The Risk to Vietnamese Growth

Rampant inflation could lead the Communist Party to turn its back on economic liberalization.

By DON PHAN

Vietnam has been an occasional darling of international investors, and right now the on-again-off-again romance appears to be back on again. Sustaining that will be another matter, however. All is not well, as the country experiences an expanding credit bubble and suffers mounting inflation. This raises the danger that Hanoi could retreat from market reforms at the National Congress of the Communist Party set for January.

The "story" for international investors consists of high growth rates coupled with an entrepreneurial population. Foreign investment has flowed to utilities, manufacturing and real estate in the hopes of serving Vietnam's growing middle class. Foreign direct investment this year is $12.2 billion as the country slowly brings back investors it lost during the global financial crisis.

This growth story comes with caveats, however. The most obvious is inflation. Current estimates peg this year's price increase at nearly 9% year-over-year, after Vietnamese consumers recovered from inflation as high 27% in late 2008. The two largest cities, Hanoi and Ho Chi Minh City, have seen prices increase by 1% for the month of September alone.

The fundamental problem is that Hanoi has tried to use ultra-cheap bank credit to fuel growth, a strategy that has sparked inflation. The State Bank of Vietnam has kept real interest rates in negative territory by setting the refinancing rate at 8% and discount rate at 6%. Meanwhile, new credit amounted to 37% of GDP in 2007, 20% in 2008 and 35% last year. The government aims to expand credit by another 25% of GDP this year in an effort to fuel growth.

Liberalization has not been rapid enough to create profitable new uses for that cash. Instead, much of the money goes to large, inefficient state-owned enterprises. Small business owners have long complained about being unable to procure loans from Vietnamese commercial banks. Banks have instead been extending large amounts of credit to the likes of Vinashin, the near-bankrupt ship-building conglomerate and one of Vietnam's largest state-owned enterprises. The company carries an estimated $4.7 billion in debt and is the single largest debtor for many Vietnamese banks.

One consequence of this credit-expansion policy is that since all the new money is not funding productive investments, it is generating rapid inflation instead. Another result is that banks have left themselves exposed to huge write-downs once Vinashin's total bill comes due. When Fitch downgraded Vietnam's credit rating from BB- to B+ in July, it noted that if Vietnam's banks used international accounting standards, nonperforming loans would be three to five times higher than what is reported under Vietnam's standards. The Government
Inspection Office last week discovered that five commercial banks had violated procedures by granting short-term loans they should not have.

To make matters worse, there is also the lurking danger of a balance of payments crisis. Last month, the International Monetary Fund reported that Vietnam’s foreign currency reserves for the first half of the year had fallen to only seven weeks worth of imports, below the three-month guideline recommended to avert a balance of payments crisis.

Large amounts of foreign currency from international trade and overseas remittances do flow into Vietnam’s economy, but a large, unknown amount does not end up in the banking system. Vietnamese business owners who survived through times of war, famine and hyperinflation have become accustomed to holding onto dollars and gold rather than the volatile dong. It is unlikely that sentiment on the dong will pick up enough to shift behavior away from hoarding dollars to selling dollars to banks.

The central bank is not blind to all these dangers. State Bank of Vietnam Governor Nguyen Van Giau has tried to rein in inflation by tightening monetary policy. This month he raised the required capital-adequacy ratio to 9% from 8% in an attempt to force banks to hold more cash on their balance sheets instead of lending.

But here politics comes into play, and particularly the jostling for position ahead of January’s Congress. The politically connected managers who run Vietnam’s large state-owned enterprises hold considerable sway in the upcoming Congress, so ambitious party officials ignore demands for cheap credit at their own peril. As a result, no sooner had Mr. Giau raised the capital ratio than other government officials pressed the central bank to further lower lending rates, effectively negating the tightening. Mr. Giau will likely not have a free hand to tame inflation until after January.

Instead, it is starting to look like party officials increasingly attribute all these worries not to their own economic mismanagement and failure to implement deeper reforms, but to the reforms they have already made. One sign is that the government has resorted to old-style price controls rather than market-based mechanisms like interest-rate adjustments to try to bring inflation under control.

That is the worst possible outcome. Vietnam needs more market-oriented reform, not less, to create productive outlets for longer-term capital investment. That includes giving banks greater scope to lend to small, entrepreneurial companies. It also means avoiding measures like price controls that deter long-term foreign investors while encouraging short-term speculators who bet mainly on policy moves rather than long-term growth.

Prime Minister Nguyen Tan Dung had been considered a market reformer, but it is becoming clear that command-and-control habits die hard. Investors will watch January’s Congress closely to see whether Hanoi still understands that liberalization is the path to growth, or whether Vietnam retreats back to its old ways.

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