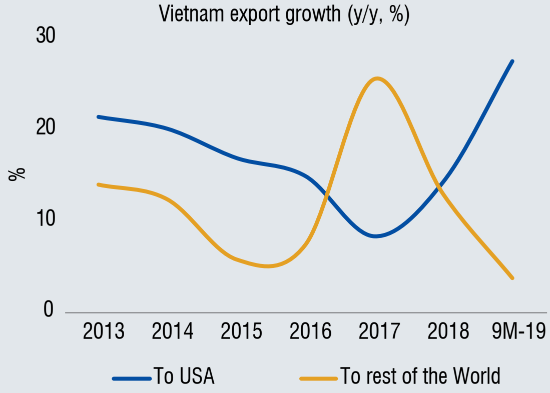


Source: Vietnam Customs.

Box I.3. How to explain the export resilience in Vietnam?

Vietnam's exports are expected to increase by about 10 percent during 2019, but this overall rate reflects two different trajectories (Figure I.22).On the one hand, it reflects an acceleration of the growth rate toward the U.S. market (up by over 10 percentage points between 2018 and 2019) and, on the other hand, a slower rate of expansion toward the non-U.S. markets (down by almost 10 percentage points).

Figure I.22.The boom in exports from Vietnam is recent and unique to the U.S. market



Source: Vietnam Customs.

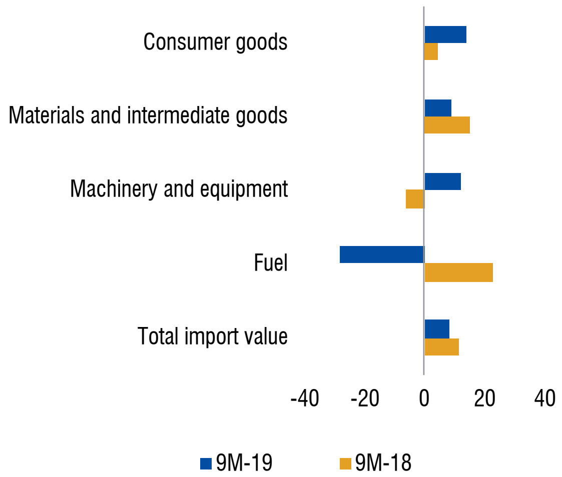
For those reasons, the recent boom in exports to the U.S. must be rooted in the recent change in U.S. trade policy - the increase in tariffs on a wide range of Chinese exports. The subsequent market response to the change in relative prices was therefore to substitute the demand for Chinese products by similar but cheaper products coming from other countries. This substitution effect has worked at full speed for Vietnam, as illustrated in Figure I.23. For example, U.S. importers purchased more phones from Vietnam (up by 6 percent) to compensate for the decline from China (down by 8 percent). The same effect can be observed for computers, low-tech manufacturing, and apparel - which are all considered "footloose" sectors where investors can move relatively easily from one location to another because of low fixed investments. This substitution effect was bigger in Vietnam than in other Asian countries because of its proximity to the Chinese market and similar production footprints (same sectors).

Figure I.23. Trade substitution between Vietnam and China, 2019

Source: The U.S. Census Bureau. Import data from January to August 2019.

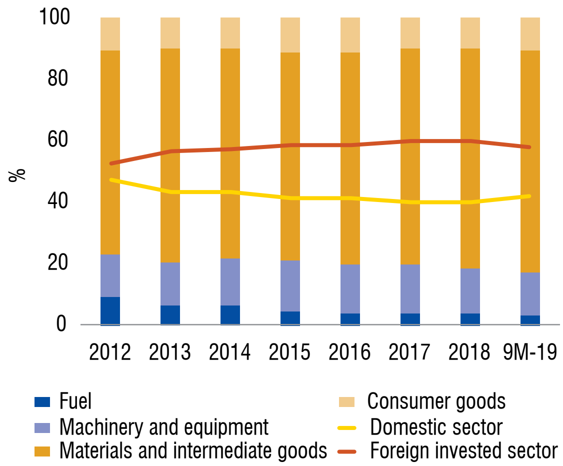
The import growth rate declined to 8.4 percent (compared to 11.5 percent in 2018) during the first nine months of 2019, driven by a slower demand for imported fuel, material, and intermediate goods (steel and other metals, plastic and chemical materials, cotton, fabrics, phone parts, fertilizer, animal feed, and so forth). Such a decline can be linked to the slowdown in exports, as a great share of inputs are purchased from abroad by exporting firms. By contrast, imports of machinery and equipment increased steadily, by 12.3 percent in the first nine months of 2019, indicating the rebound in private investment described earlier. Finally, imports of consumer goods rose strongly by 14.2 percent (y/y) reflecting buoyant demand by households, especially for automobile imports, which rocketed by 2.7 times in value between 2018 and 2019.

Figure I.24. Import growth (y/y, %)



Source: Vietnam Customs.

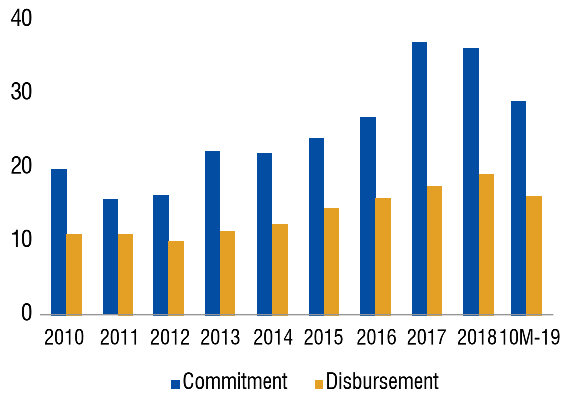
Figure I.25. Import composition (% of total)



Source: Vietnam Customs.

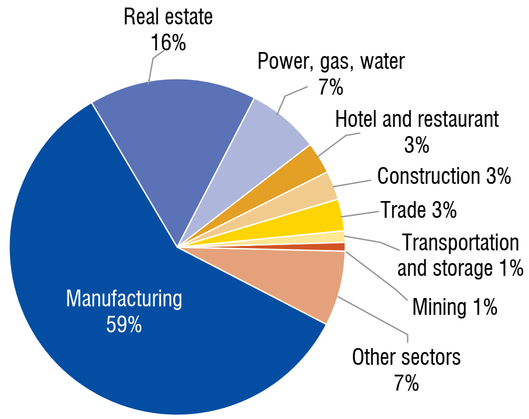
Foreign direct investment (FDI) remains the most important source of external capital for the Vietnamese economy, amounting to an estimated US$29 billion (in registration) in the first 10 months of 2019 (Figure I.26). This amount is equivalent to the one reported in 2017 and 2018, which underscores the resilience of the Vietnamese economy amidst an uncertain global context. With some of the lowest labor costs in the world, a strong openness to trade (Vietnam has signed more trade agreements than any other country in the EAP region), and an advantageous geographic location, Vietnam has been a major destination of FDI over the past decade. By the end of October 2019, more than 100 countries and territories had invested in Vietnam, with total accumulated FDI commitments of around US$358 billion in manufacturing industries, real estate, and power and gas (Figure I.27). Currently, foreign-owned firms account for about 20 percent of Vietnam's GDP, contribute to a quarter of tax revenue, and have created millions of direct and indirect jobs. Foreign companies represent about 70 percent of the country's exports, with over half of them from electronics and one-quarter from just one company (Samsung Electronics Vietnam).

Figure I.26. FDI commitment and disbursement
(US$ bn)



Source: MPI.

Figure I.27. Accumulated FDI by sector
(% of total)

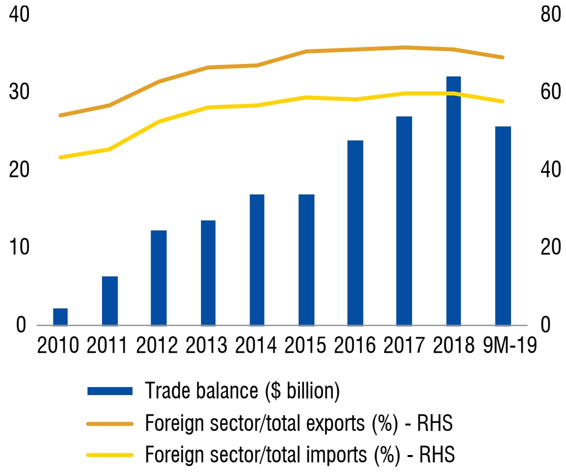


Source: MPI.

The concentration of FDI in low-skilled manufacturing and the well-publicized weak links with domestic firms have raised concerns among Vietnamese policy makers. As captured in Figure I.28, if FDI companies contribute greatly to Vietnam's fast exports expansion, they are also a major source of imports. On average, for every US$1 exported by a foreign-invested company from Vietnam, it is estimated that around US$0.50 has been used to purchase inputs from abroad, which is relatively high by international standards.[3] Another concern is that FDI has concentrated in low manufacturing exporting industries, with a modest perspective for higher real wages for the local labor force (Figure I.29). The Politburo of the Communist Party (the highest decision-making organ in Vietnam) recently adopted its first-ever resolution with the aim of improving quality and efficiency of foreign investment through 2030. The resolution encourages the foreign-invested sectors to develop, cooperate, and compete equally with other economic sectors, but also emphasizes that Vietnam will attract foreign investment in a selective manner, focusing on quality, efficiency, technology, and environmental protection. Priority will be given to projects that use advanced technology and modern management with high added value and spillover effects and are able to connect to the global production and supply chain. The resolution sets forth the overall goal of making policies and regulations on foreign investment cooperation more competitive to serve international integration and meet the requirements of growth model reform; economic restructuring; environmental protection; effective solutions to social issues; and improvement of quality, efficiency, and competitiveness of the economy.

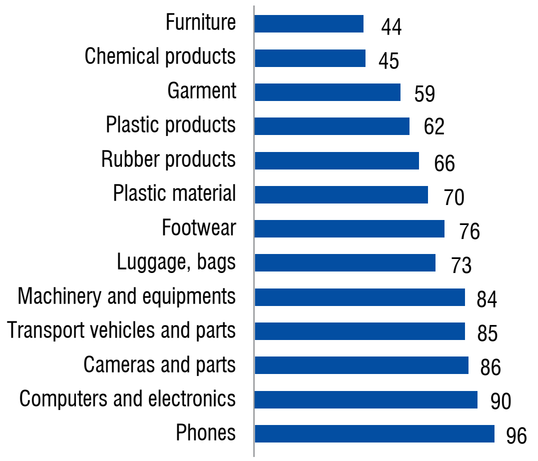
3 According to the OECD, the import content of exports in Vietnam is five to six times higher than for high-income countries such the United States and Japan. The import content in Vietnam is equivalent to Malta's or Luxembourg's, which are considered "transit" destinations.

Figure I.28. Exports-imports of the foreign sector *(growth in %)*



Source: Vietnam Customs.

Figure I.29. Foreign sector in manufacturing exports *(% of total)*

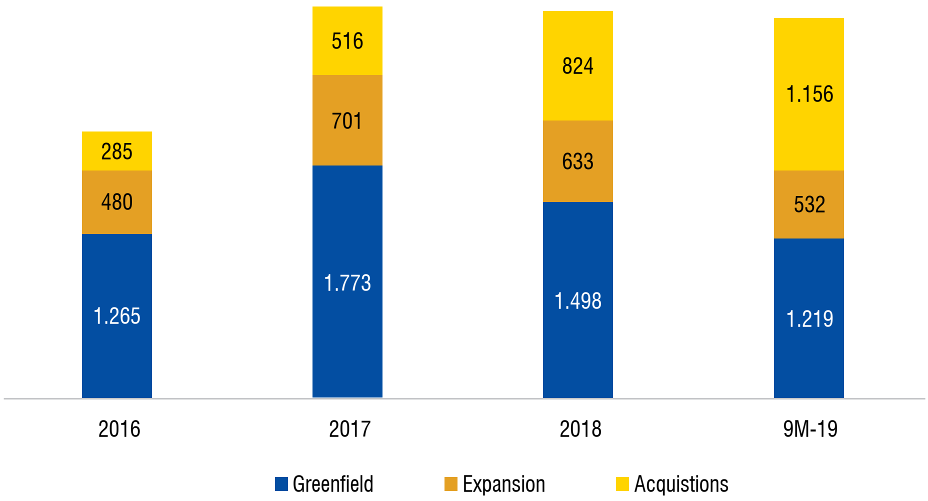


Source: Vietnam Customs.

Recent official data on FDI patterns suggest a possible shift from greenfield to mergers and acquisitions (M&A) since 2017 (Figure I.30). On the one hand, greenfield FDI has declined significantly—by 15 percent in 2018 and by a further 22 percent in the first nine months of 2019. On the other hand, the value of capital contribution and equity purchases of local companies by foreigners has moved from a modest US$0.28 billion per month in 2016 to US$1.2 billion per month during the first nine months of 2019. While it might be too early to draw conclusions, this may reflect two emerging trends. The decline in greenfield projects can be associated to the deterioration of the global environment, where international investors have become more prudent, including toward Vietnam. The gradual increase in M&A could be the result of the stronger interest by foreign firms in domestic consumers, who have become more demanding in recent years. This interest has been encouraged by the privatization program (resulting in purchases of SOEs) and by easier procedures to acquire licenses than for greenfield projects.[4] The decline in greenfield investment, if sustained, may lead to slower export growth in the future, as the main motivation behind such investments has been traditionally to take advantage of low labor costs and then to dispatch production to global markets. The expected impact of M&A can be positive if the new owners bring updated technologies to existing firms. As one point of evidence, research shows that foreign M&A tends to lead to increased R&D investment in the acquired firm, whereas domestic M&A results in less R&D spending.[5] However, these acquisitions could be simply the transfer of assets from one locale to a foreign owner.

4 For example, Saigon Beverage Company (SABECO) was sold to a Thai company for US$4 billion in 2017.
5 Bertrand and Zuniga 2004.

Figure I.30. The shift in foreign investment in Vietnam *(monthly average, US$ million)*



Source: MPI.

I.3. MEDIUM-TERM ECONOMIC OUTLOOK AND RISKS

Vietnam's medium-term outlook remains positive

Real GDP is expected to grow at around 6.8 percent in 2019 and then to converge gradually toward 6.5 percent in the next three years, in line with potential output (Table I.1). The agriculture sector is expected to rebound from a relatively poor performance in 2019, thanks to improved sanitary and climatic conditions, while the service sector should continue to expand in response to growing domestic demand. This baseline scenario assumes that the Vietnam export sector will only be moderately affected by the slowdown in global markets, which should gradually recover according to the latest IMF and World Bank projections for 2020 onward. The contribution of the public sector will increase marginally through efficiency gains in the execution of the investment program, which should be improved by the recent measures adopted in June 2019. Further reforms in the strategic areas of SOEs and financial market, as well as the development of value chains (including through linkage programs with FDI firms), should enhance private sector expansion and generate productivity gains.

Inflation should remain around 3 percent on a yearly basis even if some pressures could emerge in the near term on account of planned increases in several administrative prices by the government. Food prices will also remain sensitive to climatic conditions but are forecasted to grown moderately as the result of the improved performance of the agriculture sector. Overall, the monetary authorities should maintain their prudent policy stance, keeping money supply and credit growth in line with the projected expansion of the economy, and closely monitoring the stability of the banking sector, which remains undercapitalized and vulnerable to nonperforming loans.

The current account is expected to slightly deteriorate, and the export growth rate should decline due to the slowdown in the demand by foreign markets. This lower rate should be partly offset by a reduction in imports due to the close correlation between these two variables in Vietnam. The level of FDI inflows is projected to remain stable even if the shift toward more acquisitions and less greenfield projects continued, partly reflecting the growing interest of foreign investors in the domestic market.

The government is projected to reduce its fiscal deficit gradually, from 3.4 percent of GDP in 2019 to 3.2 percent of GDP in 2021, in line with its commitment to further reduce the public debt. Such target should be attained through an increase in domestic revenue, as the result of a series of policy and administrative reforms. Improving tax collection is not only important for efficiency and equity reasons, but also for financing the projected increase in capital expenditures that will be requested to meet the ambitious targets in terms of social and infrastructure spending. The government will increase the allocative and financial efficiency of expenditure through improved planning, selection, and implementation of projects.

Table I.1. Vietnam selected economic indicators

	2017	2018e	2019e	2020f	2021f
GDP growth (%)	6.8	7.1	6.8	6.5	6.5
Consumer price index (annual average, %)	3.5	3.5	3.0	3.3	3.3
Current account balance (% of GDP)	-0.7	2.3	1.9	1.4	1.3
Fiscal balance (% of GDP, MOF)	-2.7	-3.5	-3.4	-3.4	-3.2
Fiscal balance (% of GDP, GFS)[a]	-4.7	-4.4	-4.4	-4.2	-3.9
Public debt (% of GDP, MOF)	61.4	58.4	56.1	54.3	53.3
Public debt (% GDP, GFS)[b]	58.2	55.6	54.4	53.3	52.5

Sources: GSO, IMF, MOF, SBV, and World Bank.

Note: a. Excluding extrabudgetary funds. b. Excluding cross-debt among government entities.

Growing risk and mitigation measures

This medium-term outlook is subject to several downside risks on both the domestic and external fronts. Domestically, delayed implementation of structural reforms may worsen medium-term growth prospects. The privatization program and the restructuring of SOEs, after a promising start in 2017, has already slowed considerably in recent months. On the external side, trade disputes between major economies could undermine export momentum over the short term, while Vietnam's economy remains susceptible to a further slowdown in the global economy through trade and investment channels. The interest of foreign investors might also cool, as many of them might postpone or cancel their projects. If both exports and FDI inflows were to slow, the Vietnamese economy would lose its main engine of growth.

The possible reduction in foreign demand could, in principle, be mitigated by a fiscal stimulus, which would increase the domestic demand in the short term. Such a policy move would have to be closely monitored as the level of public borrowing remains relatively high despite recent progress in reducing the debt to GDP to around 56 percent, significantly lower than the threshold set by the government at 65 percent. The 2018 Debt-Sustainability Analysis conducted by the IMF suggests that the threshold level should be closer to 55 percent of GDP for long-term debt and fiscal sustainability.[6] The government should rather focus its policy response on further improving the quality of its spending, which still suffers from weak allocative and financial efficiencies.

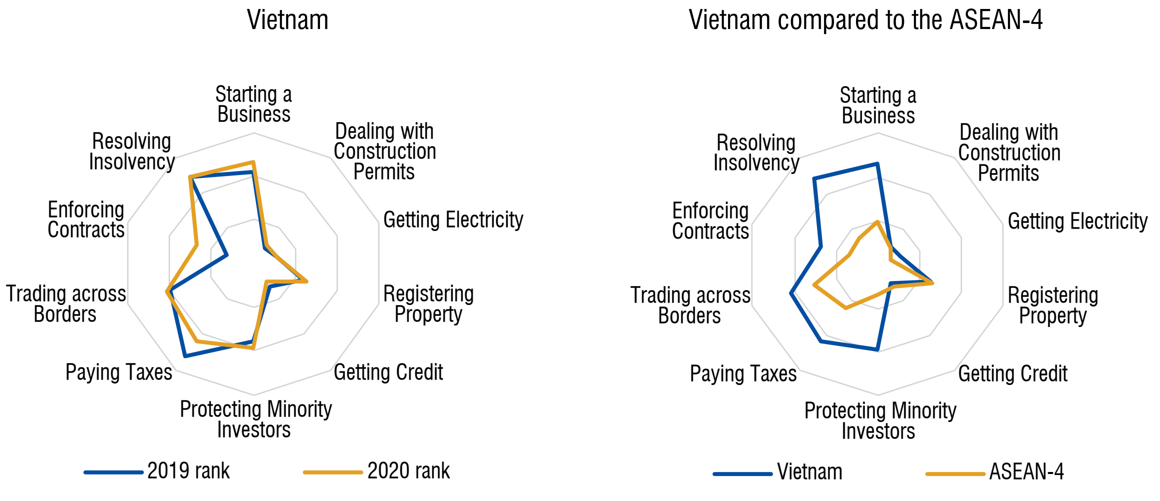
6 See IMF 2018.

Concurrently, the longer-term response of the government should be to accelerate the development of the domestic private sector. Such development would partly meet the growing demand by consumers over the past few years and would help better balance the current growth model, which has mainly been driven by external demand. However, many private firms operating in the domestic market face severe obstacles preventing their expansion. As a result, these firms appear weakly productive, reporting a value added by worker of less than US$4,000 per year, which is approximately five times less than the FDI sector and two times less than the SOE sector.[7] Equally worrisome is that their productivity level seems to decline (rather than increase) due to the multiplication of constraints in recent years.[8]

The recent Doing Business report points in that direction. While Vietnam ranks relatively well compared to its peers with the same level of income per capita, it is still lagging more advanced economies in East Asia (Figure I.31). It has also failed to make significant progress over the past two years, even losing one rank in 2020, after showing a strong progression between 2010 and 2016 (up by more than 20 ranks). This stagnation suggests that the pace of reform in the business environment has slowed, at least compared to other countries. The sub-indicators of tax filings and payments, trade procedures, and company registrations should receive the greatest attention from the authorities, as, according the latest Doing Business report, Vietnam ranks lower than 100th in all of them.

Beyond administrative procedures, private firms are facing other major obstacles. The World Bank 2016 enterprise survey revealed that over 22 percent of firms perceived access to finance as the most severe constraint, followed by informal competition (17 percent) and poorly educated workers (10 percent) (Figure I.32). This ranking justifies the attention given in the next section of this report to how to increase the sources of long-term finance in Vietnam.

Figure I.31. Ease of Doing Business ranking



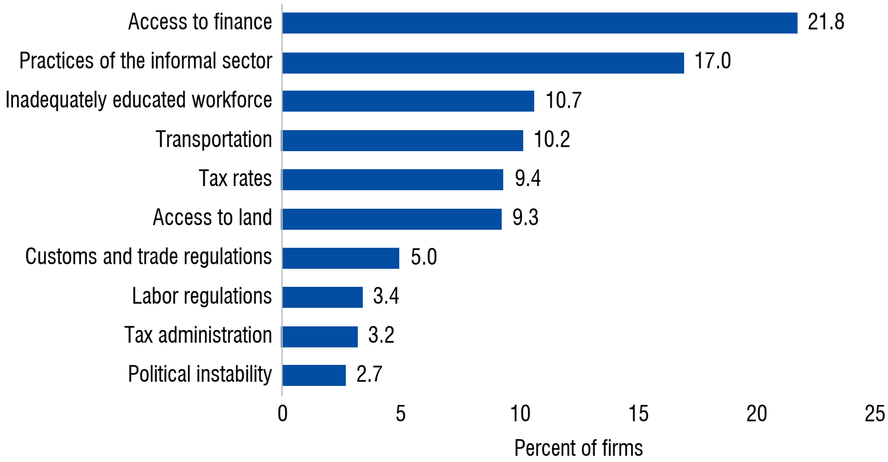
Source: World Bank.

Note: Economies are ranked from 1 to 190 on their ease of doing business, where 1 is the best. The ASEAN-4 comprises Brunei Darussalam, Malaysia, Singapore, and Thailand.

7 Pasquier-Doumer, Oudin, and Nguyen 2017.

8 World Bank 2019, draft of "Policy Note on Firms Development."

Figure I.32. Vietnam ranking of the top business environment obstacles for firms



Source: World Bank Enterprises Survey 2016.

SECTION II

THE IMPORTANCE OF CAPITAL MARKETS FOR LONG-TERM FINANCING

- Vietnam's success over the past two decades has been financed by a substantial increase in banking activities, as the ratio of credit to GDP jumped from 17 percent in 1996 to over 130 percent in 2018.
- While this expansion has allowed the financing of productive activities, sustained long-term financing to many domestic private firms may be constrained going forward.
- All around the world, including in East Asia, capital markets have proved to be efficient complements to credit provided by banks as they are more inclined to finance long-term, riskier productive activities, including in infrastructure and R&D.
- The government has undertaken a series of recent reforms, but the domestic capital market in Vietnam remains underdeveloped compared to most developed and regional economies.
- Five directions for future reforms are proposed to accelerate the development of capital markets in Vietnam.

II.1. FINANCIAL MARKETS IN CONTEXT

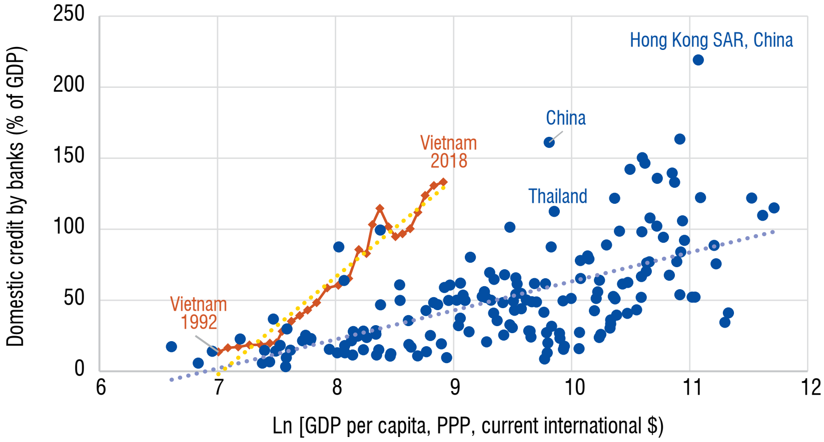
Both economic theory and empirical evidence demonstrate that economic growth and financial markets development are closely interconnected. Most of the higher-income economies in the world are also those with the highest credit-to-GDP ratio (Figure II.1). Such correlation is also apparent in the recent history of Vietnam, as the rapid economic growth reported over the past 25 years has been accompanied by a surge in banking credit from 17 percent of GDP in 1996 to over 130 percent of GDP in 2018. Today, Vietnam is by far the low middle-income economy with the highest credit-to-GDP ratio. These comparisons suggest that the development of the banking sector may have reached its limits compared to the size of the economy.

Such a rapid development of the banking sector, albeit beneficial, has arguably created some challenges that may prevent the emergence of a dynamic private sector. The first challenge is that, traditionally, allocation of credit by banks has been concentrated toward the public sector, including SOEs, which accounts for a relatively large percentage of the banks' portfolio. More recently, consumer lending in the form of mortgages, vehicle loans, and unsecured personal credit have also increased rapidly, rising from 5.6 percent of total credit in 2014 to around 19.7 percent in 2018.[9] These concentrations have not only increased the exposure of the banking sector to shocks, but also contributed to crowding out the credit available for private firms, in particular small and medium-sized enterprises, which today represent only a marginal share of the credit market in Vietnam.[10]

9 As a percentage of the national loan book (World Bank estimates).

10 According the 2016 Enterprises Survey, only 29 percent of the firms use bank credit to finance their investment, and only 15 percent of their investment needs are funded by bank credit.

Figure II.1. Higher GDP per capita and credit development are closely correlated



Source: World Bank.

Note: PPP = purchasing power parity.

The second challenge is that the financial market remains highly concentrated around bank credit in Vietnam. Other instruments (bonds and equities) accounted for approximately 40 percent of total finance activities at end-2018, which reflects a rapid increase in the past few years, but still far from the weight reported in more advanced countries, not only all over the world but also in the region. For example, in Thailand, the Philippines, and Indonesia, the size of the local bond market and of the market capitalization of listed companies far exceeds the value of domestic credit provided by the banking sector. Furthermore, in Vietnam, bonds issued by the government represent close to half of the bond and equity markets, leaving a smaller share to private instruments.

This report discusses why the development of capital markets has become so important for the future expansion of the Vietnamese economy. Although progress has been realized by Vietnam in recent years, the country still lags most East Asian economies and, more importantly, remains unable to finance all the needs of its hungry productive sector, including private firms and SOEs. Five policy options are suggested, with the objective of encouraging the adoption of policy reforms and actions that will stimulate the development of new and innovative long-term financing options in Vietnam.

II.2. WHY IS THE DEVELOPMENT OF CAPITAL MARKETS SO IMPORTANT FOR VIETNAM?

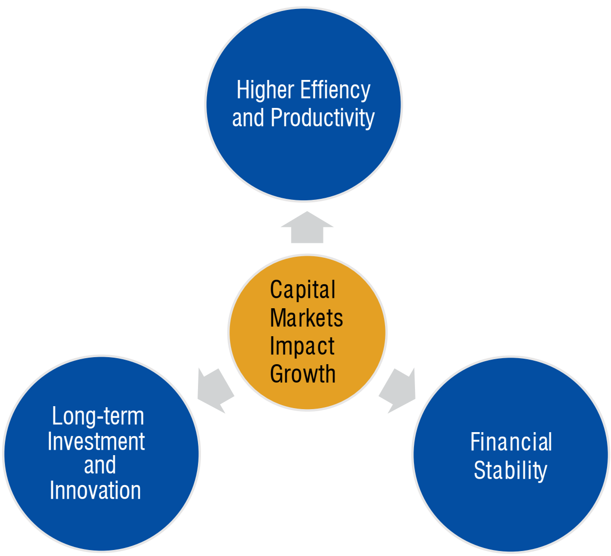
Today, the financial market in Vietnam has a limited range of long-term financial products due to its excessive concentration around the banking sector. The provision of long-term credit by banks to firms has been constrained by the short-term nature of their deposits (over 80 percent are one year or less), and by relatively high transaction costs due to the lack of information, lack of sufficient collateral, and a weak insolvency regime. This limits the extent to which the real sector can transact, trade, insure, and manage risks, and save or invest in the long term. The lack of long-term financing markets also limits the financing of infrastructure in Vietnam.

The current bank business model and resource structure are not entirely suitable for financing long-term investments. Thus, capital markets have emerged as a solution for financing longer-term and riskier projects through the use of debt and equities. In fact, banks and capital markets complement each other, with the former more specialized in rigid, standardized, and collateralized arrangements aiming at funding more traditional activities, and the latter in tailor-made and mostly unsecured contracts.[11] The ability to share the profit (equity market) and to transfer an asset (liquidity on the secondary markets) make capital markets more appealing for investors with a higher appetite for risk, which are generally found in frontier markets and complex projects.

A great deal of empirical evidence has emphasized the positive relationship between capital markets development and economic growth. A forthcoming World Bank publication[12] presents several papers that underscore the positive effect of stock market development, measured by capitalization, value traded, and turnover, on GDP growth and per capita GDP growth. The estimated impact of a 10-percentage-point increase in stock value traded on GDP growth ranges between 0.15 and 0.4 percentage points, depending on the sample of countries and the period.[13] Country-specific studies in East Asia (including China, Malaysia, and Thailand) have all confirmed such a positive relationship over time.[14] In Thailand, a recent study covering 1997–2016 established that the stock market contributed to the country's economic growth by funding allocation to private investment, leading to the enlargement of the manufacturing sector and employment.[15] In short, well-functioning capital markets are found to be good vehicles to stimulate investments by firms and then economic growth.[16]

The positive impact associated to the development of capital markets is not only on the quantity of investments made by firms, but also on the quality. Several cross-country studies have found that an increase in the value of market capitalization fosters innovation, as measured by the number of patents, R&D expenses, and high-tech exports.[17] Other studies have evidenced the positive correlation between capital market development and the level of productivity in a large sample of economies.[18] These results confirm that capital markets are generally better equipped than banks to hedge the risks associated with investments in R&D and intangible assets.

Figure II.2. Capital markets impact growth, three main channels



11 Demirguc-Kunt, Feyen, and Levine 2012.
12 World Bank, forthcoming.
13 Adjasi and Yartey 2007; Naik and Padhi 2015.
14 Choong et al. 2003; Nordin and Nordin 2006.
15 Wanaset 2018.
16 Calomiris, Larrain, and Schmukler 2018; Carlin and Mayer 2003; Geng and N'Diaye 2012.
17 For example, Hsu, Tian, and Xu 2014.
18 Bekaert, Harvey, and Lundbald 2011; Levine and Zervos 1998.

The impact of capital markets on economic growth goes beyond their capacity to provide financing of long-term investments, as it also contributes to the resilience of the financial system as a whole. Capital markets ensure deeper liquidity and diversify risks, reducing the vulnerability of the system to shocks.[19]

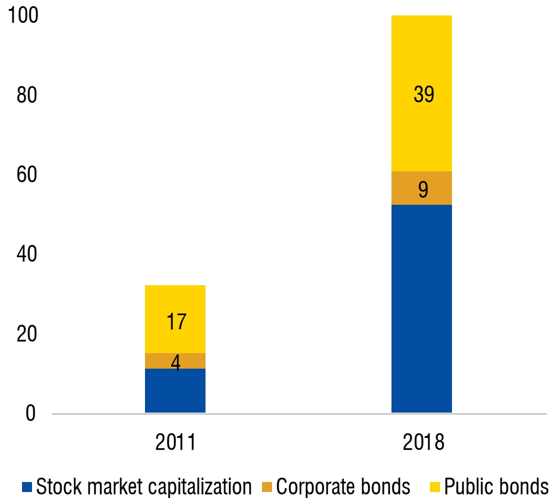
II.3. RECENT PROGRESS IN VIETNAM

The Government of Vietnam has recognized the importance of capital markets as a channel to provide long-term and diversified sources of financing to the domestic productive sectors. These markets have also been increasingly seen as a substitute for foreign aid as the country recently graduated from concessional loans provided by both the World Bank and the Asian Development Bank, respectively, in 2017 and 2018. Within this vision, the government has initially focused on the bond market, as outlined in the Vietnam Bond Market Development Roadmap 2017–2020. The Roadmap, issued through a Government Decision,[20] aims at (a) building a more sustainable market for medium- and long-term financing to support the economy; (b) expanding the investor base with scale and high quality; (c) diversifying market products and operations; (d) enhancing market transparency and efficiency; and (e) adopting and aligning with international standards and practices. The government set a target that the bond markets should reach 45 percent of GDP (of which government bonds and government guaranteed bonds shall account for 38 percent and corporate bonds 7 percent) by 2020.

As a result, Vietnam's capital markets have achieved robust growth over the past few years. The size of the bond and stock markets jumped from less than 40 percent of GDP in 2011 to almost 100 percent of GDP at the of June 2019, which represents about 68 percent of the total value of the credit provided by the banks (Figure II.3). Despite this rapid expansion, Vietnam continues to lag other member countries of the Association of Southeast Asian Nations (ASEAN), as evidenced by the size of their bond markets (Figure II.4). The relatively rapid expansion of the bond market in Vietnam has been concentrated in issuances from the public sector as the use of bonds by corporations has remained mainly limited to banks and real estate companies.

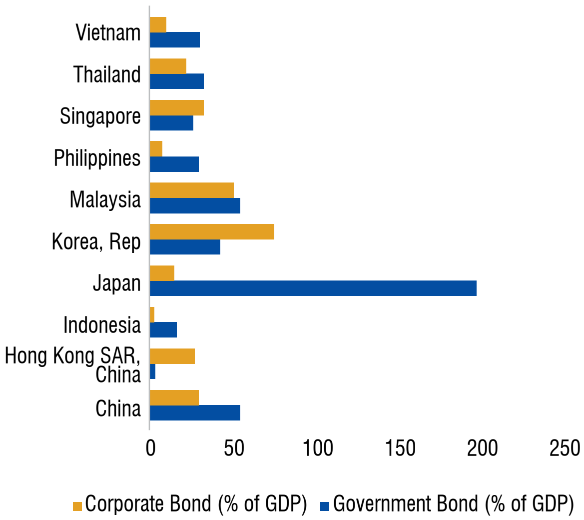
19 World Bank 2019.
20 Decision 1191/QD-TTg.

Figure II.3. Vietnam financial market profile
(% of GDP)



Sources: MOF, SBV, and World Bank.

Figure II.4. Size of selected Asian local currency bond markets
(outstanding bonds as % of GDP as at June 2019)



Source: Asian Bonds Online, ADB.

Note: The percentage for corporate bonds in this chart only covered listed corporate bonds. Outstanding government bonds includes only marketable instruments.

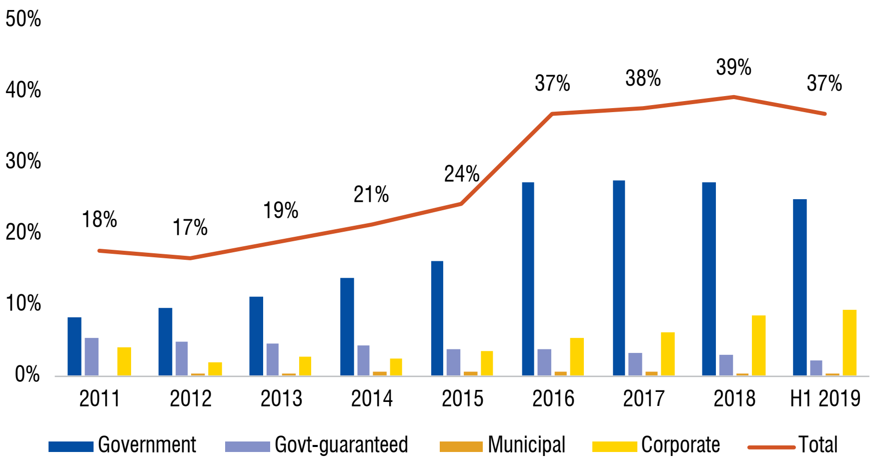
A more detailed description of the main segments of the domestic capital market in Vietnam, that is, the government bond market, the corporate bond market, and the equity (stock) market, is presented below.

Government Bond Market

At the end of 2018, the size of the government bond market reached 39.1 percent of GDP, up from only 17.7 percent of GDP at the end of 2011, reaching a nominal value of US$50.9 billion (Figure II.5). The biggest jump was observed in 2016 (up by almost 8 percent of GDP), when loans from the Vietnam Social Security Fund were converted to government bonds. Furthermore, the authorities initiated their strategy to rebalance their debt from foreign to local currency, and so reduce the public sector's exposure to foreign currency movements. Their motivation was also to respond to the predicted decline in concessional lending from international financial institutions.

The increased reliance on bond financing was accompanied by an effort to modernize the legal framework. The Public Debt Management Law, as amended by the National Assembly, became effective on July 1, 2018. Concurrently, Decree 95 was adopted to regulate the issuance, registration, depository, listing, and trading of government debt instruments. As such, it provides a new framework for the primary dealer system and a liquidity support facility in the form of a securities lending facility operated by the Vietnam State Treasury (VST). To improve the efficiency of the government bond market operation, three circulars have been issued—Circular 110/2018 on the issuance and settlement of government debt instruments; Circular 111/2018 on the switch and repurchase of government, government guaranteed, and municipal bonds in the domestic market; and Circular 30/2019 on registration, depository, listing, trading, and settlement of government and government guaranteed debt instruments. These circulars were designed to remove gaps from the current legislation and facilitate liability management (through switches and buybacks), the smooth functioning of the primary dealer system, the securities lending facility (liquidity support) offered by the VST, and same-day trading for primary dealers to enhance the efficiency of the market making system.

Figure II.5. Size of bond markets (as % of GDP)



Source: MOF.

To support this strategy further, the government has introduced several market mechanisms aimed at improving the functioning of the domestic bond market.

- The VST has introduced regular auctions, with auction dates announced for the whole year. The selection of tenors has become more predictable, but they are only announced shortly before the auction, preventing investors from planning well in advance.

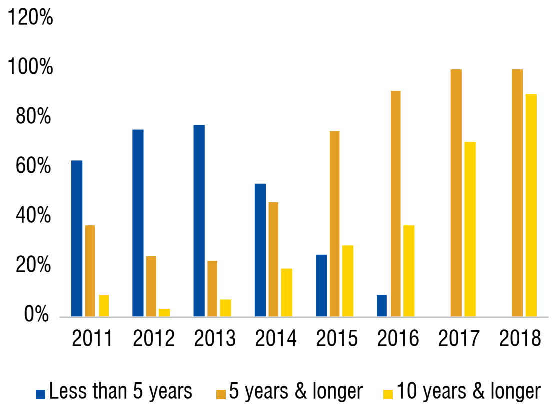
- The benchmark issuance program implemented by the VST should help reduce debt portfolio fragmentation. The number of outstanding instruments has recently started declining; however, as of June 2019, the portfolio still consists of more than 170 marketable instruments. Since the beginning of 2019, the VST increased the target size of the benchmark bonds issuance and has successfully and consistently achieved this target in the case of the 10- and 15-year bonds. The targeted outstanding volume of the benchmark bonds, which is currently around US$500 million equivalent, is expected to be increased in the coming years to improve the liquidity of the instruments further and support the consolidation of the portfolio. Liability management operations are also being considered to reduce the fragmentation of the portfolio and mitigate the refinancing risk of the benchmark government bonds.[21]

As a result of the government bond market development, the yield curve has been gradually extended up to 30 years, with regular issuances of 5-, 7-, 10-, 15-, 20-, and 30-year maturities, providing reference rates for the private market (Figure II.6). Most of the issuances in the first nine months of 2019 were realized in the 10- and 15-year segments due to, among other reasons, the demand coming from the Vietnam Social Security Fund (Figure II.7). There is also healthy demand from the insurance companies in the longer segments due to their longer-term liabilities, which supports the gradual increase of the issuance in the maturity segment beyond the 15-year segment. The average remaining term-to-maturity

21 Circular 111, which came into effect on January 1, 2019, provides an appropriate legal framework for the switch and buyback transactions.

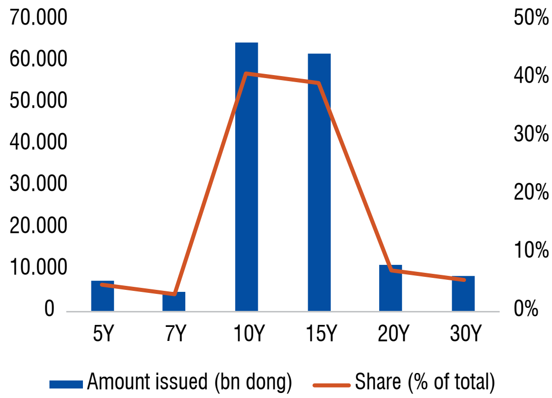
of the government bond portfolio improved significantly in the last few years, rising from 3.18 years in 2011 to 6.83 years at the end of 2018.

Figure II.6. Issuance tenor, 2011–18



Source: MOF.

Figure II.7. Bond maturity (9M-2019)



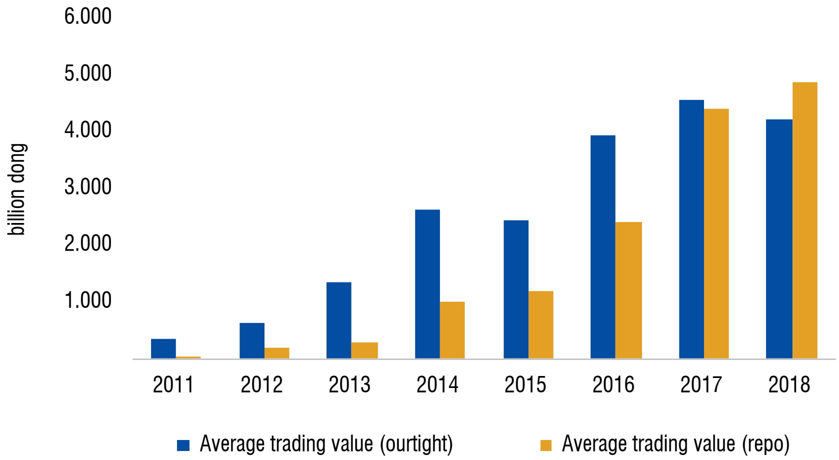
Source: MOF.

Due to the improving primary market and growing market size, secondary market liquidity has also increased (Figure II.8). The secondary market turnover has improved, with an average trading amount of around VND 10,000 billion per day in 2019 compared to VND 1,670 billion per session in 2013, and VND 6,285 billion per session in 2016. Banks are the main players, with more than 80 percent of the trading volume, while the participation of foreign investors declined from close to 20 percent in 2013 to below 5 percent in 2018.

Looking forward, the authorities should further consolidate the portfolio and improve the predictability of their issuances. They should use benchmark targets and keep reopening bonds until the target size is fully met in each maturity segment. Such an effort should be accompanied by an improvement in cash management, as the use of bonds requires more attention to fluctuations in liquidity, especially through the Treasury Single Account. In addition, the coordination should be strengthened among the four entities involved in the government debt management framework: (a) the MoF's Debt Management External Finance Department, which is responsible for external funding, designing the medium-term debt management strategy, and the annual borrowing plan; (b) the MoF's Banking and Finance Institution Department, which makes policy decisions on domestic market development; (c) the VST, which designs the issuance calendar and executes the domestic fund raising; and (d) the State Bank of Vietnam (SBV).[22] Improved predictability through the combination of these three actions will increase liquidity, which will, in turn, help improve price discovery, strengthen the reliability of the yield curve as a price reference for nongovernment bonds, and eventually improve the reliability of the government bonds as a funding source for economic development in Vietnam.

22 The domestic market development strategy should take into consideration the absorptive capacity of the market, and target issuance size for benchmark bonds to ensure liquidity of such bonds.

Figure II.8. Secondary market trading volume (VND billion)



Source: Hanoi Stock Exchange.

Further emphasis should be on the transparent functioning of the secondary market. Today, the repo market lags far behind its potential due to legal obstacles. The absence of short-term reference rates, the high cost associated with short-term repos, discrepancies between the SBV and Hanoi Stock Exchange (HNX) regulations, and the holding limits and accounting rules all discourage commercial banks from further increasing their repo market activities. [23] The yield curve published by the HNX is so far not considered reliable by market participants since it is unable to reflect the actual secondary market levels because of delays in publication and dissemination.

Corporate Bond Market

Over the past few years, the corporate bond market has increased, but not as fast as the public bond market. Its size doubled, nonetheless, from about 4.1 percent of GDP in 2011 to over 9.4 percent of GDP in 2019, reaching around VND 590 trillion by end-June. Corporate bonds were mainly issued by commercial banks (35 percent of total issuance), real estate companies (21 percent), and securities firms (5 percent). However, most of these are private placement bonds and are not listed on the country's exchange markets.

In the coming years, efforts to recapitalize big state-owned banks, fund major SOEs, and finance infrastructure projects, including real estate development, will be the main drivers for the development of the corporate bond market. These sectors require long-term funding, whereas banks are not natural providers of such funding. Using the local bond market to recapitalize major public sector banks and SOEs will have a major impact in the near term on improving financial stability and potentially attracting more local and foreign institutional investors. For example, given the government's budget and debt constraints, new ways to finance energy infrastructure development must be sought. Accessing new sources of financing for Vietnam Electricity, the state electricity company, is paramount to ensure much-needed investment in the energy sector to meet growing expected demand over the coming years.[24]

23 The Vietnam Bond Market Association introduced a local global master repurchase agreement (GMRA) based on the international standards (International Capital Market Association GMRA) in March 2019. However, it is too early to assess its impact.

24 See World Bank Group 2018.

A well-developed corporate bond market would provide opportunities for the various sectors to create instruments appropriate to their funding needs, but the legal and regulatory framework appears to be a key obstacle for the seemingly nascent development of the corporate bond market in Vietnam. Most corporate bonds are issued in the opaque private placement market, hindering active participation from the broad institutional investor community. Compared to the rules for public offerings, private placements require no formal regulatory approval and only minimal disclosure to investors, making access to this market relatively easy and less costly. Since the procedures for a private placement are much simpler and faster than those associated with a public bond offering, most issuers tend to prefer private placements. In addition, private placement of corporate bonds presents a regulatory loophole bypassing public offers. Until recently, bonds issued under a private placement could essentially be purchased by many investors, including retail investors in the secondary market.[25] Taking advantage of this regulatory loophole, some of the bonds that were intended to be sold to retail investors were first purchased in the primary market by the arrangers or affiliates (through a private placement), then immediately resold in the secondary market. This regulatory loophole rendered the public offering market effectively unusable.

Decree 163, issued in late 2018, while being constructive, provides only a temporary and imperfect solution. By prohibiting the resale of private placement bonds to retail/public investors within a one-year period, it aims at keeping bonds issued via private placement within the private market. However, the decree has not removed the risks associated with retail/public investor protection, given that the bonds may eventually be available to public investors without sufficient safeguards. The introduction of better definitions of private placement and professional/qualified investors will be important in the amendment of the Securities Law.

A challenge arising from the prevalence of the private placement market is the limited information available about the market. Confidentiality is a core element of the private market; thus, there are limited credible data available to the public to assess market information, even on an aggregated basis. Although reporting to the authorities is mandatory, data have not yet been shared on a consistent and regular basis. When information is available, it is frequently not up to the standards acceptable to many professional investors. To improve market transparency, it is therefore essential to promote the public and listed corporate bond markets.

Another impediment to the growth of the corporate bond market is the lack of a credit culture based on proper disclosure. Most investors in the corporate bond market are banks, which can rely on their relationships and on collateral when they invest in corporate bonds. Other investors, such as insurance companies and private funds, have limited access to borrower information. Efforts are currently underway as the government recently issued new regulations designed to encourage the establishment of a local credit-ratings industry, since no well-recognized credit rating agency is currently operating in Vietnam.

As the market develops, there is a need to improve the functioning of secondary markets for corporate bonds. Listing should be encouraged to improve disclosure and price discovery, through greater publication of trades and the use of the clean price, a more useful price reference, as the core price for the purposes of reporting and publishing trades. Market mechanism and clearing/settlement infrastructure should also be improved, to remove the pre-funding requirement for trade, which constrains liquidity in the secondary market.[26] The consolidation of the two stock exchanges and the upcoming upgrade of

25 At the time of writing, a draft of a new Securities Law is being discussed in the National Assembly. On the issue of private placement and resale to retail investors, the draft Securities Law provides that private placement of bonds issued by public companies can be offered to and traded by only professional investors. However, the draft also stipulates that private placement of bonds by non-public companies is governed by the Enterprise Laws.

26 This issue is relevant not only to corporate bonds, but also to government bonds and the equity market.

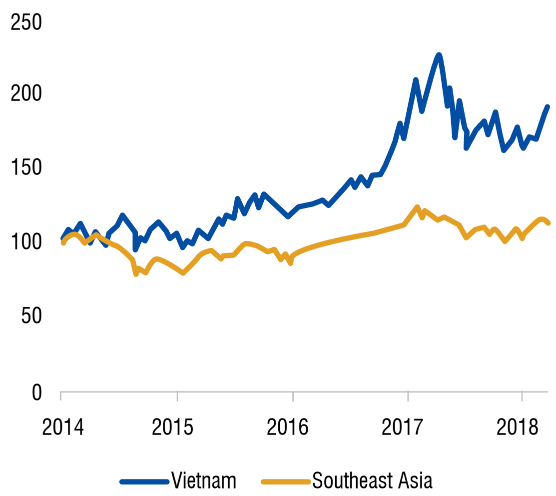
market infrastructure provide the opportunity for a broad-based improvement in the efficiency of trading, clearing, and settlement mechanisms.

Equity (Stock) Market

Vietnam's stock market has performed well, growing by 67 percent over the past five years, and outperforming other ASEAN markets (Figure II.9). The total market valuation of listed companies was equal to 52 percent of GDP at end-2018, slightly above Indonesia and China but far from the level reported in the Philippines, Malaysia, and Thailand (Figure II.10).[27] This performance is explained by abundant liquidity and by positive expectations of the market on the SOE equitization process.[28]

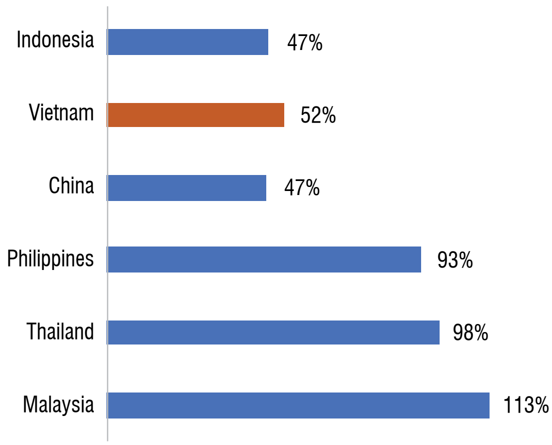
The equity market has been used to raise capital directly by only a few companies over the past few years, even though there seems to be sufficient broad market liquidity to support more activities. The total of Initial Public Offerings (IPOs) and Follow-on Offerings (FOs) reached US$3.8 billion between 2016 and 2018, which was the lowest amount raised among the Philippines (US$4.7), Malaysia (US$5.1), Thailand (US$5.8) and, of course, China (US$$143 billion). In 2018, about two-thirds of these deals were from only two companies (Techcombank, US$0.9 billion) and Vinhomes (US$1.3 billion). The secondary market in Vietnam equity markets has been more active, with a modest turnover ratio of 40 percent, which is in the midrange to the ratios reported by peer markets in the region (Figure II.11).

Figure II.9. Vietnam stock price index compared to Southeast Asia, total returns



Source: CEI.

Figure II.10. Market capitalization compared to regional peers (% of 2018 GDP)



Source: Refinitive Datastream.

There are currently two segments of stock markets between the HOSE[29] and the HNX, and an additional unlisted but "registered" market called the Unlisted Public Company Market (UPCOM), housed at the HNX. As of March 2019, the market capitalization of the HOSE (VND 3,247 trillion) was approximately

27 According to the Government of Vietnam, market capitalization of Vietnam's stock market in terms of GDP was at 72 to 73 percent as of March 2019, although this seems to include unlisted stocks and is thus irrelevant for comparison purposes. The different data and numbers emphasize the need to provide consistent and reliable information to foreign investors based on the internationally acceptable approach.

28 IMF, Vietnam: Staff report for the 2018 Article IV consultation. Selected Issues, July 2018.

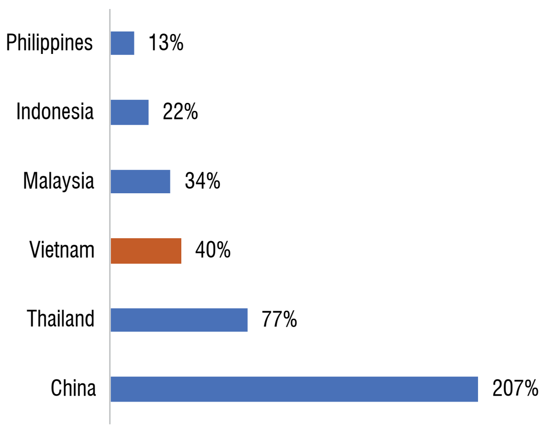
29 Ho Chi Minh City Stock Exchange or Ho Chi Minh Stock Exchange (HOSE or HSX).

three times that of the HNX (VND 1,091 trillion, including the UPCOM). It lists larger companies including large SOEs, and is the main market for IPOs, as well as the market where foreign investors in Vietnam typically participate. The UPCOM was set up to encourage unlisted public companies to participate in the securities market, boosting visibility and accessibility to investors and allowing better regulation of over-the-counter trading for the authorities. However, disclosure remains a critical issue among the UPCOM companies, which is of particular concern as the stocks are available to be traded by the public investors, just like listed stocks. There are currently over 756 listed stocks on the two exchanges (378 stocks on each of the two exchanges), plus 738 companies registered on UPCOM. The largest 10 stocks account for 46.9 percent of total market capitalization of the Vietnam stock market (Figure II.12).

Global index providers are monitoring Vietnam's equity market activities for a possible reclassification from Frontier Markets to Emerging Markets. Gauging Vietnam's equity market activities, the FTSE Russell added Vietnam to its watch list in September 2018 to possibly reclassify from Frontier Markets to Secondary Emerging. Vietnam is also seeking to be upgraded as a Morgan Stanley Capital International (MSCI) Emerging Market. However, such a reclassification is pending, among other things, the effective solution to provide foreign investors with access to and transparency of stocks subject to foreign ownership limits that are still applied to Vietnamese stocks.[30] The limits appear to have created some price discovery issues for those companies whose foreign ownership has reached the limit; for these stocks, prices quoted in the Exchange may not be the actual price obtained by foreign investors. This seems to be a major, but not necessarily the only, issue to be addressed.

Figure II.11. Market liquidity

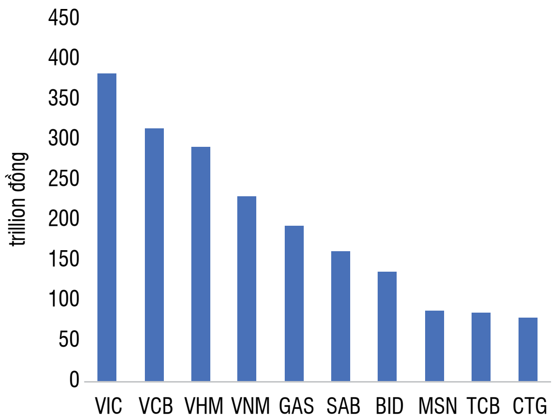
(turnover ratio, %)



Source: Refinitive Datastream and The Global Economy, by end-2018.

Figure II.12. Top 10 market capitalization

(trillion dong)



Source: Refinitive Datastream and The Global Economy, by end-2018.

Investors, especially foreign investors, also face challenges in information disclosure. Concerns about the lack of quality disclosure and access to management for listed companies, as well as a lack of information in English available to foreign investors in a timely manner, further limit foreign investment in the market in Vietnam. This, among other factors, has hindered the Vietnam stock market from being

30 In 2015, a policy removing the limitation on foreign shareholders' ownership of public companies (previously set at a fixed foreign ownership limitation of 49 percent for public companies and 30 percent for banks) came into effect, along with other policies that aimed to ease procedures for foreign investors to open a trading account. Certain conditional sectors and sensitive sectors remain restricted. As of September 2018, only 25 listed companies had removed their limitations on foreign shareholder ownership of public companies.

included in the Emerging Market category in the global stock indexes, keeping the market from attracting a broader investor base.

II.4. KEY REFORMS TO SUPPORT LONG-TERM FINANCING

The development of capital markets, as a complement to banking, has been on the radar screen of policy makers in Vietnam. Both the bond and equity markets have expanded rapidly in recent years, but the outstanding market value of these markets remains low compared to peers in the region, suggesting that there is still ample room for growth.

Moving ahead will require furter attention to the rules of the game, as experience has shown that transparency and competition are required to ensure that capital markets effectively play their role of providers of long-term financing. The authorities must strike a balance between protecting investors and preserving investor confidence for the right development of the market, and offering flexibility in the investment and fundraising processes to ensure that costs to access the market are not prohibitively expensive.

With these objectives in mind, the following five policy options for policy makers are proposed.

Pillar 1. Improving the Legal Foundation for Financing

Modernizing the legal and regulatory foundation for the capital markets should be a priority. A strong and stable regulatory and legal framework and efficient market infrastructure are fundamental to provide market participants with the confidence to enter the market. Among priorities are the revisions of the Security Law and its implementing bylaws, as there is an urgent need to improve market and disclosure transparency, conduct of market participants, institutional and operational arrangements, and market infrastructure to meet international standards. Improving the regulatory and policy framework to reform the private placement market and promote the public/listed market for corporate bonds should be a major focus.

Supervisory and enforcement capacity will need to be enhanced to ensure market integrity and efficiency, which in turn will provide a more competitive cost of funding for the government and enterprises, including for infrastructure funding. These should be accompanied by a package of incentives for issuers (for example, more flexible structure and uses of the bonds and other instruments, such as asset-backed securities) and for investors (for example, level-playing-field taxes).

Pillar 2. Improving Governance, Disclosure and Information Dissemination, and Market Infrastructure

A significant challenge in Vietnam is the need to build a robust credit culture where risks are measured and priced objectively through a high standard of information disclosure. Exposure to the corporate bond market remains extremely limited today. This is in part due to the lack of transparency and information currently available to prospective investors. It is also due to the lack of enough high-quality issues on offer in the primary market, since many recent bond issues have been structured as private placement transactions and placed mainly with local banks. In this regard, corporate governance and credit rating issues will need to be addressed. High - quality information - such as provided by credit rating agencies-is required to ensure that financial markets can function adequately, and bond issuances could be evaluated and priced accordingly.

Accessible and reliable information about the market and the securities issued is necessary to increase investor confidence. There is room for improvement in providing reliable pricing information of shares and government bonds to foreign investors. This is important, as Vietnam aspires to include its equity and bonds in more mainstream emerging market equity and bond indexes.[31] In the corporate bond market, access to corporate disclosure is thus far limited due to the prominence of private placements. Developing the public and listed corporate bond market would help bring more issuers into the more transparent market segment, while establishing an information center for private placement bonds to address the remaining issues.

Improving market mechanisms, including infrastructure upgrade, is also necessary to ensure market efficiency. Policies and practices that add cost and hinder trade and investment should be removed. Among critical issues are the pre-funding and pre-validation of trade, which are costly to market participants (investors and intermediaries) and therefore constrain liquidity. This is another major issue, among others, that has so far prevented Vietnam from being upgraded into emerging market status in the global stock and bond indexes.

Pillar 3. Promoting Innovative Products to Respond to Market Needs

Demands for long-term financing, particularly for infrastructure, will remain high as Vietnam continues its current growth trajectory and rapid urbanization. The lack of investment in infrastructure would pose a binding constraint on continued sustained high economic growth. Banks are unlikely to meet the full extent of this growing demand, due to their liquidity and capital constraints and the maturity mismatches such lending would entail. Typical financing in Vietnam has a maturity of 7 to 10 years, including the development period for greenfield projects, whereas a reasonable economic amortization period for infrastructure projects would range from 15 to 20 years given an asset's cash flow. The government also faces fiscal constraints and a statutory debt limit on public borrowing.

New instruments to finance the real sector (such as infrastructure and housing) including project bonds, infrastructure funds, and other financial instruments, and solutions are necessary to support infrastructure investments in Vietnam. To spur the creation of additional investment opportunities, supportive legislation and regulations and less burdensome issuance processes are necessary to encourage businesses to issue new and relevant products to cover the depth and breadth of the market. These products include, but are not limited to, infrastructure project bonds, asset-backed securities, and real estate/infrastructure investment funds. To date, however, there is no legislation governing the establishment and ownership of legal vehicles (for example, special purpose vehicles [SPVs]) for structured finance transactions that supports the development of these financial products. Taxation of SPVs should eventually also be optimized for them to deliver their benefits to capital market development.

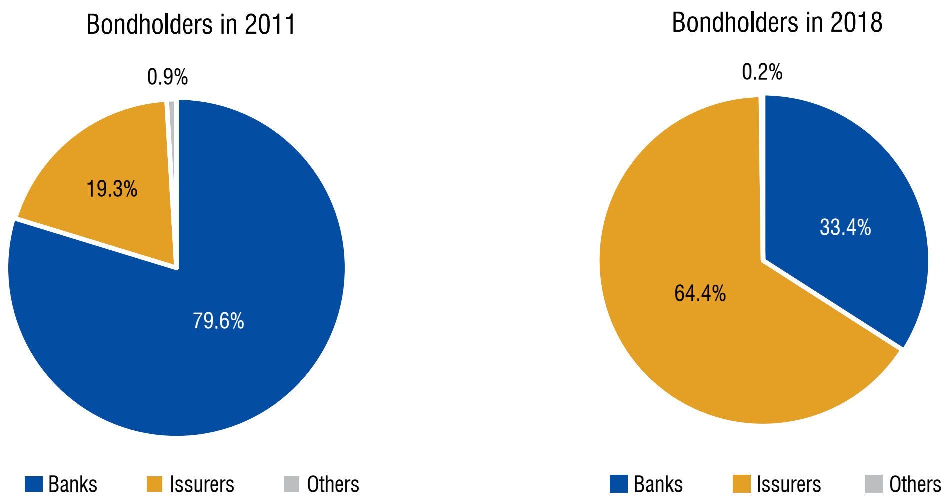
Pillar 4. Widening the Investor Base for Capital Markets

Broadening the investor base, especially non-bank investors, will be key in the development of capital markets. A broader and more diverse investor base is important not only to sustain market growth, but also to increase liquidity and reduce volatility. Different types of investors have different investment horizons (for example, short or long term), risk appetite, and investment strategies and approaches, all of which would reduce herd behavior in the market. From a market development perspective, the various rules and regulations that govern buy-side activity are important since these can either help promote or impede bond market growth. This includes legislation and/or regulations governing the permissible investment activities of entities such as the Vietnam Social Security Fund (VSSF) and pension funds, life insurance companies, mutual funds, and local and foreign banks.

31 Such as the MSCI Emerging Market for equity and the JPMorgan Government Bond Index for bonds.

The universe of potential investors in the bond market continues to grow; thus, it is important to maintain this momentum. The increase of non-bank investors in government bondholding has been particularly driven by the VSSF. By end-August 2018, the insurance sector (which includes the VSSF) was holding up to 64 percent of government securities (up from only 20 percent in 2011) (Figure II.13). Commercial banks have seen their dominance diminish as they were only holding a third of government bonds in 2018, even if they remain the most active on the corporate bond market.

Figure II.13. Composition of the government bond market investor base



Source: MOF.

Although there are positive signals of increasing participation of insurance companies and retail investors, either directly or indirectly through mutual funds, further expanding the investor base is important. A diversified group of investors, including domestic, foreign, bank and non-bank, as well as retail sectors with varying investment horizons and risk tolerance, is necessary for developing the domestic market and increasing the liquidity along the yield curve of the government and corporate bond markets. The role of institutional investors such as pension funds, insurance companies, and mutual funds is important in deepening the market and expanding and diversifying the investor base for local bond markets.

One option would be to modify the investment policy of the biggest institutional investor, VSSF. Historically, VSSF investments have primarily taken the form of direct lending to the government (85 percent, prior to 2016), bank deposits with approved commercial banks (14 percent), and strategic investments (1 percent). Yet, the adoption of Decree 30 in 2016 has allowed VSSF to invest in tradeable instruments such as government bonds. Today, VSSF is the largest investor in the government bond market. Because of VSSF's huge (internal) demand for instruments with a 10- and 15-year maturity, most government bond issuances have been in this segment. This has crowded out other maturity segments that other investors might prefer. Reforms should be considered to open up investment by VSSF, through amendments of the Law on Social Insurance and the above decree , not only with the objective of enabling VSSF to improve its sustainability through higher investment income and reduced risk (via better investment diversification), but also because its participation in the other markets (for example, the corporate bond market) will help boost the growth in those markets as it brings diversity of the investor base.

Vietnam has a strong and rapidly growing insurance sector, with the life insurance segment expanding almost twice as fast as the non-life segment. At approximately 3 percent of GDP, Vietnam's insurance industry is relatively small compared to some other countries in the region, but it has grown rapidly over the past few years, fueled in part by Vietnam's favorable demographics, steady economic growth, and rising personal incomes, as well as improving consumer awareness and interest in insurance products generally. The life insurance segment already accounts for about half of the domestic insurance sector, and the latest premium growth figures suggest that this segment will continue to grow rapidly over the next five years. The strong growth of Vietnam's insurance industry, and particularly the life insurance segment, provides a unique opportunity to further expand the non-bank investor base. These institutions tend to invest in high-quality, long-duration debt instruments, including corporate bonds. Under the right environment of a growing supply of high-quality issues and access to enhanced information disclosure platforms, several of the larger life insurers could play an active role as investors in the government and corporate bond market.

Private pension funds and mutual funds are still in their infancy in Vietnam. The experience so far suggests that the uptake for private pension funds will take time;[32] and further regulatory work is needed to provide guidelines and promote the development of this potential industry, which will in turn become a potentially important investor in the capital markets and diversify away from the public pension system and the banking sector. Vietnam's mutual funds industry has been growing but is still at an early stage of development after the industry started to emerge in 2013, much later than in China, India, Indonesia, and the Philippines. Mutual funds are a cornerstone for capital market development, playing an important role in attracting retail investors. The development of the sector is important to diversify the domestic institutional investor base and help mobilize domestic savings more efficiently. Among other reforms to be considered are leveling the tax playing field across financial instruments (that is, a tax on income from funds versus a tax on income from bank deposits) and increasing the tax-deductible level of contributions to private pension funds based on percentage of income.

Foreign investor participation in the bond market is very small. Small market size, lack of benchmark bond issuances, an absence of hedging instruments, and the fact that Vietnam is not included in any of the major global emerging market bond indexes have been the main factors behind limited foreign investor activity.[33] For this market, improving the benchmark issuance program and higher benchmark target sizes would attract more foreign investors to consider investments in Vietnam and potentially bring it closer to the inclusion in the global bond indexes in the next two to three years (see Box II.1). Foreign investors can have a positive influence on market development through the positive pressure they place on the quality and services of intermediaries and their emphasis on a safe, sound, and robust market infrastructure. However, they may also increase volatility and the domestic market's exposure to international markets and potential emerging market turmoil. On the corporate side, reliable and timely information in English, including corporate disclosure, is essential for foreign investors.

32 Decree 88, adopted in 2016, provides the legal framework for the establishment of private pension funds.

33 Vietnam is currently classified as a frontier market.

Box II.1. Vietnam's inclusion in the emerging market global bond indexes would help attract foreign investors

A medium-term objective for Vietnam would be to be included in major global bond indexes. Almost all of Vietnam's peer countries in the region, such as Indonesia, Malaysia, the Philippines, and Thailand, are included in the JPMorgan Global Bond Index, which is the most widely followed benchmark index. Inclusion would thrust Vietnam' s capital market onto the radar screen of institutional foreign investors.

The major quantitative precondition to join a global bond index is to reach US$1 billion equivalent outstanding volume in a single bond. Qualitative criteria are related to the depth of the foreign exchange market; ease of market access, including the custodian services; market development including price transparency, predictability, and consistency of the issuance program; secondary market liquidity; and acceptance of the market prices by the issuer. Despite its growing size, Vietnam's government bond market has not yet reached this threshold, and further improvements are also needed on market practices, which are not yet fully aligned with international standards.

A final word of caution from the banking sector could be useful. While it is important to broaden the investor base to non-bank participants, a sound banking system is a precondition for developing capital markets. Banks provide sources of liquidity to capital markets as they have been by far the largest participants in the corporate bond market in Vietnam. Their role is also to develop appropriate risk-based pricing, thereby creating opportunities for highly rated companies to issue corporate bonds. They have been a major issuer of corporate bonds themselves. The strategic position requires commercial banks to be sound and to be monitored adequately over time though prudential ratios (in line with Basle II requirements).[34]

As corporations issue more bonds, this will have implications for bank balance sheets. These implications will need to be taken into account, and stronger coordination is required among the key stakeholders, primarily the SBV and the MOF, to ensure a more holistic vision for the development of a sound financial sector, which includes a viable corporate bond market and sound banking system.

Pillar 5. Strengthening Long-Term Finance through the Government's Leadership

The government must play several roles in the development of capital markets. As explained, it must be a regulator by designing and implementing the rules of the game, but it is also itself a major player through the issuances of bonds. To the extent that public bonds dominate the market, the mechanism used by the government to conduct these operations will influence the way the market will function in the coming years.

The experience of emerging markets demonstrates that the government can influence the yield curve of bonds by extending maturities. This has proven to be an effective way to stimulate corporate issuance by creating a reference price for investors, on both short and long end of the curve. The government can also impact the amount of liquidity available in the market by guaranteeing predictable issuances so that potential investors can plan their investments well in advance. In Vietnam, further improvements should be sought in the yield curve development through building larger benchmark sizes and consolidation

34 SBV took several measures including (a) the treatment of bonds as part of credit or loans in prudential ratio calculations (for example, credit growth, and loan-to-deposit ratio); (b) the addition of bonds and loans to the same debtor in the single borrower limit calculation; (c) prohibition of buying bonds whose proceeds are used for loan restructuring; and (d) collateral monitoring requirements similar to those of loans.

of instruments. Implementation of the new market-making framework, with a liquidity facility from the MoF/State Treasury, will help bring more liquidity, which will in turn improve the pricing of fixed-income instruments, including both government and corporate bonds. A more developed government bond market not only provides a much-needed foundation for other instruments (benchmark pricing, market infrastructure), but is also an entry point for foreign investors, who typically start by investing in more liquid and less risky instruments such as government bonds (sovereign versus corporate credit).

Another aspect would be to encourage the use of risk-hedging instruments. The development of currency-hedging instruments in the market would encourage the broader entry of foreign investors and continuous participation in the bond market. Hedging instruments would further encourage their broader entry and continuous participation in the bond market. The authorities should consider measures to make transactions of risk-hedging instruments—particularly interest rate and currency hedging—more efficient and establish regulatory and market infrastructure for this market (for example, a trade reporting mechanism and prudential requirements).

Finally, the authorities should consider establishing a more reliable short-term reference rate to complete the yield curve from short-end to long-end. This will help improve the pricing of variable rate instruments and provide a stronger anchor for longer-tenor instruments. Without it, corporate bonds use a composite of select bank deposit rates as a reference, which is far from ideal due to its bias toward select banks and weak governance control. Reliable short-term rates will also improve efficiency in the pricing of hedging instruments (for example, swaps, forwards) and make the market more liquid.

II.5. LOOKING TO THE FUTURE

As Vietnam strives to become an upper middle-income country with higher demand for financing its development and less access to concessional resources, challenges remain in terms of improving financial intermediation and developing its capital markets to diversify sources of long-term funding. The banking sector has taken center stage in the renewed effort to reform the financial sector, as the credit provided by banks account for over 130 percent of GDP.

Increasingly, the government has focused on the need to develop capital markets to improve resource allocation in the Vietnamese economy. Empirical evidence has shown that these markets can play a central role in the mobilization of savings, the diversification of risks, and the allocation of resources in the economy, all of which are critical for Vietnam's future growth trajectory. Efficient bonds and equity markets can support not only private firms but also the state, including SOEs, in its need to increase and diversify its sources of funding for its ambitious investment program.

Supporting the development of capital markets requires a continued focus on creating an ecosystem that includes a sound legal and regulatory framework, relevant financial products, diversified investors and improved governance, disclosure and infrastructure, and better coordination among government agencies. Beyond these actions, the government will have to carefully consider the balance between innovation and stability when moving forward. The experience has demonstrated that the rapid expansion of capital markets can boost financing opportunities for the economy, but it can also increase the risks of contagion. Moreover, developing capital markets will have implications for the banking sector, particularly with regard to banks' capital raising efforts. These important implications will need to be taken into account and stronger coordination among the key stakeholders, primarily the SBV and MOF, will be required to ensure the development of a sound financial sector that includes viable capital markets and a sound banking system. The capacity of the government to respond to these challenges will ultimately determine to a large extent if and at what pace Vietnam will be capable of joining the group of most advanced economies.

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