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A PLAN TO BOOST GDP GROWTH

Executive summary

- The economy is in a liquidity trap. There is a paradox: i) Successive reductions in policy rates have improved the liquidity of the banking system. ii) But the additional liquidity cannot be channeled into economic areas where it would do the most good: loans to business at low rates so as to stimulate productive activities. Instead, enterprises find credit either un-obtainable or obtainable only at high costs.
- According to economic theory, with inflation moderating and interest rates lowering, investment and other business activities should have picked up. The SBV is forming its policy along those precepts. In a weak economy, the standard remedy is to inject liquidity and lower interest rates. That combination would act as a stimulus to increase aggregate demand, both in investments (by enterprises) and spending (by consumers). But so far, this has not happened.
- Due to particular characteristics of the VN economy (see: our memo on the transmission of SBV policy), the effect of monetary policy has been impeded in stimulating demand. So fiscal policy should be deployed to deal with economic stagnation.
 1. The state should step up with more spending, more investments: purpose is to fill the gap in effective demand.
 2. It can also stimulate additional demand in the economy by lowering costs and prices by means of tax exemptions for business enterprises.

Background

- At this time, the economy is in a state of stagnation. In Q1 GDP grew at 4%. When compared to an average rate of 7% during the decade of 2000- 2010, an output gap of 2 – 3% has opened up.
- The stagnation persists, not for want of policy remedies issued by government agencies to stimulate economic growth. The SBV has reduced its policy rates on 2 occasions in April alone. It has removed a large part of the real estate sector from a non-productive category and encouraged lending to ongoing projects. Loans to finance domestic (but not foreign) consumption have been similarly facilitated. However, such moves of monetary relaxation have had limited impact in lowering loan rates to business enterprises. As many as 50,000 of them have either stopped operations or scaled back production by end of 2011.
- Furthermore, a support package for business has been issued by the MOF, consisting mainly of tax deferrals (VAT, CIT) which would provide companies with an extra source of capital for their operations.

Comments

- There is a widespread consensus that economic weakness stems from a lack of effective demand. A severe contraction in credit growth was held responsible. In the event, credit and M2 increased by 11% and 10%, respectively, in 2011. Credit actually declined by 1.56% in Q1. Such a reversal of fund flows comes as a shock to an economy which had become accustomed to a credit growth of 39% and 29% in 2009 and 2010, respectively. A hard landing was to be expected, and it happened in Q1-12
- With an easing in monetary policy, liquidity has improved substantially in the banking system. It can be traced to these sources.
 1. Injection of funds by the SBV through open market operations.
 2. When the central bank enters the FX market to purchase dollars and boost its official reserves, an equivalent amount of VND liquidity is pumped into the system. Without a complete sterilization, more funding is available for the banking system.
 3. At present a 10% interest differential exists in favor of deposits in VND versus in USD. Private parties have a strong incentive to convert dollar accounts into VND by selling USD to the SBV or to commercial banks. The latter would have more VND resources for lending or investment purposes.
- With such an abundance of liquidity, it is a legitimate question to ask which channels it has gone into. We can name a few.
 1. Into government or government guaranteed bonds and Treasury bills. Repeated auctions by the MOF of its bonds have been successful with an over-subscription rate of 300 – 400%. The number of bidders (mostly large state and private banks, and subsidiaries of foreign banks) is robust at ten or more per session. With so much banks idle money flowing into bonds, the VGB yield curve shifted down constantly in recent months. The 5 year VGB benchmark bond rate is now down to 9.45%.
 2. Among private investors, when they convert out of dollar accounts they keep the proceeds in VND deposits to earn high returns or deploy them into stocks. Gold and USD are no longer popular investment choices due to their price stability as engineered by state policy.

- It can be said that monetary policy has been used very effectively in controlling inflation and stabilizing the dong. And these are 2 major goals of government policy. But when it comes to stimulating economic growth, monetary policy may have reached its limit.
- The economy finds itself in a liquidity trap: when interest rates fall, liquidity becomes more abundant, but does not flow into business loans where it is needed. Instead it goes into fixed income where returns are low but safety is high. Business lending is regarded as risky and banks become highly risk-averse.
- It is now time for fiscal measures to be utilized in a more forceful manner and on a wider scale.

Our proposal

- We propose a program whereby the government decreases its tax collections and at the same time increases its expenditures. The purpose is to inject demand into a system when private agents (enterprises, consumers) have scaled back their spending.
- Our program is composed of these fiscal measures.
 1. A concerted program to offer tax relief for business and consumers
 - a. Exemptions of business taxes (for ex: VAT, CIT). We emphasize exemptions for a certain period (say, one year). The current MOF plan **only allows a deferral**, which means that the tax obligations do not go away but just move six months down the road. Therefore, most business would be reluctant to use this as capital for production or investment purposes. The expansionary impact on business would be quite muted.
 - b. Exemptions of taxes (VAT) on consumption purchases. It is effectively equivalent to a 10% reduction in prices of all consumer items. In a country where private consumption accounts for 70% of GDP, the effect of this measure would be significant and substantial.
 2. The 2 steps above are interlinked and complement each other: they result in lower costs and lower prices, which stimulate demand in a stagnant economy.
 3. A concerted plan to increase public spending.
 - a. Public investment programs can be accelerated, especially those in high priority areas like infrastructure. They serve to put immediate income into the hands of workers as well as lay the groundwork for future economic production.
 4. We are cognizant of evidence that efficiency in government projects is not high. One solution is to have a PPP set-up. It would combine financial resources by the state and execution effectiveness from private entrepreneurs.

Conclusion

- Monetary policy has reached its limit of effectiveness. Policy rates can be cut 1% more each quarter as per SBV declarations. But both the banks and businesses are reluctant to lend and borrow, respectively. As Keynes once said: “you can lead a horse to the water (ie. causing lower interest) but you cannot make it drink (ie. make banks lend or business borrow) “.

- It is time for forceful fiscal measures to be deployed. The private sector (enterprises, consumers) has scaled back in their effective demand due to a poor economic environment. The public sector should step up to the plate and supply a stimulus. Its actions would then percolate through various sectors. As per the multiplier effect, the cumulative impact would be many times larger than an original policy measure.
- This is an opportune time to use fiscal policy. It can be financed by borrowing at a low rate as the government bond market is flooded with idle money from major commercial banks. In the event, latest bond data showed that the 5 year benchmark VGB's are purchased by banks at a low yield of 9.45%.