

Viet Nam Economic Pulse
Financing Development for Recovery in Viet Nam: Principles and Prospects
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Abstract

Development financing is among the most pressing issues facing developing countries. Economic recovery from the Covid-19 pandemic, the transition to renewable energy systems, mitigation of the negative effects of climate change on vulnerable communities and realization of the Sustainable Development Goals place heavy demands on economies to increase the share of national output allocated to investment. Financial liberalization, once considered a panacea for low saving and investment rates, lost much of its luster after successive national and global financial crises. But the failure of financial liberalization does not mean we can simply turn back the clock to the pre-globalization era. Every country will need to devise solutions appropriate to its level of development, economic structures and ambitions. This paper sets out three core principles of development finance and explains their implications for economic recovery from Covid-19 and the achievement of the SDGs and national development goals. Development finance will remain primarily a national concern, and governments need to respond through the creation of reform of national institutions including National Development Banks and sovereign wealth funds. More efficient public investment and curbs on speculative activity will also be important.

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I. Introduction

The coronavirus pandemic is a human tragedy of historic proportions and one that has caused immense economic hardship around the world. The number of people living in extreme poverty increased for the first time since 1997, and early estimates suggest that global poverty will not return to 2019 levels before 2023. The resurgence of the virus in 2021 has dashed hopes for an immediate return to the pre-pandemic growth trajectory, especially in Asia where vaccination rates were low entering the second half of the year. The pandemic was also a stark reminder of the interconnectedness of human societies and the need for international solidarity and cooperation to solve global problems. The development of effective vaccines was a scientific triumph, but even the best technology cannot defeat the virus without collective action to ensure that everyone has access to them no matter where they live and their level of income.

The world faces other challenges of equal or even greater significance to sustainable development. Failure to limit global warming to 1.5°C above preindustrial levels—a goal that seems more out of reach with each passing year—could result in the loss of as much as one-tenth of global economic output by 2050, and even more—upwards of 25 percent—in vulnerable regions like Southeast Asia (Swiss Re Institute, 2021). Meanwhile, with less than a decade left to realize the 2030 Agenda, the world still has a long way to go to eliminate poverty and achieve the other Sustainable Development Goals.

Meeting these challenges is complicated by the fact that the global economy was underperforming even before the pandemic hit. The world never recovered fully from the Global Financial Crisis (GFC) of 2008, as is apparent in sluggish investment rates—despite historically low interest rates—and falling trade volumes. A decade of expansionary monetary policy after the crisis had fueled the accumulation of public and private debt on a massive scale. According to the Institute for International Finance, the global debt to GDP ratio reached an all-time high of 355% in 2020, from about 200% in 2000. Property and equity prices have reached unprecedented levels while investment in productive activities has slumped in every corner of the globe.

Achieving a robust recovery from the coronavirus pandemic and realizing the Sustainable Development Goals by 2030 will require a significant increase in public and private investment over the next decade. In an often-cited study published in 2019, the World Bank estimates that low and middle-income countries need to invest \$2.1 trillion per year (measured in constant 2011 US dollars) to achieve the SDGs, to build the infrastructure needed to convert from fossil fuels to renewable energy systems and to protect people and communities from the negative effects of climate change (Rozenberg & Fay, 2019). Financing this surge in investment in ways that are not inflationary and do not impose an excessive debt burden on governments, businesses and households is one of the most pressing problems facing the developing world.

For many years, the default position of the international financial institutions was faith in financial liberalization—relaxation of government controls on lending, interest rates,

international capital flows and exchange rates—to generate savings and allocate them to the most efficient investment opportunities. It was thought that since market prices convey complete information about the value of financial assets, government intervention leads to the mispricing of risk and the suppression of saving. Flexible exchange rates match the supply and demand for dollars, reducing the need for central banks to hold foreign currency reserves and imposing discipline on profligate governments. Market-determined interest rates stimulate savings, reduce the cost of borrowing and redirect international capital flows to developing countries, where capital is scarce, and rates of return are higher than in the high-income countries.

Many developing countries embraced financial liberalization from the 1970s, but the results were disappointing. Domestic saving and investment rates fell, exchange rate volatility increased, and financial crises occurred with alarming regularity. Yet faith in the benefits of unregulated financial markets remained strong, even after the East Asian Financial Crisis in 1997-1998. In East Asia, slogans like “crony capitalism” were offered in place of a rigorous analysis of this historic, region-wide failure of financial systems. It was not until financial crisis came to the shores of the North Atlantic that confidence in the inherent stability of financial markets was shaken. In the wake of the Global Financial Crisis in 2008, advocates of financial liberalization accepted the need for regulatory limits on domestic credit growth and controls on cross-border capital flows (Gallagher & Tian, 2017).

The failure of the project of financial liberalization does not mean that we can turn back the clock to the pre-globalization era. Given the fractious, multipolar geopolitics of the 21st century, it is unlikely that an international consensus on a new global financial architecture can be forged. When the IMF calls for a “New Bretton Woods,” it is suggesting change at the margins—debt restructuring and concessional lending—not an overhaul of the current system of free capital movement and floating exchange rates (Georgieva, 2020). In the absence of a global solution, every country needs to find answers appropriate to its own level of development, industrial requirements and social and political objectives. There is no one-size-fits-all solution: policies appropriate to small, resource-rich countries will not work in populous middle-income countries that regularly post large trade deficits. Governments need to devise sensible combinations of market incentives, regulatory safeguards and judicious use of the public sector balance sheet to finance public and private investment while reducing the incidence and severity of financial crises.

Viet Nam must consistently invest a larger share of national income if it is to achieve the targets set out in the Ten-Year Development Strategy of achieving upper middle-income status by 2030 and high-income status by the centennial year of 2045, while also meeting the challenges of Covid-19 and climate change. A reasonable target given the scale of the challenges that the country faces would be to sustain an investment rate of between thirty-five and forty percent of national output. Viet Nam achieved this benchmark for about a decade, from 2001 to 2011, after which investment has steadily fallen as a share of national income. There are many reasons for the decline in the investment rate, some of which stemmed from changes in the global economy after the GFC and were beyond the government’s control. However, policy has also played a role, notably a decline in public

investment and a shift in public expenditure from investment to consumption. Returns to public investment are still high in Viet Nam, and the ratio of public capital to national output is still low.

This paper makes the case that the solutions to Viet Nam's financing gap are to be found at home. Domestic resource mobilization is the key to increasing the supply of long-term finance for productive investment. Government must play a more active role mobilizing resources and structuring incentives to lengthen time horizons, conserve scarce foreign exchange and encourage investment in socially desirable projects. Because of constraints on other forms of industrial policy—trade protection, local content requirements, subsidies—imposed by multilateral and bilateral agreements, finance is now one of the most effective instruments available to achieve industrial development goals such as building national competitiveness, increasing value added in domestic industries and upgrading technological capabilities.¹

The next section of the paper presents three core principles of sustainable development finance strategy. Based on these principles, the third section proposes strategies to increase the supply of long-term finance for development. These include national development banking, public investment, sovereign wealth funds and policies to encourage productive investment and discourage speculation. The final section discusses policy implications and future prospects. This section also addresses short-term policies to stimulate economic recovery following the recent resurgence of the Covid-19 pandemic.

II. Three core principles of development finance

Development finance is essentially a national endeavor, and that government must play a central role in increasing access to long-term finance. To understand why this is so, we first consider some basic principles of finance from the developing country perspective. This section addresses three key issues: i) the relationship of investment to domestic saving; ii) the inherent instability of financial markets; and, iii) the risks associated with over-reliance on international capital flows. We then apply these principles to concrete development finance strategies in the following section.

Principle 1: Saving follows investment (not the other way round)

In the version of finance presented in most economics textbooks, households save in banks, and businesses borrow from banks for investment. Households make consumption decisions based on their time preferences—jam today versus jam tomorrow—and interest rates, and businesses borrow the money balances that accumulate as a result. Financial markets find equilibrium at the real interest rate, which is the price at which the supply of “loanable funds” (household savings) is equal to the amount of capital that demanded by businesses to finance their investment plans. Countries invest a larger share of national income if households and governments are frugal, and less if they consume more of their

¹ Other instruments that the government still has recourse to include investment in research capacity and education, public investment in infrastructure, government procurement and national security.

income. The investment rate and the level of income is higher in the long run if the government, households and businesses run budget surpluses.

The textbook story is modified slightly in a world of globally integrated financial markets. Countries that record trade surpluses (that export more than they import) accumulate capital that is invested in deficit countries. China's current account surpluses are channeled into foreign exchange reserves, much of which are invested in US government securities. Aside from the United States, Capital importing countries are thought to include developing countries that use inflows of foreign exchange to finance imports of capital goods—machines and technology—for industrial development.

The textbook story hinges on two rather dubious assumptions. The first is that the supply of credit is limited by the stock of loanable funds, or the amount of money previously saved from income.² Banks in this view play a passive role, receiving funds from households and transmitting them to investors. What the textbook version omits is the ability of banks to create money as part of the lending process. When banks make loans, they create deposits, which businesses draw on to pay wages and other production costs. These expenditures generate incomes, a portion of which is saved. Thus, in a money economy it is more correct to say that investment creates savings, not the other way round. Saving and investment are not in equilibrium at the real interest rate; they are always equal in an *ex-post* accounting sense regardless of the prevailing rate of interest. The investment process also alters the distribution of income because it generates income streams that affect both the savings rate (companies and households save out of income) and demand for investment.

Finance is properly understood as the provision of liquidity (cash) to investors to cover expenditures that cannot be financed out of profits.³ Banks are limited in their ability to create money not by the volume of a pre-existing stock of savings, but by their access to credit-worthy projects and by their need to meet their own financial obligations, including making cash available to depositors on demand (Kaldor, 1978, p. 179). Banks and firms (if they borrow or sell equity directly to the public) rely on financial markets to bridge the gap between their long-term capital requirements and the liquidity they need to cover immediate obligations. The secondary markets help banks close the gap between short-term liabilities and long-term assets. The fact that banks do not rely on previous saving to finance lending is most apparent during a speculative boom, when inflated asset prices embolden banks to create credit at rates that are destabilizing from the macroeconomic perspective.

This brings us to the second textbook assumption, which is that the economy operates at full employment at the equilibrium real interest rate. With this assumption in place, saving has no effect on aggregate demand: consumption forgone is automatically and

² In the economics literature this is referred to as the assumption that the money supply is exogenous or created outside of the banking system.

³ "Increased investment will always be accompanied by increased saving, but it can never be preceded by it. Disharding and credit expansion provides not an alternative to increased saving, but a necessary preparation for it. It is the parent, not the twin, of increased saving" (Keynes, 2013, p. 281).

instantaneously recycled as investment. But in the real world, aggregate demand does indeed expand and contract during the business cycle, raising or lowering expected profits and the level of planned investment. When interest rates fall, businesses do not react by rushing to increase investment to take advantage of the lower cost of funds. They are more likely to put investment plans on hold as expectations of future sales and profits are recalibrated, taking shifts in demand into account (Taylor, 1983). Thus, more saving means less consumption but not necessarily more investment.⁴

The full employment assumption is misleading everywhere, but it is especially inappropriate in surplus labor economies like Viet Nam, where much of the workforce is engaged in low productivity activities in agriculture or traditional services. Underemployment (disguised unemployment) holds down average wages and creates opportunities for foreign and domestic investors to earn profits producing labor-intensive exports goods like electronics, garments and footwear. Developing economies are demand constrained, as shown by the transformative effect of export demand on output and productivity growth. It could be said that the main benefit of foreign direct investment is not necessarily the inflow of foreign capital but instead access to export markets that comes with producing for the big global brands.⁵ Relocating labor from agriculture to export industries does not reduce output in the former precisely because labor is underutilized. Access to foreign demand for consumer goods mobilizes surplus labor, giving rise to the close relationship between the growth rate of manufactured exports and labor productivity growth that is an enduring feature of the development process (Nguyen Thang & Pincus, 2021).

Relaxing the full employment assumption allows us to dispense with the textbook notion that investment is saving-constrained. Since investment generates both income and saving, a low domestic saving rate reflects a shortage of viable investment opportunities, not low interest rates. The investment rate responds to demand and profit expectations that are independent of the interest rate. Studies of a cross-section of countries confirm that saving is more appropriately seen an outcome of investment and productivity growth rather than their cause (Kumar et al., 2020).

The idea that saving follows investment, and that investment is primarily driven by expectations of future profits and not the prior existence of savings, has a long pedigree in development economics. The pioneers of the discipline recognized that late industrializing countries struggle to compete with incumbents possessing advantages like advanced technologies, access to scale economies, and experience managing large, complex enterprises (Hirschman, 1972; Kaldor, 1967). Government policies to reduce investment risks and raise profit expectations, such as local content rules, selective protection, R&D subsidies, export incentives and access to subsidized credit, are needed (UNCTAD, 2016a).

⁴ “The absurd, though almost universal, idea that an act of individual saving is just as good for effective demand as an act of individual consumption, has been fostered by the fallacy, much more specious than the conclusion derived from it, that an increased desire to hold wealth, being much the same thing as an increased desire to hold investments, provide a stimulus to their production; so that current investment is promoted by individual saving to same extent as present consumption is diminished” (Keynes, 2013, p. 211).

⁵ A large proportion of foreign direct investment is reinvested profits, meaning that like domestic investment FDI is mostly funded out of profits. See page 20 below.

These methods and other were used to great effect by the successful East Asian industrializing countries, beginning with Japan in the early 20th century and including Korea, Taiwan, Singapore and China. Development finance strategy was closely bound up with industrial policy and cannot be understood in isolation from the development of technological capabilities, export promotion and the growth of domestic firms.

A quick look at the Korean experience helps illustrate the point. Korea began its rapid industrialization in the 1960s with extremely low saving rates: gross domestic saving was just 0.3% of GDP in 1960 and did not reach 20% until 1973 (Figure 1). However, as the investment rate rose through the 1970s, saving increased in tandem, topping 30% in 1978 and remaining above that level until the present. Saving was the result, not the cause of growth (Shin & Chang, 2003, p. 7). The main constraint on investment was the availability of foreign exchange since Korea needed to import technology and capital goods. Until 1984, Korea routinely recorded large trade deficits, averaging 8% of GDP from 1960 to 1983. The government actively targeted credit and foreign exchange to export-oriented industries, restricting access to credit for consumption and speculation.

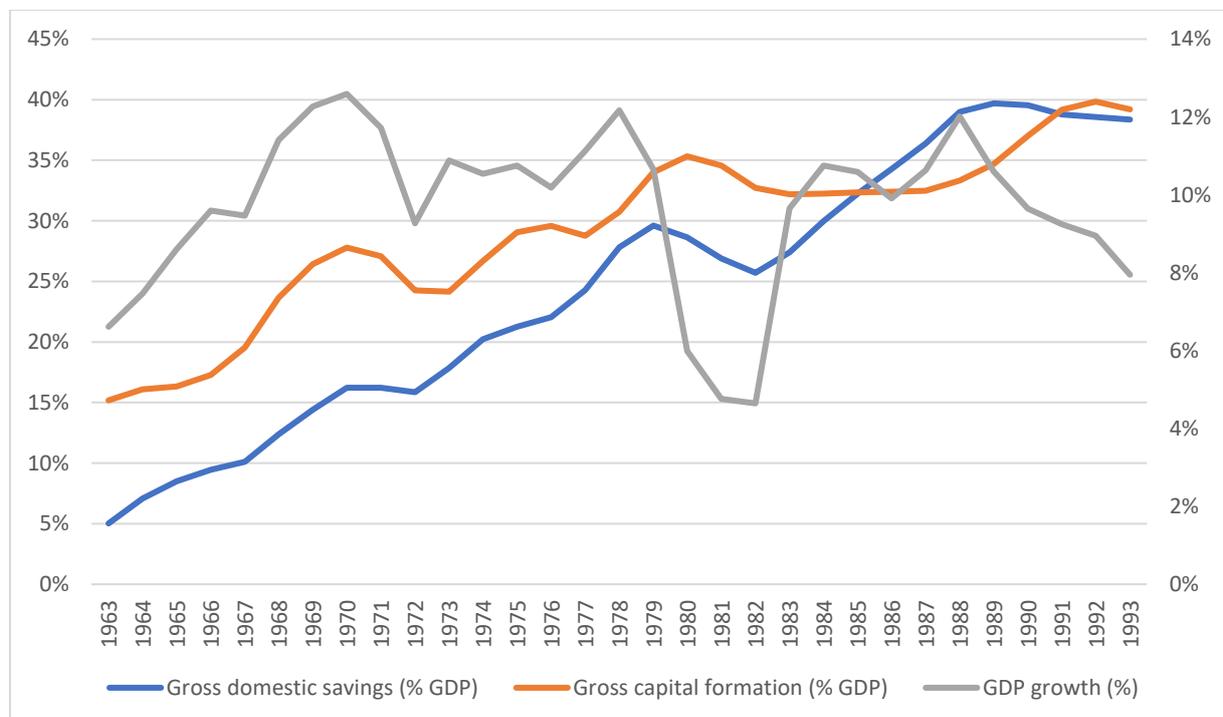


Figure 1. Korea, gross domestic savings, gross capital formation and GDP growth, three year moving averages, 1963-1993

Source: World Bank

Principle 2: Loans are not like pork chops

Since Joseph Schumpeter published his *Theory of Economic Development* in 1911, economists have examined the entrepreneurial role of financial institutions (Schumpeter, 1983). In contrast to the textbook model, Schumpeter emphasized the active role that bankers play in assessing the profitability of alternative investment projects and the

likelihood that borrowers will be able to repay their loans.⁶ For Schumpeter, entrepreneurs finance investment mainly out of profits, but need credit to cover expenses incurred during the production process. It is the investor's need for liquidity, and uncertainty about the outcome of their investment projects, that imparts to banks a strategic role in development. Investment decisions do not hinge on the real interest rate, but on the judgement of bankers.

Beginning in the 1960s, the idea that prices capture all relevant information about the value of financial assets gained traction among economists and policymakers. Combined with the loanable funds approach, the efficient market hypothesis provided the theoretical rationale for financial liberalization. "Financial repression" was the result of government manipulation of interest rates, which discouraged saving and prompted households to hold unproductive assets like gold, land and foreign currency rather than bank deposits. Low interest rates misallocated capital to less risky projects, thereby lowering economywide rates of return (McKinnon, 1973; Shaw, 1973). These closed economy models were allied to a broader set of arguments in favor of capital account liberalization. Proponents of financial liberalization knew that capital flows entail risks, but argued that the threat of capital outflows would impose discipline on profligate governments—a claim that was still being put forward by the international financial institutions on the eve of the East Asian Financial Crisis (Fischer, 1997).

The central claim of financial liberalization was that market pricing of financial assets boosts domestic saving and investment. However, over time it became increasingly apparent that saving rates were not responding as expected. Maxwell Fry, the author of a leading textbook on financial development, and an enthusiastic backer of financial liberalization, reluctantly concludes in his survey of the evidence that "the real interest rate has virtually no direct effect on the level of saving," but adds hopefully that it "may exert an indirect effect by increasing the rate of economic growth" (Fry, 1995, p. 188). As we would expect, saving increased most rapidly in fast-growing economies that invested a larger share of national income like China, Korea and Singapore—not coincidentally, countries with "repressed" financial systems. We have already noted how Korea used financial repression to direct credit and foreign exchange to export industries. In Viet Nam, savings were higher after 2000 despite a trend decline in the real rate of interest reflecting the country's higher income per capita and rapid growth.

The main effect of financial liberalization was to multiply the incidence of financial crisis. Arestis and Stein review evidence from fifty-three countries for the years 1980 to 1995 (Arestis & Stein, 2005) and conclude that higher real interest rates and financial deregulation failed to generate more domestic savings or investment but did spark rapid growth of consumer borrowing and speculation in fixed and financial assets. Excessive risk taking, and unsustainable credit booms are often associated with banking and financial crises in emerging markets (Eichengreen & Arteta, 2002). Kaminsky and Reinhart find that

⁶ '[T]he banker must not only know what the transaction in which he is asked to finance and how it is likely to turn out, but he must also know the customer, his business, and even his private habits, and get, by frequently 'talking things over him', a clear picture of the situation (Schumpeter, 1939, p. 116).

banking crises regularly occur as a result of currency crises following on from capital account liberalization (G. L. Kaminsky & Reinhart, 1999).

In a widely read critique of financial liberalization in Latin America, Carlos Diaz-Alejandro explained the failure of financial liberalization to generate stable equilibria in capital markets by contrasting markets for normal goods like meat with the market for credit.⁷ When we visit the local butcher, we exchange cash for a specific quantity of meat of a known quality. Loans, bonds and equities, by way of contrast, represent a promise to surrender a return on investment at some future date. The ultimate value of the investment cannot be known in advance, and the probability that the borrower will default is greater than zero. Therefore, the bank—the buyer of the promise—must consider factors other than the price (the interest rate). Banks and other lenders ration credit based on subjective assessments of the creditworthiness of borrowers and the viability of their projects. Prices are a poor indicator of value because the riskiest borrowers are the most desperate for funding are willing to pay the highest interest rates (Stiglitz & Weiss, 1981). Lenders write numerous covenants into loan agreements to reduce the likelihood of default, for example the promise of collateral assets and the right to recall capital in the case of unforeseen events. But it is impossible to obtain complete information about borrowers (asymmetric information) and borrowers have an incentive to take on more risk than they tell their lenders about (moral hazard). Credit markets are subject irreducible uncertainty because the future is unknown and cannot be predicted based on past events.

In responding to these criticisms, proponents of financial liberalization recognized the risks inherent in financial markets but argued that these can be managed through rigorous bank regulation and supervision, capital adequacy requirements and other safeguards. Some have argued that financial liberalization is more likely to succeed in the presence of certain preconditions, such as macroeconomic stability, a mature financial system and free trade (McKinnon, 1993). Yet recent experience, including the East Asia financial crisis and the GFC, suggests that even with these preconditions in place liberalized financial markets, in both developing and advanced countries, are subject to herd behavior and instability.

It is often said that generals always prepare to fight the last war, and economists are well versed on the causes last crisis but never see the next one coming. It is in the nature of financial innovation to devise new ways to increase leverage during the boom when demand for credit is high. Banks earn profits by making loans, as asset prices rise it is rational for every bank to expand credit even as the macroeconomic effect of them all doing so at once is a destabilizing credit bubble (H. Minsky, 1992). The precise mechanisms change

⁷ “The former,” he writes, “is a spot transaction; the latter involves a promise to repay in the future which may or may not be sincere or wholly credible. Enforcing the loan contract or liquidating collateral property will involve costs, and even with speedy enforcement the bank may be unable to get all of its money back. The bank will incur costs to explore the creditworthiness of borrowers; the butcher will not care much for the reputation of cash-carrying customers.” Finance is trading in commitments about the future, and therefore always involves rationing based on the credibility of borrowers and access to liquidity (Diaz-Alejandro, 1985, p. 2)

but the internal dynamics remain the same. Credit markets tend to fragility during the boom as leverage increases and safeguards are abandoned.

Indonesia offers a cautionary tale. In 1996, two Harvard economists published a book extolling Indonesia's ability to maintain macroeconomic stability while carrying out a radical liberalization of the financial system. "The Indonesian experience with implementing policies for the banking sector," they write:

demonstrates that freeing up direct controls over prices, allocation and entry of new institutions need not lead to crises and chaos as it has in some countries, but instead can result in reasonably healthy growth, expanded services and improved efficiency (Cole & Slade, 1996, p. 140).

Within two years of the book's appearance the banking system had collapsed, the rupiah was in freefall and the country's military-backed government of thirty years had been forced from power. The economy contracted by 15% and the headcount poverty rate rose to 63% within one year.⁸ The ultimate cause of the crisis was the progressive hollowing out of corporate balance sheets as Indonesian conglomerates, many of which had opened their own banks, engineered complex financial structures to retain control domestic assets while parking their cash overseas (Matsumoto, 2010). Many of these loans were unlawful, but even if they had been detected by the authorities there were plenty of domestic and foreign lenders ready to step in. In the lead up to the crisis, Indonesian corporations had successfully listed subsidiaries on global stock markets and issued international bonds, including Sinarmas Corporation's \$14 billion bond issue that would eventually gain notoriety as the largest corporate default in Asian history. The lesson from Indonesia and other countries hit hard by the East Asia Financial Crisis is that financial markets are prone to instability during periods of expansion; that financial innovation is not always socially beneficial; and that governments must step in to stop the creation of credit bubbles before they reach levels that can destabilize the macroeconomy.

Principle 3: Development finance is primarily a national concern

Economists have long believed that the rate of return on capital is higher in developing countries where capital-labor ratios are lower. International capital flows from north to south are therefore expected to accelerate global growth and reduce inequality (Viner, 1947). Capital flows from richer to poorer countries have been sporadic and small relative to flows between rich countries, even after financial globalization took hold from the 1980s.⁹

From the vantage point of today, the absence of North-South capital flows is not terribly surprising. Countries that record current account surpluses by definition export capital. Commodity exporters run large trade surpluses when prices are high, for example during the commodity boom in the early years of this century. The relocation of labor-intensive

⁸ Measured as population living on less than \$1.90 per day (2011 dollars) as published in the World Development Indicators.

⁹ Capital flows are larger between rich countries than between rich and poor countries. The failure of north-south capital flows to materialize on a large scale is often referred to as the Lucas Paradox, in reference to an article on the subject by Robert Lucas (Lucas, 1990).

manufacturing to China, Southeast Asia and Mexico produced trade surpluses and capital exports from some of these countries.

Countries in developing Asia have recycled export surpluses into foreign exchange reserves, as shown in Figure 2, which presents capital flows for the thirty largest developing countries by population since 2000. Foreign exchange reserves accounted for a large proportion of net outflows, especially during the commodity boom. Repeated experience of financial crisis has persuaded these countries to accumulate reserves as self-insurance against capital market and exchange rate volatility. From just US\$223 billion in 1990, reserves rose to \$8.1 trillion in 2020. Reserves held by developing Asian countries increased from \$73 billion to \$4.8 trillion over the same period, with China alone holding \$3.2 trillion. The large ASEAN countries (Indonesia, Malaysia, Philippines and Viet Nam) now control foreign exchange reserves equivalent to 25% of GDP.

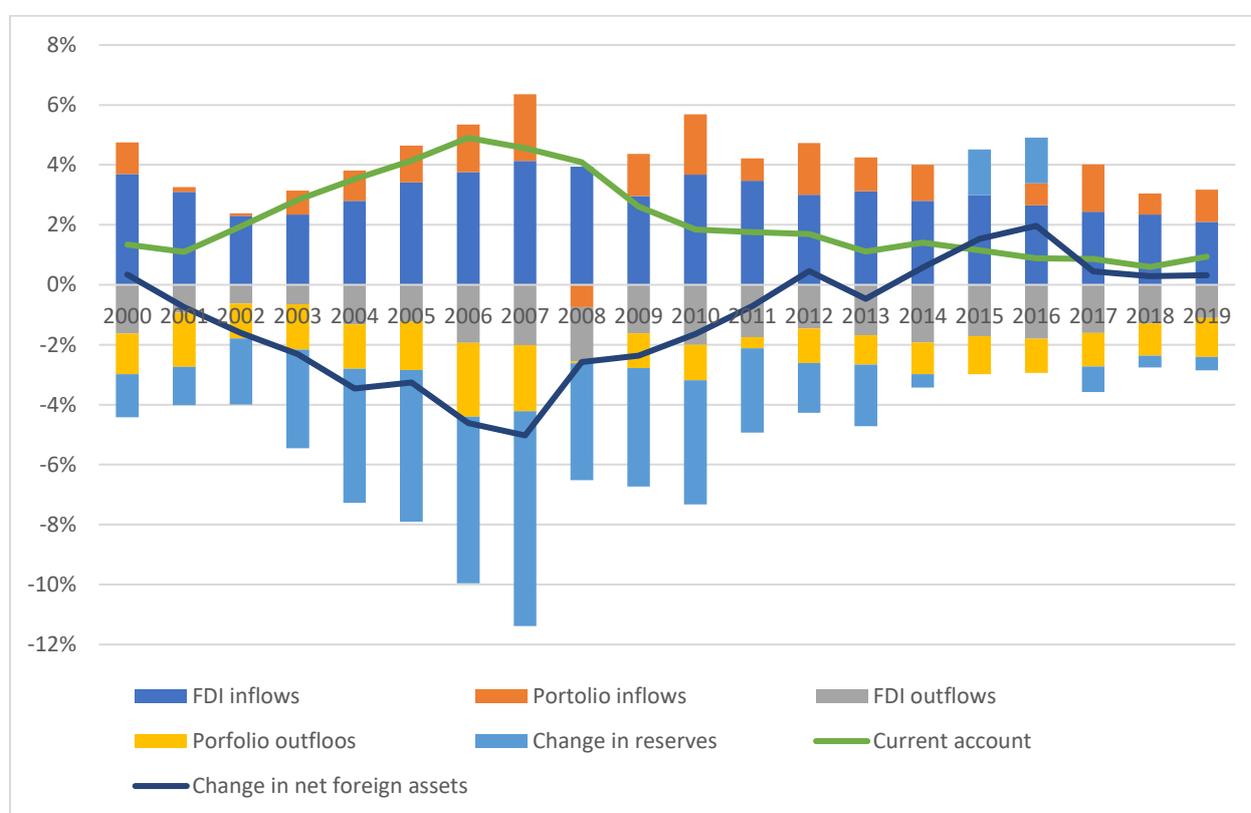


Figure 2. Capital flows to the 30 largest developing countries as % GDP

Source: IMF

Central banks in developing countries accumulate foreign exchange reserves on a large scale to guard against exchange rate fluctuations and to discourage speculators from betting against their currencies. But self-insurance comes at a cost: trillions of dollars in reserves are held in safe assets like US treasuries that earn lower returns than those on offer at home. Moreover, countries like India and Indonesia that run trade deficits in most years finance reserve accumulation by acquiring expensive, risky liabilities like foreign direct investment and dollar bonds. This balance sheet mismatch increases exposure to foreign exchange risk for the countries concerned especially if these investments generate returns in the domestic currency (for example FDI oriented to domestic services) (UNCTAD, 2020b).

Capital inflows in fact play only a minor role in the developing world despite years of capital account liberalization. This is evident from the fact that more than 90% of fixed investment in developing countries is financed domestically. Moreover, no stable empirical relationship exists between capital inflows and growth. This is to be expected. Capital flows into developing countries for a variety of reasons: to invest in natural resource exploitation and export manufacturing; to produce goods and services for the domestic market; to acquire financial and physical assets; and for consumption. Just knowing the dimensions of capital inflows does not tell us much about their impact on the economy. Several authors have even detected a *negative* relationship between international capital flows and growth. Prasad, Rajan and Subramian find a robust negative relationship between the ratio of capital inflows to GDP and growth of income per capita after controlling for initial level of income and dependency ratios.¹⁰ They find that countries that grow fastest maintain a *rate of investment* higher than the median of all countries and also *rely less on imported capital* than the median country. One of the explanations they offer for the negative effect of foreign capital is that capital inflows are associated with overvaluation of the domestic currency, which discourages exports (Prasad et al., 2007). Similarly, Aizenman and coauthors find that “countries with higher self-financing ratios grew significantly faster than countries with low self-financing ratios” (Aizenman et al., 2007, p. 684). In other words, the less countries depend on foreign capital the faster they grow on average.

One of the reasons that a reliance on foreign capital could be associated with slower economic growth is that capital flows are strongly procyclical. Risk appetite increases during the boom and falls when asset prices decline, accentuating the peaks and valleys of the business cycle. Thus, developing countries have easy and relatively cheap access to foreign financing when interest rates are low in advanced countries but often experience a sudden reversal of flows, and deeper recessions, when rates rise.

Some readers may agree that the growth effects of portfolio flows are open to question, but still maintain that foreign direct investment (FDI) is good for growth. FDI implies a longer time commitment and is less procyclical than portfolio flows. It is more stable because FDI assets are comprised of factories, mines and equipment, and the parent company assumes at least some of the investment risk. FDI in manufacturing forms part of a viable export-led growth strategy, integrating domestic industry into global supply chains, and in the process creating steady, formal sector jobs for low-skilled workers. Technology “spillovers” from foreign to domestic firms accelerate growth and stimulate domestic private investment.

However, the distinction between FDI and portfolio investment is often more apparent than real. FDI is defined as investment made by a resident of one country to establish a “lasting interest” in an enterprise in another country. In the official statistics, a lasting interest is said to be in evidence when the investor controls ten percent of a foreign establishment; below that level the investment is categorized as a portfolio flow like buying shares on the stock market. Once the initial investment has been made, all subsequent transactions, including

¹⁰ Initial level of income bears a negative relationship to the rate of growth because richer countries tend to grow more slowly. The share of working age adults to total population (the dependency ratio minus one) is positively related to growth because a higher proportion of the population is economically active.

loans, are recorded as direct investment. Retained earnings are first recorded as an outflow of investment income on the current account and then as FDI inflows on the financial account. Reinvested profits make up a substantial proportion of total FDI, estimated by UNCTAD at about fifty percent of the total stock of invested capital, and probably more in developing countries (UNCTAD, 2020a, p. 4). But even this may underestimate the contribution of retained earnings to FDI. Statistics published by the US Department of Commerce show that retained earnings comprised 79% of total US outward FDI for the decade 2010 to 2019 (Figure 3).¹¹ Less than half of the stock of FDI represents new equity and loans invested in developing countries, and instead consists of profits earned in these countries and reclassified as FDI.

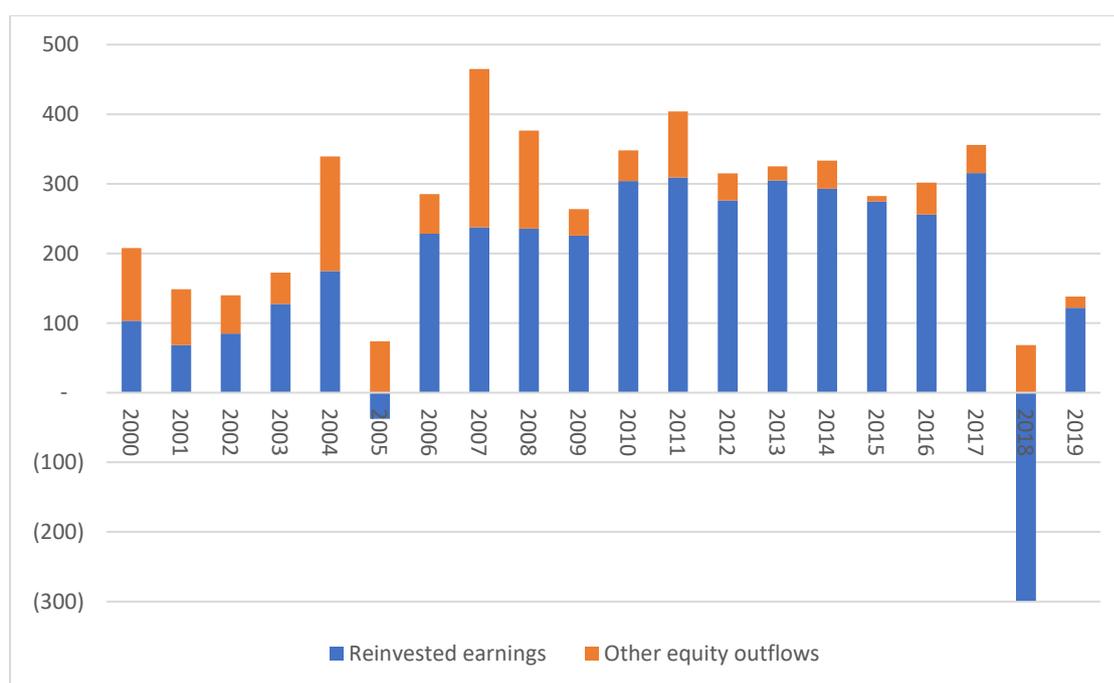


Figure 3. Retained earnings and other equity, US outward FDI, 2000-2019

Source: Bureau of Economic Analysis, US Department of Commerce

There are other problems with the usual distinction between FDI and portfolio investment. The presumption that FDI assets are more difficult to liquidate does not hold up in practice. It is common for foreign affiliates to borrow against their in-country assets, the proceeds from which can be used to acquire other assets or simply repatriated. Foreign investors can also just as easily accelerate profit remittances or pay down liabilities to parent companies (Bird & Rajan, 2002). Combined with the fact that the bulk of these liabilities have accrued over time from profits on domestic operations, it becomes increasingly difficult to detect a meaningful difference between short-term portfolio flows and long-term FDI.

In some ways portfolio flows may actually be superior to FDI. Foreign investors expect higher returns from direct investments because they assume at least part of the risk. Figure

¹¹ The negative figure for retained earnings in 2018 was a reaction to a provision of the US Tax Cut and Jobs Act of 2017 that levied a one-time tax on undistributed foreign earnings in the fourth quarter of 2017. US multinationals were able to repatriate cash held in overseas affiliates in 2018 without additional taxes.

4 shows average returns for FDI investments and 10-year government bonds for four Southeast Asian countries: Indonesia, Malaysia, Thailand and the Philippines (data for Viet Nam are not available). Over the fifteen-year period 2005-2019 the average rate of return on FDI was twice the level of bond yields (12 vs 6%). Even this wide difference probably underestimates the returns to FDI, as most international companies will not undertake a project that does not yield more than 20% per annum and offers relatively short capital recoupment periods (Kregel, 2014, p. 67). The difference narrowed in recent years as the commodity boom came to an end and as growth of global trade in manufactured goods has slowed. FDI firms also boost profits through transfer pricing mechanisms (over-invoicing of imports and under-invoicing of exports), which also reduces tax liabilities in the host country.

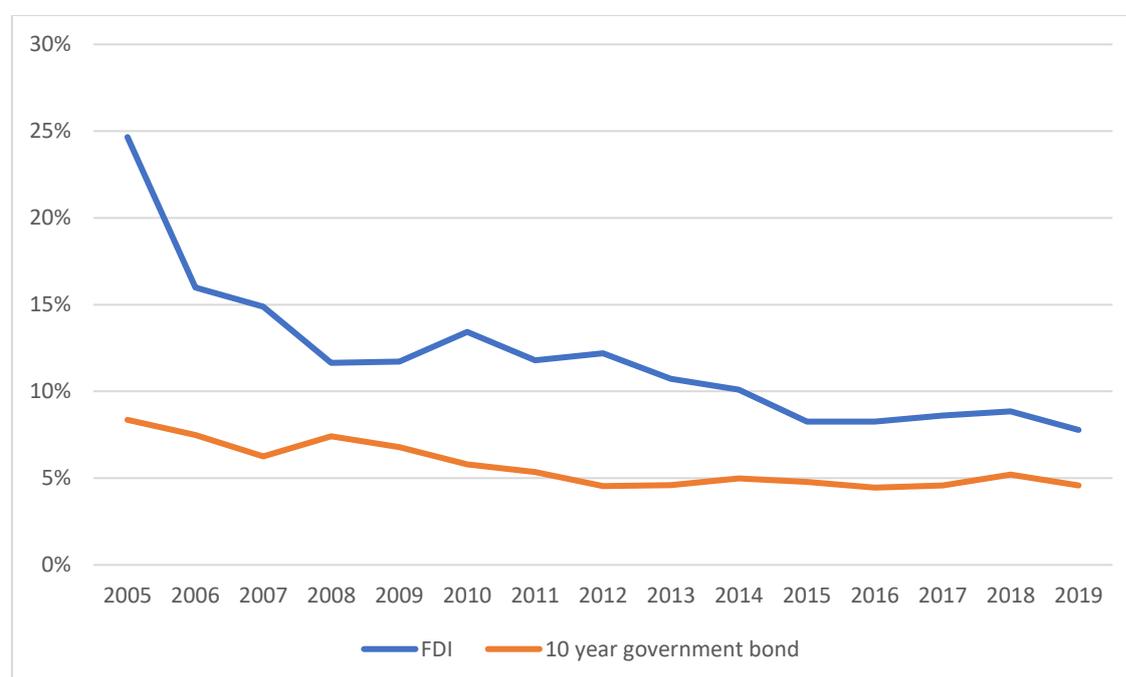


Figure 4. Rate of Return of FDI compared to 10-year government bond, Indonesia, Malaysia, Philippines and Thailand, 2005-2019

Source: UNCTAD and IMF, Investing.com for bond yields

Profit remittances and debt repayments add up over time as the stock of FDI rises. Figure 5 presents two sides of the FDI coin in Viet Nam. As the country has integrated into global supply chains, the trade balance has moved decisively into positive territory, achieving a consistent surplus from 2014 that by 2019 was nearly USD 20 billion. However, the outflow of payments also increased to USD 19 billion in the same year. The situation is even less favorable when FDI industries are inward oriented and do not generate the foreign exchange needed to cover profit remittances and other income payments. For example, because Indonesia runs persistent trade deficits, outgoing income payments related to FDI must be covered by ever-larger inflows of portfolio capital. In Indonesia's case, these flows consist of government and corporate bonds and bank loans. As liabilities accumulate, Indonesia's macroeconomic policy space has narrowed as holders of Indonesian assets demand higher rates of return and an overvalued exchange rate relative to the US dollar.

This is a vicious circle, as the overvalued exchange rate and high interest rates make exports less competitive and suppress the domestic rate of investment (Akyüz, 2017, p. 184).

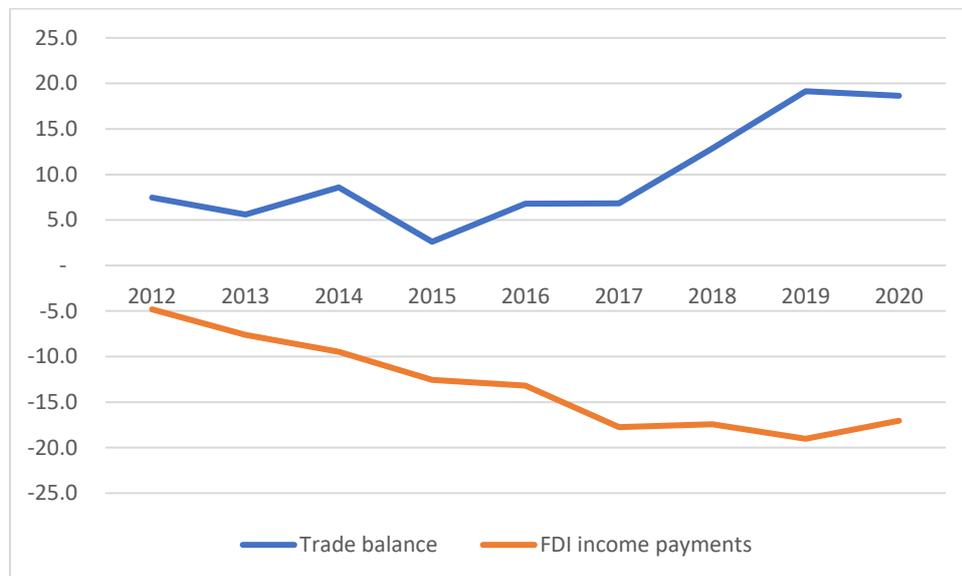


Figure 5. Net primary income and trade balance, USD billions, Viet Nam

Source: State Bank of Viet Nam

Studies exploring the relationship between FDI and economic growth have produced mixed results. Put succinctly, no consistent relationship emerges that would lead us to conclude that FDI is unambiguously good or bad for growth in all situations (Lipsey, 2004). Various authors claim to have identified the conditions under which FDI is associated with more rapid growth: some report that the relationship is strong only in richer countries (de Vita & Kyaw, 2009); or in countries with developed financial markets (C.-C. Lee & Chang, 2009); or countries posting higher than average levels of educational attainment (Li & Liu, 2005); that pursue a liberal trading regime (Zhang, 2001); or are better able to control corruption (Okada & Samreth, 2014). Others find no stable relationship at all between FDI and growth (Carkovic & Levine, 2005) and some even find a negative relationship (Herzer, 2012).

One reason for the confusion is that FDI comes in different forms. Albert O. Hirschman's observation that the intensity of forward and backward linkages varies among industries and settings remains valid even in our world of globalized, decentralized production (Hirschman, 1972). Most foreign investment in the developing world is directed to natural resource exploitation, which generates export earnings and tax revenues, but creates relatively few jobs and production linkages (Morris et al., 2012). Companies that mainly produce consumer goods and services for the domestic market create jobs but their impact on the balance of trade depends on the import-intensity of production and the extent to which domestic production by foreign companies substitutes for imports or for goods produced by domestic firms. Thus, the impact of FDI on the growth rate of the domestic economy depends on the characteristics of foreign firms and their relationship to the broader economy.

Export-oriented manufacturing creates jobs and earns foreign exchange. Among Asian countries, Wang finds that FDI was growth-enhancing in manufacturing but not in other sectors for the decade prior to the East Asian financial crisis (Wang, 2009). The productivity-enhancing effects of labor-intensive manufacturing are significant in surplus labor economies as workers move from low productivity occupations in agriculture and traditional services into formal sector manufacturing. However, it is the growth of manufacturing output rather than foreign ownership that is the crucial factor. As a simple exercise to illustrate the point, we divide low- and middle-income countries into four groups: those for which FDI was on average greater or less than five percent of GDP, and those recording growth of manufacturing value added of more or less than five percent per annum for two ten-year periods (2000-2009 and 2010-2019) (Table 1). In the first period, countries receiving more FDI did grow faster, but this outcome is mostly due to more rapid growth of manufacturing in these countries. In the second period, the growth rates of low- and high-FDI countries are identical, but countries enjoying more rapid growth of manufacturing still grew faster on average.

Table 1. Foreign direct investment, manufacturing and GDP Growth: low- and middle-income countries 2000-2019

2000-2009	Growth of MVA < 5%		Growth of MVA > 5%		Total	
	PC GDP growth	Count	PC GDP growth	Count	PC GDP growth	Count
FDI < 5% GDP	1.8%	51	4.6%	18	2.5%	69
FDI > 5% GDP	2.2%	13	5.2%	16	3.9%	29
Total	1.9%	64	4.9%	34	2.9%	98
2010-2019	PC GDP growth	Count	PC GDP growth	Count	PC GDP growth	Count
	FDI < 5% GDP	1.9%	54	3.8%	21	2.4%
FDI > 5% GDP	1.8%	17	3.2%	14	2.4%	31
Total	1.9%	71	3.6%	35	2.4%	106

Source: World Development Indicators

The contribution of export-oriented foreign firms to the balance of payments depends on the import intensity of production. Trade agreements limit the scope of governments to incentivize FDI firms to purchase inputs from local suppliers, for example through local content rules or tariffs. Without these policies, foreign companies develop few backward linkages to domestic firms, especially in the garment and electronics industries (Sanchez-Martin et al., 2015; Winkler, 2013). Although results vary across industries, researchers have found that the presence of FDI firms in the domestic economy is no more likely to promote the transfer of technology than normal trading relationships (Newman et al., 2018).

Over the long period, the impact of FDI on capital formation depends on whether it crowds in or crowds out domestic private investment. Market-seeking FDI is likely to crowd out domestic private investment if foreign firms use the latest technology and have more experience managing large-scale operations. Amighini and colleagues find that even when FDI increases the overall rate of investment, it displaces domestic investment in specific industries. Displacement effects are largest in trade-related industries, and FDI in

manufacturing is more likely to result in an increase in total domestic investment than foreign investment in other sectors (Amighini et al., 2017).

Morrissey and Udomkerdmongkol find that FDI crowds out domestic private investment, and the effect is strongest in politically stable countries. They hypothesize that foreign investors reduce exposure to countries with unstable governments, reducing competition for domestic private businesses (Morrissey & Udomkerdmongkol, 2012). Jude and Leveuge argue that this effect disappears in the long run as foreign investors enter subsectors in which there are no domestic incumbents (Jude & Leveuge, 2017, p. 5). In China, FDI is associated with an increase in private investment when it enters as part of a joint venture operation, but crowds out private investment when it takes the form of a stand-alone, foreign enterprise (G. S. Chen et al., 2017).

Most studies on the impact of FDI on domestic investment do not differentiate between new investments and mergers and acquisitions, mostly because it is assumed that the acquisition of assets in the host country releases capital that can be invested elsewhere. But this is not necessarily the case, as the proceeds from asset sales can be invested in fixed assets (gold and property), remain in cash or leave the country. Several studies conclude that the impact of greenfield foreign investment on economic growth in a large cross-section of countries is positive, while that of M&A is negative (Harms & Méon, 2018; Nanda, 2009). However, if the sample is limited to developing economies, the difference between greenfield and M&A investments disappears, as neither contribute to productivity growth in these countries (Ashraf et al., 2016).

The effects of foreign direct investment—on the balance of payments, economic growth and productivity—depend on a range of factors including the specific characteristics of the host country and sectors and industry receiving investment, the trade orientation of FDI firms, and the type of financing involved. The breadth and depth of linkages to domestic firms, including the transfer of technology, knowledge and skills from foreign to domestic firms, are important factors over the long term. FDI policy should therefore play close attention to the impact of foreign investment projects on balance of payments, the potential to develop foreign and backward linkages to domestic firms, and the scope for technology transfer rather than simply focus on short term factors like the volume of investment or number of jobs created.

III. Strategies to increase the supply of long-term development finance for recovery

“The essential contribution of financial markets to the process of development,” writes Jan Kregel, is “to render long-term financing commitments sufficiently liquid to validate the commitment of resources to long-term uses without requiring individual investors to make long-term financing commitments (Kregel, 2014, p. 11). Simply put, investment projects—especially large-scale, slow-gestating projects—need long-term financing but investors prefer assets that can be readily converted into cash. The role of the financial markets is to bridge the gap between the supply and demand for long-term credit.

Commercial banks, whose liabilities are mostly short-term (deposits), are constrained in their ability to carry out this function. Dense and liquid secondary markets help banks transform short-term liabilities into long-term assets. Stock markets give companies access to long-term capital by creating a mechanism through which individual investors can cash out whenever they want. But in the early stages of development, these markets and institutions are too small and shallow to generate liquidity on the scale and for the duration required by industry to invest in slow-gestating, capital-intensive projects. Late industrializing countries have pursued a variety of strategies to overcome these constraints (Gerschenkron, 1962). European countries capitalized private development banks, guaranteed loans and injected credit directly to new industries from the mid-19th century. The pre-war Japanese government purchased commercial bank bonds to create long-term liabilities to the banking system. State-owned national development banks emerged as an instrument to promote industrialization in newly independent countries after the Second World War (Amsden, 2001).

Viet Nam, like many other late industrializing countries, relies primarily on bank credit (Table 2). Asia outperforms other middle-income countries in mobilizing credit (except for Indonesia and the Philippines). Equity and corporate bond markets play a larger role in Malaysia and Thailand but not decisively so: Asia follows the general pattern of bank-dominated financial systems. As in Europe, bank-based industrial business groups in Japan, Korea and Taiwan had sufficiently long time horizons to invest in industries needing time to build up competitiveness (Khanna & Yafeh, 2007). Governments offered inducements to steer conglomerates toward manufacturing and exports, even as they provided protection from imports, particularly for upstream industries. Finance was an important instrument to increase the profitability of industrial investment in pursuit of structural transformation (Di John, 2020).

Table 2. Sources of investment capital as % GDP, 2017

	Private credit by deposit money banks to GDP (%)	Corporate bond issuance volume to GDP (%)	Stock market capitalization to GDP (%)	Total
Vietnam	121%	0%	44%	165%
China	151%	4%	65%	220%
India	47%	1%	75%	123%
Indonesia	37%	1%	47%	85%
Malaysia	116%	4%	128%	249%
Philippines	44%	1%	82%	127%
Thailand	113%	4%	110%	226%
Lower middle-income countries	35%	1%	36%	72%
Upper middle-income countries	48%	2%	60%	110%

Source: World Bank Financial Development Database

NB: Viet Corporate bond figure for 2016; Thailand bank credit for 2016.

Even in advanced countries with competitive manufacturing firms and well-developed capital markets, governments step in to increase the availability of long-term financing. The United States government created two quasi-private entities, Fannie Mae and Freddie Mac, to purchase mortgages below a threshold value from banks and finance companies.¹² Fannie and Freddie then hold mortgages on their books or securitize and sell them to institutional investors.¹³ The Small Business Administration (SBA) is another prominent example. The agency was in the news recently when it was tasked with managing the US government's \$349 billion paycheck protection program to support wage employees during the Covid-19 pandemic. Prior to this highly visible role, the organization has led a more mundane existence as a capital market intermediary for small and medium-sized businesses. Established in 1953, SBA has grown into one of the largest lending and loan guarantee agencies in the world, with assets of over \$100 billion (Orzechowski, 2020).

Thus, even the US, the country with the largest and deepest capital markets in the world, relies on government to direct long-term lending to specific classes of borrowers. These are just two examples: other programs provide loans and loan guarantees to farmers, university students and infrastructure projects. According to a recent estimate, the US government extended six trillion dollars in loans and loan guarantees from 1992 to 2012. And even this figure does not include billions in emergency lending to banks, insurance companies and the automobile industry in the wake of the GFC, or the vast, state-financed venture capital funds distributed through agencies like NASA, DARPA and university research programs (Elliott, 2011; Mazzucato, 2015). These institutions deploy the government's balance sheet to provide liquidity and alter businesses' profitability calculations to mobilize resources for long-term investment.

National Development Banking

Multilateral development banks (MDB) like the World Bank and Asian Development Bank borrow on international capital markets at preferred rates and use these funds to finance projects in developing countries.¹⁴ There are now around thirty such institutions in operation including sub-regional banks. The creation of new multilateral development banks in recent years suggests that the model is still relevant. New entrants include the European Bank for Reconstruction and Development (1991), the New Development Bank (2014) established by Brazil, China, India, Russia and South Africa (the BRIC Bank), the OPEC Fund for international Development (2014), and China's Asia Infrastructure Investment Bank (2015). MDBs have diversified their portfolios over the years, adding new instruments such as loan guarantees, equity investment and political risk insurance.

National Development Banks (NDB) operate in an analogous manner, using the government's capacity to borrow at low interest rates to channel credit to priority

¹² Formally known as the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, respectively.

¹³ These companies famously collapsed and were bailed out by the US Treasury in 2008 as housing prices plummeted as the GFC unfolded. However, the cause of their collapse had more to do with their participation in the non-agency mortgage backed securities market (securities bought from investment banks) than a failure of the core funding model (Frame et al., 2015).

¹⁴ Concessional lending is financed by donor country governments.

investment projects, classes of borrowers and institutions and to achieve specific policy goals.¹⁵ NDBs emerged as important financial institutions in the aftermath of World War II, when newly independent nations and countries rebuilding after the war set up public sector entities to mobilize capital. Two hundred fifty NDBs are now in operation including more than seventy in Asia (Nehru, 2019). In 2015, NDBs mobilized \$5 trillion for investment, five times more than the multilateral development banks combined (Griffith-Jones et al., 2018, p. 36). The main business of NDBs is discounting and guaranteeing loans made by commercial and investment banks, although many NDBs are also engaged in direct lending. One of the main advantages of NDBs over multilateral institutions is that they lend in domestic currencies, reducing foreign exchange risk. Most are profitable and maintain higher equity to asset ratios than the commercial sector. The state owns a majority stake in nearly all NDBs, although one-fourth have some form of private participation.

NDBs came to the fore during the GFC because they were among the few financing vehicles able to ramp up investment at a time when virtually all private financial institutions were retrenching (Luna-Martinez & Vicente, 2012, p. 8). Countercyclical finance—increasing lending during recessions and reducing it during periods of rapid credit growth—is an essential instrument of fiscal policy. Stefanie Griffith-Jones identifies four other roles performed by NDBs: i) financing innovation and structural transformation through investment in new industries; ii) financial inclusion and increasing the supply of credit to SMEs; iii) infrastructure and other large-scale projects; and iv) financing other public goods, notably climate change mitigation and adaptation (Griffith-Jones et al., 2018).

To get a sense of the potential of these institutions it is useful to focus on four of the largest measured in terms of the ratio of assets to GDP. These are: Germany's Kreditanstalt für Wiederaufbau (KfW) (14.5%); China Development Bank (12.2%); The Brazilian Development Bank (BNDES) (11.7%); and the Korean Development Bank (KDB) (6.7%). These institutions are not only the largest but also some of the most innovative, having successfully adapted to deep structural changes in their host economies and the global financial system over a period of many decades.

KfW was established in 1949 to manage US Marshall Plan funding after the war. New functions were added after reconstruction, including lending to SMEs and new ventures, housing, education and renewable energy. KfW maintains divisions to support German exporters and international development projects and helped finance German reunification in the 1990s. The bank is 80% owned by the federal government and 20% by the states, and funds itself on the capital markets through federally guaranteed bonds. Assets total more than 500 billion euros, and most loans are provided through domestic financial institutions. Borrowers typically apply through their local bank, which forwards the loan to KfW for refinancing at favorable rates and longer maturities. Liability is shared between KfW and

¹⁵ Development finance institutions, including National Development Banks, are legally independent, government supported financial institutions that have an explicit mandate to achieve public policy goals in a region, sector or for specific population groups. They are usually wholly or partially state owned, but there are examples of privately-owned development banks, including France's pioneering Credit Mobilier, established in 1848 (Di John, 2020).

originating bank to maintain the relationship between the borrower and the local institution. KfW also lends directly for education, export financing and large-scale infrastructure projects.

The bank's capacity to deliver financing on a large scale and closely monitor results was pivotal to the German government's post-GFC stimulus program. KfW disbursed more than seven billion euros in 2009 in direct lending and through commercial bank guarantees. By the conclusion of the program, loans had reached eleven thousand enterprises, 94 percent of which were SMEs. Owing to KfW's central role in implementation, Germany's stimulus program performed better and sustained demand more effectively than stimulus programs in other countries that relied solely on commercial and investment banks (Moslener et al., 2018, p. 112).

China has three development banks: the Export-Import Bank of China, the Agriculture Development Bank of China and the China Development Bank (CDB). CDB was established in 1994 to separate policy from commercial banking. In 1995, commercial banks were given autonomy from policymakers and were no longer used to deliver directed credit. As part of this process, CDB inherited a portfolio of mostly non-viable projects about which it knew very little. When the East Asia Financial Crisis arrived in 1997, the institution was effectively bankrupt. The central government established an asset management company in 1999 that took over most of its non-performing loans, and with the acquisition of the China Investment Bank, CDB established a branch network and internalized responsibility for loan supervision. Governance systems were restructured to separate loan evaluation and approvals from loan officers and branches, which helped shield the bank from pressure to finance politically connected projects (Xu, 2018, p. 82).

With \$2.5 trillion in assets at the end of 2020, CDB is now the largest development bank in the world. About 20 percent of its assets consists of international development projects including loans connected to China's One Belt One Road (OBOR) initiative. About two-thirds of funds are raised through bond issues guaranteed by the central government and therefore carrying relatively low interest rates (M. Chen, 2020).

Fiscal reforms in the 1990s banned local governments from issuing loan guarantees, restricting their ability to raise finance from commercial banks. In response, cities established local government financing vehicles (LGFV), which received land and infrastructure assets to use as collateral to raise funds without need of an explicit guarantee. Local investment projects were the principal vehicle of the government's countercyclical fiscal policy in 2009, when CDB lending increased by 88 percent in one year. CDB actively participated in infrastructure lending based on this model until a new budget law in 2015 once again allowed local governments to issue bonds directly.

Brazilian development is a story of alternating periods of inflation and stagnation (Figure 6). The boom years of the 1970s were followed by two decades of hyperinflation, indebtedness, inequality and rising poverty. The history of BNDES is closely bound up with the ebb and flow of public and private investment. The bank participated actively in financing domestic industry under import-substitution policies in the 1970s, including

investments in petrochemicals, capital goods and information technology. In that decade BNDES was responsible for eleven percent of all investment in the manufacturing sector (Griffith-Jones et al., 2018). As the only major provider of long-term finance in Brazil, BNDES played a central role in the privatization of large state-owned industries in the 1990s (Macedo, 2000). From the turn of the millennium until 2015, BNDES has concentrated on the closing the nation’s infrastructure gap. The Growth Acceleration Program (PAC) launched by the Lula da Silva administration in 2007, included major investments in infrastructure, and also became the flagship program of the government’s countercyclical fiscal policy with the arrival of the GFC. The program was continued under the Rousseff administration (PAC-2), supplemented by a separate Logistics Investment Program (PIL) from 2012 specifically for highway and railroad construction. Disbursements increased four-fold from 2007 to 2013, making BNDES one of the five largest development banks in the world (Stuart & Ramos, 2018).

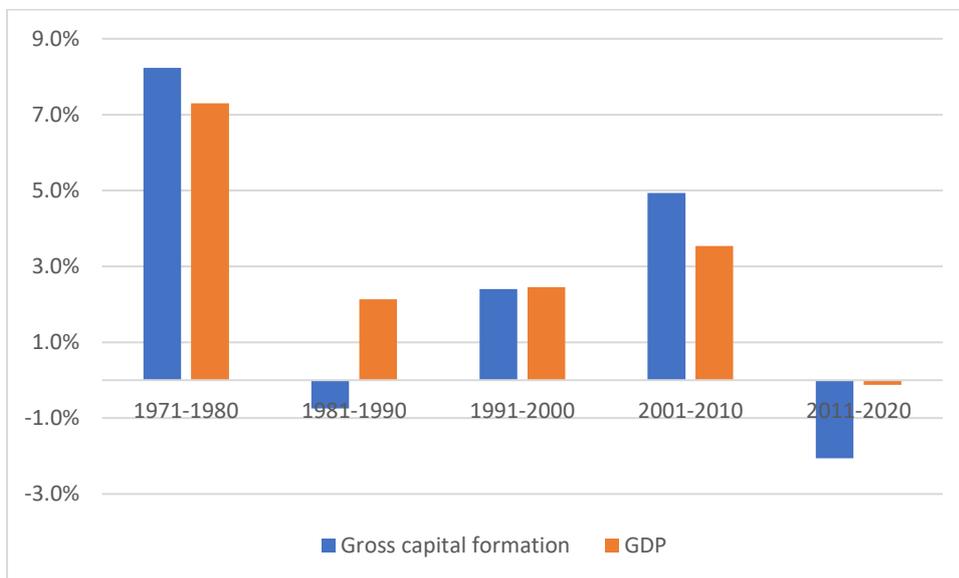


Figure 6. Average annual growth of gross capital formation and GDP, Brazil

Source: World Development Indicators

BNDES’ indirect lending programs enable public and private banks to extend loan maturities and its guarantees attract private capital into infrastructure investments under PAC and PIL. However, in response to the government’s decision to keep tariffs (fees and tolls) low, BNDES opted to provide financing below its established rates, which eventually forced the bank to rely more heavily on the national treasury for injections of capital. Renewed dependence on government support exposed the bank to shifts in the political winds, and when a government austerity program was implemented in 2016 BNDES was obliged to reduce its level of activity (Stuart & Ramos, 2018).

Likw KfW, the origins of the Korean Development Bank (KDB) can be traced back to the distribution of US development assistance for war reconstruction. Founded in 1954, the bank originally distributed American funds and issued its own bonds to raise capital for long-term investments. When government policy shifted to export promotion in the 1960s, KDB financed manufacturing firms and guaranteed foreign loans for imported capital goods (K.

Lee, 2017, p. 5). By the 1970s the focus of the government had moved on to the development of heavy industries such as chemicals, shipbuilding, steel, machinery and electronics. These capital and technology intensive industries required imports of capital goods and therefore access to abundant supplies of foreign exchange. The National Investment Fund was created to channel capital through KDB to the new industries. KDB also borrowed from institutions like the World Bank and floated international bonds to raise additional capital. Lending volume increased ten-fold during the 1970s, but slowed in the 1980s as the focus again shifted, this time to high-technology industries. KDB established the Korea Technology Financing Corporation to stimulate venture capital investments in new industries and provided financing directly for R&D investments.

The role of KDB has continued to evolve, including forays into international investment banking, countercyclical fiscal policy and corporate restructuring following the East Asian Financial Crisis. At the same time, the bank has continued to carry out its core function as a source of long-term finance for industrial development and infrastructure (UNCTAD, 2016b).

The experience of these institutions demonstrates the variety of instruments used by NDBs to increase the supply of long-term finance for infrastructure and industry. In a developing country setting, secondary markets are not sufficiently liquid or dense to bridge the gap between the demand for long-term funding and the preference for liquid assets. NDBs take advantage of the government's access to capital markets to expand the supply of non-state credit through second-tier lending, loan guarantees, syndicated lending and other instruments. We have seen that even in advanced countries like the US and Germany, public institutions are still needed to achieve specific policy goals, for example support for small businesses and energy conservation. Another common theme is the capacity of NDBs to act countercyclically to support investment and aggregate demand during periods of recession or crisis, for example during the East Asian financial crisis and the GFC.

Not all NDBs have succeeded, and there are plenty of examples of national development banks in Asia that have underperformed because of managerial or technical constraints or that have fallen victim to corruption scandals.¹⁶ The Viet Nam Development Bank (VDB), which handles ODA financing and also raises capital on the domestic capital markets, still operates as a traditional policy bank much like the China Development Bank prior to reforms in the 1990s. Accounting irregularities are common and the bank is not run on a commercial basis (Duc Tho, 2021). Annual reports do not appear regularly and even the State Bank of Viet Nam does not report on its operations. As in other countries in Asia, in the absence of an appropriate regulatory framework and oversight, "NDBs can become prey to powerful political forces that can undermine their effectiveness" (Nehru, 2019, p. 262).

Requiring private co-financing of NDB loans and loan guarantees has proven to be an effective check on political capture of development bank operations. Private involvement increases the effectiveness of monitoring and supervision. Even with a minority stake, the

¹⁶ The Indonesian Development Bank (*Bank Pembangunan Indonesia*) lost an estimated \$430 million on a single transaction in the 1990s, and the bank's remaining assets were eventually merged into Bank Mandiri, a new state-owned commercial bank created after the East Asian Financial Crisis.

government can retain control over strategic assets through golden shares and other mechanisms (Musacchio Farias & Lazzarini, 2014). Asian NDBs have demanded substantial collateral from private firms receiving NDB credits to incentivize private business groups to use loans for productive purposes (Xu, 2018).

Sovereign Wealth Funds

Countries that regularly record trade surpluses have established sovereign wealth funds (SWF) to mobilize foreign exchange reserves for domestic purposes. These organizations manage national reserves to achieve strategic objectives such as conserving the value of resource rents and to protect living standards for future generations, to finance industrial projects or to invest in a countercyclical manner while avoiding large fiscal deficits. Because they have no short-term liabilities, they are free to finance long-term ventures unconstrained by liquidity concerns. They operate separately from the central bank, finance ministry and other authorities to shield them from political influence. The top 100 SWFs controlled \$8.6 trillion in assets in 2020, 85% of which are in developing countries (Table 3).¹⁷ Fifty-two SWFs were established from 2000 to 2015, including forty in the developing world.

Table 3. Ten largest Sovereign Wealth Funds, 2020

Country	Name	Assets (USD billions)
Norway	Government Pension Fund Global	1,289.5
China	China Investment Corporation	1,045.7
Kuwait	Kuwait Investment Authority	692.9
Abu Dhabi	Abu Dhabi Investment Authority	649.2
Hong Kong	Hong Kong Monetary Authority Investment Portfolio	580.5
Singapore	Temasek Holdings	484.4
Singapore	GIC Private Limited	453.2
Saudi Arabia	Public Investment Fund	430.0
China	National Council for Social Security Fund	372.1
Dubai	Investment Corporation of Dubai	302.3
Total		6,299.8

Source: SWF Institute

While a majority of SWF are funded from natural resource exports, recent years have seen an increase in funds financed from other sources. Asian countries that have accumulated vast foreign exchange reserves from trade surpluses have begun to question the wisdom of holding large volumes of low-yielding, dollar-denominated assets. Elsewhere proceeds from the privatization of state assets, have been channeled into SWFs. Changes in the source of capital has been accompanied by a shift in objectives from intergenerational equity to national development and countercyclical investment policy. In the past, SWFs were motivated by a desire to conserve national wealth derived from resource rents in the form of international investments. Thus, future generations of Norwegians would benefit from the country's oil wealth long after the last well had run dry. The mission of Asian SWFs, in

¹⁷ See www.swfinstitute.org.

addition to managing national wealth, includes contributing to economic stability and transformation of the national economy.

These aims need not be mutually exclusive. SWFs have a long history of investing in infrastructure, hospitals and schools while at the same time acquiring a diversified portfolio of international assets. However, if one of the goals of the fund is to moderate the impact of the business cycle on domestic demand, care must be taken to ensure that disbursement of funds for national projects is timed to coincide with periods of slower domestic credit growth.

A common principle of SWFs is that they restrict themselves to commercially viable investments, earning a rate of return that preserves the value of capital in real terms. Projects that have a positive social rate of return but are not financially feasible are better left to the government's public investment budget, where adequate provision can be made for subsidization and operations and maintenance. Limiting SWFs to minority stakes in investments ensures that only viable projects are taken on and enables SWFs to avail themselves of external expertise (Gelb et al., 2014, p. 11).

Discouraging Speculation

It is one thing to generate more investible resources; it is quite another to invest them wisely. The GFC and other financial crises began with the formation of asset bubbles, usually in property markets. In every financial era, bankers and other financiers conceive of innovative means to increase leverage within the confines (and sometimes outside of) prevailing laws and regulations. From margin trading before the Great Depression, junk bonds in the lead up to the US savings and loan crisis, to Collateralized Debt Obligations of the GFC, financial innovation fuels the asset bubbles that eventually burst, with catastrophic consequences for the real economy (H. P. Minsky, 2008, p. 199).

Asset bubbles are a missed opportunity in two senses. First and most obviously, they inevitably collapse, destroying businesses and capital and depressing economic growth as households and firms reduce investment and consumption as they wind down their liabilities. They also represent a diversion of capital away from socially productive investment into risky speculative activities. In the United States, private non-residential investment has not yet recovered from the GFC, but house prices have already surpassed the levels recorded in 2007. Meanwhile, as of October 2021 the S&P 500 is trading at *three times* pre-crisis levels. Policies are needed to change the incentive structures facing firms and individuals, reducing returns to speculative activities and more making it more profitable to invest in projects that create jobs, raise productivity and generate export revenues.

Like Korea, Japan used a form of financial repression to redirect credit from short to long-term uses, especially in export industries. However, from the early 1980s restrictions on lending to the property sector were relaxed and nonfinancial corporations crowded into the sector as prices rose. Real estate prices more than doubled in the latter half of the decade, and by 1989 Japanese land and buildings were valued at US\$24 trillion, four times that of the US (Sheng, 2009, p. 65). When the bubble burst, Japanese corporations embarked on a

decades-long deleveraging process, destroying trillions in assets and suppressing investment demand. Despite years of expansionary fiscal and monetary policy, domestic investment remained subdued and the country entered into a recession from which it has never really emerged (Koo, 2009).

Once asset bubbles form it is politically difficult to unwind them; too many powerful people have their wealth tied up in houses, office buildings and equities. The aim must be to prevent bubbles from forming in the first place. There are two main instruments to achieve this: restricting the ability of banks to lend into property and stock market booms; and taxing capital gains to reduce the attractiveness of speculating in land and equities. Capital requirements for real estate lending must be high enough to discourage banks from overlending, and maximum loan to value ratios should be established to prevent borrowers from taking unnecessary risks. Capital gains taxes should not exempt family homes and mortgages should not receive tax relief. Property taxes should reflect rising land values and form the core of local government finance, giving local authorities an incentive to improve capacity to assess properties and collect the tax (Turner, 2017, p. 183). These measures may be politically unpopular, especially with the emerging middle classes, but they are necessary to prevent asset price inflation and the diversion of investment capital from productive purposes to speculation.

Public investment to “crowd in” private investment

Development of infrastructure, and improvements to education and health contribute to productivity growth levels and create an enabling environment for private business activity (Aschauer, 1988; Greene & Villanueva, 1991). However, economists have often argued that excessive public investment competes with private investment for domestic savings (Buiter, 1977; Evans & Karras, 1994). The view rests on two familiar assumptions: that domestic savings are a pre-existing stock of loanable funds accumulated by frugal households and governments; and, that the economy operates at full employment, such that an increase in one category of expenditure must come at the expense of another. But if these assumptions do not hold, efficient (in the sense of generating a positive social rate of return) public investment projects create opportunities for private investment by removing bottlenecks in the economy such as high logistics costs and shortages of skilled workers.

Table 4. Infrastructure Investment Requirements (% GDP), Developing Asia

		2016-2030	
	Public investment in infrastructure 2011	Investment requirement without climate change	Investment requirement with climate change
South Asia	4.8%	6.9%	8.8%
Southeast Asia	2.1%	5.0%	5.7%

Source: Asian Development Bank, 2017

Outside of China, developing Asia suffers from a widening infrastructure gap. Although great strides have been made in communications and information technology, investment in transport and logistics, renewable energy and access to clean water and sanitation have not kept pace with demand in most countries. Climate change adaptation and mitigation has increased the investment requirement in Southeast Asia by nearly one percentage point of

GDP, and nearly two percentage points in South Asia according to the Asian Development Bank (Table 4).

There are reasons to suppose that the positive impact of public investment is greater in developing than in advanced countries. Returns to public investment are likely higher in the former because of infrastructure backlogs. Figure 7 shows the relationship between public capital stock (as a share of GDP) and income per capita in 2017 for countries in the region. While not a linear relationship, there is a vast difference between lower income countries grouped in the bottom left of the chart and upper-middle- and higher-income countries.

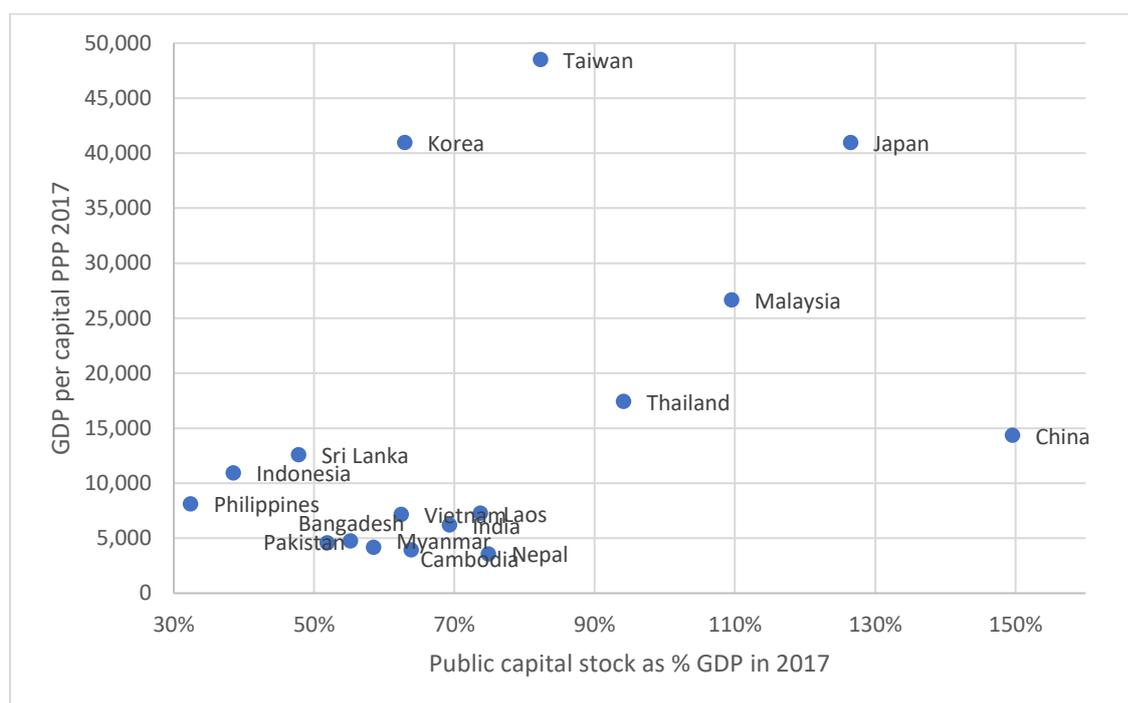


Figure 7. Public capital stock as % GDP and GDP per capita in PPP USD, 2017

Source: IMF

Studies of the relationship between public and private investment find that public investment crowds in private investment in developing countries, but not necessarily in high income countries. Erden and Holcombe, for example, report that a ten percent increase in public investment is associated with a two percent rise in private investment in their sample of developing countries, but found a negative relationship among advanced countries (Erden & Holcombe, 2005). Cavallo and Daude confirm this result but conclude that the crowding in effect is conditional on the quality of domestic economic institutions (Cavallo & Daude, 2011). Bahal, Raissi and Tulin find a strong crowding-in effect of public investment in India, but only after 1980 when policies that had suppressed private investment were reversed (Bahal et al., 2018). The relationship between public and private investment is particularly strong in the agricultural sector in both the long run and short run in India, and the trend decline in public investment is a significant cause of slowing productivity growth in the sector (Akber & Paltasingh, 2019).

As discussed above in the context of national development banks, the experience of the GFC was a reminder of the role of public investment in countercyclical fiscal policy. During recessions, public investment supports aggregate demand while adding to the nation's productive capacity. In a widely cited study, Kaminsky, Reinhart and Vegh find that while fiscal policy is generally countercyclical in high-income countries, it is procyclical in nearly all developing countries (including Viet Nam) (G. Kaminsky et al., 2004). An important difference between developing and advanced countries is dependence on natural resource exports, which is associated with procyclical revenue and expenditure policy (Herrera et al., 2019).

During the Covid-19 pandemic, the government has attempted accelerate disbursement of public investment funds to sustain aggregate demand and create conditions favorable for growth. Efforts are being made to focus on larger projects of national importance and more monitor outcomes more closely. Still, by the end of the third quarter of 2021 less than half of the annual investment plan had been disbursed, less than the same period in 2020.¹⁸ Social distancing and lockdowns have been a factor, as have chronic problems such land clearance and bidding delays, poor planning and execution by contractors, and confusion over legal and regulatory changes. In July, the Prime Minister established a working group chaired by Deputy Prime Minister Pham Binh Minh to remove obstacles to the timely completion of public investment projects.¹⁹ Local authorities have argued that further decentralization of authority is needed to cut red tape. But according to the Deputy Prime Minister, half of the complaints that he has received about regulatory obstacles to public investment disbursements are attributable to misinterpretation of the rules by local leaders.²⁰

Viet Nam's system of public investment is already one of the most decentralized in the world (World Bank, 2018, p. 20). However, decentralization of authority has not accelerated disbursements or increase the completion rate, which has fallen consistently over the past decade. Management of public investment is fragmented and not transparent, and the central government lacks the instruments and authority needed to prioritize investments or monitor outcomes. Project selection is not rigorous and is heavily politicized; there are no established criteria to rank projects by socio-economic feasibility. Although the Government has announced plans to introduce regional planning mechanisms and upgrade monitoring of project implementation, there has been little progress to date. Provinces in Viet Nam are small, which means that dealing with country's most serious infrastructure bottlenecks requires strong central and regional leadership to ensure coherence in planning and implementation and cooperation among localities. Yet thus far effective regional planning structures have not been put in place. This issue will increase in importance as the country confronts the challenge of climate change. Sea level rise, floods and drought do not respect provincial borders.

¹⁸ See <https://vietnamnet.vn/en/business/vietnam-business-news-october-3-779680.html>.

¹⁹ Decision 1242/QĐ-TTg July 16, 2021.

²⁰ <http://baochinhphu.vn/Thong-cao-bao-chi/Thu-tuong-chu-tri-Hoi-nghi-ve-giai-ngan-von-dau-tu-cong/447980.vgp>.

In many countries, including Viet Nam, discussion of public investment levels is preoccupied with the size of the national debt. It is certainly the case that foreign debt is risky because interest and principal payments must be made in foreign currency, which must be earned through exports or borrowed abroad. A sudden drop in the value of the domestic currency could force the government to make spending cuts and raise interest rates to attract foreign funds. But when government debt is denominated in the domestic currency, and held by nationals, these concerns do not arise.

Aside from exchange rate concerns, the risk of government debt spiraling out of control is small. If the real rate of economic growth is higher than the real interest rate on public debt, the debt to GDP ratio will stabilize. This is equally true of public debt at 90% of GDP and at 10% of GDP. If government bonds are sold to domestic private entities (households or firms), every government liability is matched by a private sector asset, and interest payments are private sector income. Fears that government bonds somehow soak up a finite supply of savings, or reduce income by discouraging consumption, are unwarranted.

This is not to say that public debt is costless. Government borrowing can negatively affect the distribution of income because interest payments entail a transfer of income from taxpayers, many of whom are not well off, to owners of capital, including banks and insurance companies. To the extent that the government is financed by broad-based taxes like value added tax, these transfers are regressive. All the more reason for public investment to prioritize job creation and essential infrastructure for low income communities and households.

Attempts to uncover evidence of growth-inhibiting effects of public debt have not been successful. The most well-known study was carried out by Reinhart and Rogoff, two prominent American economists, who claimed to have identified a debt threshold of ninety percent of GDP, above which higher interest rates act as a brake on growth (Reinhart & Rogoff, 2011). However, soon after publication it was discovered that this conclusion was based on a series of spreadsheet errors and data glitches, and once these were resolved the relationship between public debt and slower growth disappeared (Herndon et al., 2013). Sovereign countries that control their own currency have much greater fiscal space than is often presumed by policymakers.

Does this mean the government can borrow as much as it likes without worrying about negative economic consequences? Unfortunately, no. The government can sustain a moderate deficit without fear of inflation, as the economy normally has enough excess capacity to absorb a short-run increment in aggregate demand. Over the long term, output will adjust to the higher level of national income. But a sudden increase deficit spending can generate inflationary pressures in the short-term, since a shortage of workers and wage goods—food and other essentials—could push up prices.

But inflation is not the only, or even the most serious problem. In an open economy like Viet Nam, an increase in aggregate demand will spill over into imports. Depending on prevailing conditions in international capital markets, the need to raise international financing could lead to higher interest rates and slower growth, or exchange rate depreciation and domestic

price inflation. Developing countries that record persistently large current account and government deficits can find themselves in the undesirable situation of building up foreign liabilities, which can leave the economy vulnerable to sudden shifts in international sentiment.

Until recently, developing countries had difficulty borrowing internationally in their own currencies because investors were unwilling to carry the foreign exchange risk associated with local currency bonds. This problem, which was unrelated to past episodes of exchange rate instability, was dubbed “original sin” in the economics literature because it was just a fact of life that no developing country could escape (Eichengreen et al., 2005). However, foreign investors discovered an appetite for domestic currency-denominated public debt when exceptionally low yields in the advanced countries, especially after the GFC, forced traders to look for new sources of yield. The entry of foreign buyers improved borrowing terms for issuing countries, including lower rates and longer maturities without indexing or variable rates.

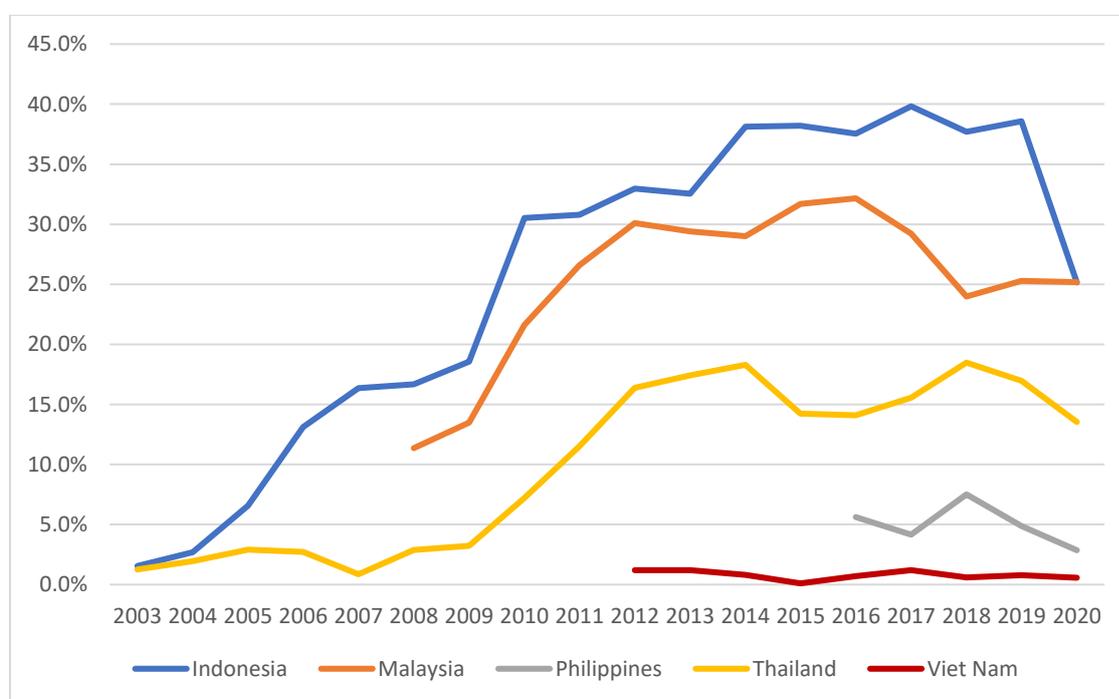


Figure 8. Share of foreign ownership of local currency bonds

Source: Asian Development Bank

This is a positive development from the perspective of exposure to exchange rate risk. Figure 8 shows the striking increase in foreign ownership of local currency bonds in Indonesia and Malaysia, and a slower rise in Thailand. These countries are now able to obtain international capital at favorable rates in their own currencies. However, there is a downside to these developments. Having opened their domestic bond markets to foreign investors, these countries are now more vulnerable to sudden shifts in bond prices should expected yields increase in the advanced countries. The “taper tantrum” of 2013, when US yields spiked on the Federal Reserve’s announcement that it would begin phasing out purchases of Treasury bonds, is an example of the turbulence that can result from heavy

reliance on international investors. As foreign investors ran for the exits, Indonesian and Malaysian interest rates shot up and the rupiah and ringgit came under heavy pressure (Akyüz, 2017, p. 104).

As noted above, in addition to increasing the volume of public investment, developing countries need to do a better job prioritizing and implementing their public investment programs. The quality of public investment selection and implementation have been shown to be an important determinant of the relationship between public investment and growth (Gupta et al., 2014). While the involvement of the private sector in infrastructure and other projects (public-private partnerships) can introduce market incentives in some situations, for most projects it has proven to be very difficult to get the incentives right, and governments have shown a tendency to select low priority PPP projects for the simple reason that they do not require government financing (Engel et al., 2014). Countries with stronger public investment management systems tend to rely less on PPS, which rely on riskier financing and are less closely aligned with government priorities (IMF, 2015)

Kickstarting the Recovery

The focus of this paper has been on increasing the supply of long-term financing for development. However, recovery from the coronavirus pandemic demands action in the short-term to help vulnerable households and communities and to restart economic activity. A survey carried out in July 2021 by the Center for Analysis and Forecasting of the Viet Nam Academy of Social Sciences with UNDP found that nearly two-thirds of all households had experienced a fall in income of more than 30 percent from the pre-pandemic period (December 2019), and half of all households were forced to reduce food purchases. The rate of transient income poverty surged from under 10% pre-crisis to 33.4% in August 2021 (based on the 2021-2025 poverty line issued by the Ministry of Labour - Invalids and Social Affairs). Many migrants were left homeless, unable to pay for rented accommodations but also prevented from returning to their home provinces (UNDP & Center for Analysis and Forecasting, 2021).

The Government introduced a VND 26 trillion support package on July 1st, 2021 (Resolution 68/NQ-CP), but only nine percent of this amount was allocated to cash transfers. The package consisted of twelve sets of policies including reduction or suspension of insurance premiums and contributions and support for formal sector workers whose jobs were suspended or lost. Responsibility for informal sector workers, migrants and micro-enterprises fell to provincial governments, which exhausted their resources two months into the resurgence of infections. By the end of August only 22% of targeted households had been reached, mostly residents in better off provinces (Institute of Labor Science and Social Affairs & UNDP, 2021). Nine out of ten respondents reported in July that they had not received support while 83% said they were in need of assistance (UNDP & Center for Analysis and Forecasting, 2021).

In comparison with other countries in the region, Viet Nam's fiscal response is modest (Figure 9). According to the IMF, from January 2020 through September 2021, Viet Nam allocated approximately 1.4% of GDP to Covid-19 relief and additional health expenditures. The Government's success in containing the virus last year reduced the need for spending in

2020, especially in comparison with neighboring countries struggling to contain large-scale community transmission of the virus. However, the situation changed in mid-2021 with the arrival of the Delta variant and a sudden spike in cases and serious illness.

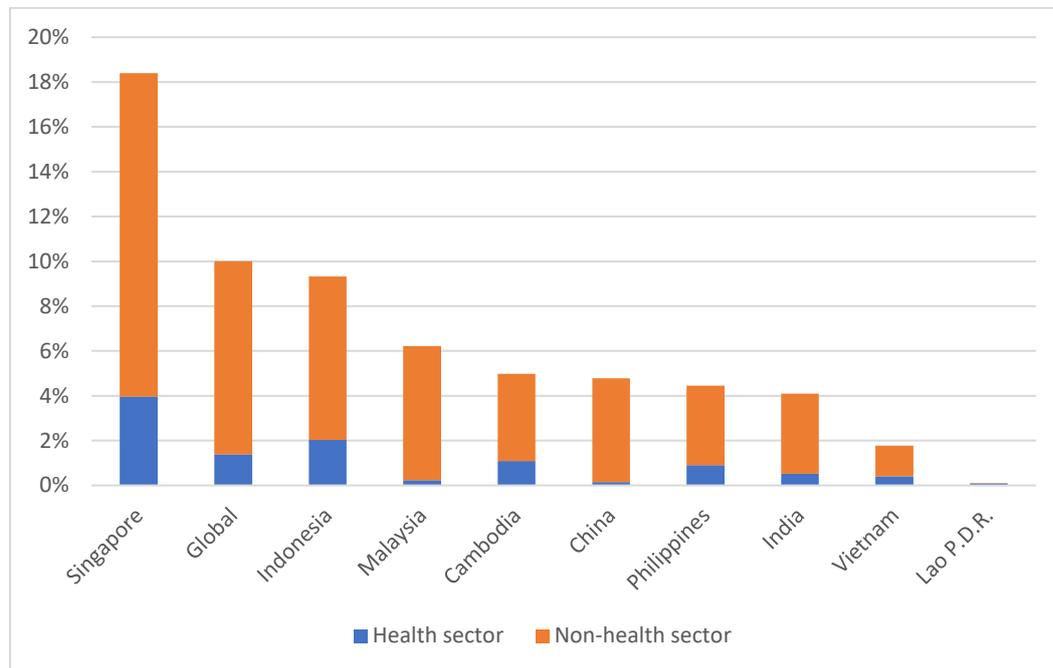


Figure 9, Fiscal response to the Covid-19 Crisis as percent of GDP from January 2020 to September 30, 2021

Source: IMF

Hopes for a rapid, V-shaped economic recovery receded as lockdowns were imposed to stem the rise of case numbers in hotspots in and around Ho Chi Minh City. Third quarter GDP contracted by a record 6.2%, led by services (down 9.3%) and industry (5%). Ninety thousand businesses suspended operations or filed for bankruptcy between January and the end of September 2021. The World Bank now expects output growth for the full year to fall below 2.5% and could even dip lower if the recovery is delayed.

The main cause of the sharp contraction in economic growth is the contraction of domestic consumption. In most years accounts for between 60 and 70% of GDP growth, but last year consumption contributed only 12% and private consumption increased by only one percent in real terms. Consumption expenditure recovered in the first half of 2021, but retail sales contracted by 30% in the third quarter. Additional support to the public—urgently needed to relieve the suffering of vulnerable households—would also support economic recovery as businesses struggle to stay afloat as aggregate demand declines.

Cash assistance on the scale required will require additional domestic borrowing in the short-term, but some of the additional spending will be recouped by the government in the form of taxes paid on consumption and earnings. Because of the consumption multiplier, the ultimate impact on aggregate demand will be much larger than the initial round of spending. Money spent in the first round on food and other essentials will provide income for shops and their workers, and for farmers. They in turn will spend a portion of their additional income on domestically produced goods and services, and so on. If the marginal

propensity to consume domestic goods and services from income is 60%, government assistance of VND 1 trillion would ultimately generate VND 2.5 trillion in spending.²¹

In an economy operating below potential, there is little risk of inflation or trade deficits resulting from the extra domestic borrowing. Domestic borrowing in VND implies no currency risk or pressure on the balance of payments. Indeed, the capital borrowed by the government is now sitting idle in form of forced saving as planned consumption (foreign trips, consumer durable goods) and investment projects are postponed. Government borrowing would mobilize these savings and use it productively to simulate economic output and employment. As we near the end of the calendar year, many businesses will be concerned that the shortfall in demand will extend through the Tet holidays, which is the period many depend on for half or even more of annual sales.

A cash assistance program of 5% of *quarterly* GDP disbursed over the final months of 2021 (or approximately VND 77 trillion) would be neither inflationary nor damage the public finances. The scale of support is similar to that provided by neighboring countries during the first round of lockdowns in 2020. Households receiving temporary assistance will spend a large proportion of the increased income, adding to final demand and generating revenue for local businesses. While some of this demand will spill over into imports, most of it will go to low-income households that mainly purchase domestic goods and services such as food, housing rent and utilities.

The quickest way to deliver this support is to provide an immediate benefit to (i) children under 6 years old on presentation of the child's birth certificate; (ii) pregnant women; (iii) elderly people from 60 years of age including people from 80 years of age that are beneficiaries of regular cash assistance programs without pensions; (iv) and people with disabilities. Administrative requirements should be kept to a minimum, and an electronic register of individuals should be compiled listing households and individuals who have received support. Cash assistance can be delivered monthly or in one payment for the final three months of 2021. The amount can be linked to the minimum subsistence requirements in Decree 20/2021/NĐ-CP (replacing Decree 136/2013/NĐ-CP).

Some will object that in a universal benefit scheme, non-poor households will receive government grants that they do not need. This is unavoidable but not a major problem given that assistance is temporary. Many wealthier families will not bother to request these relatively small amounts of money, and in any case some leakage to non-poor or vulnerable households is small price to pay to achieve the larger goals of relieving suffering and sustaining economic growth. As with all government initiatives, monitoring and evaluation of impact should be integrated into the introduction of the program.

Cash assistance is preferable to tax deferrals because the additional spending immediately contributes to the growth of aggregate demand, while tax deferrals may be saved or carried over. The Government has relied heavily on monetary policy, including interest rate reductions and subsidized lending, primarily because these programs are simple to initiate

²¹ The marginal propensity to consume is the proportion of additional income spent on domestic goods and services. The consumption multiplier is $1/(1-mpc)$.

and administer and do not require broad agreement across many branches of government. However, as we learned after the Global Financial Crisis in 2008, subsidized lending leads to a build-up of liabilities in the corporate and household sectors, which can delay the recovery as borrowers redirect income from investment and consumption to paying down debt.

Monetary policy should focus on helping otherwise healthy companies during the period of suppressed domestic demand. If these companies were to go out of business during the pandemic, the recovery would be delayed as it would take time for new businesses to establish themselves. The government does not have full information on which companies are in good condition, but the banks do have this information: SBV can work closely with banks to enable them to extend existing credit lines for several months. SBV can also show some lenience in loan classifications to prevent a situation in which banks are penalized for rolling over loans for their valued clients. But the government must be careful to avoid undermining the financial health of the commercial banks. New lending should be carefully targeted and tied to employment guarantees for workers. SBV must also ensure that the credit market remains liquid so that normal transactions are not impeded.

The lesson from the rapid spread of the Delta variant is that setbacks are not only possible, but they are also to be expected. Therefore, in addition to delivering immediate support, preparations must also be made for medium-term programs to sustain growth and private consumption if needed. The supplemental programs could address issues that cannot be managed in the short term, for example:

- An accelerated transition to electronic registration for social assistance programs based on unique national identification numbers rather than residence;
- A program of public works organized by local government agencies that have a backlog of maintenance and repair projects that could be started quickly. Public works are useful because it is self-targeting: only people who really need the money will turn up.
- Assistance for migrants to return to their place of work quickly and to find and pay for rented accommodation;
- A program to distribute inexpensive, domestically produced tablet computers to all school aged children who will need these devices for home schooling resulting from the pandemic;
- Provision of vouchers for free or subsidized access to specific domestically produced goods, including rice, fruit and vegetables, cooking oil, clothing, books and school supplies.

The objective of these policies and programs is to aid disadvantaged people in case of a longer lockdown, and to sustain domestic consumption. The emphasis is on goods and services that are most needed that are domestically produced, which would stimulate domestic production, create jobs and increase Government revenue.

IV. Conclusions and Policy Implications

Containing the Covid-19 pandemic and restarting economic activity are urgent, immediate policy challenges. Once these objectives have been achieved, attention will again turn to

realizing the Socio-Economic Development Plan, the Socio-Economic Development Strategy and the SDGs by 2030. Protecting vulnerable regions and populations from the effects of climate change, and the development of renewable energy systems, will require a massive investment effort. This will all take place in the context of a global economy plagued by uncertainties, including a build-up of private debt, a fractious multilateral trading regime, rising inequality and a global slowdown in productivity growth.

Viet Nam needs to maintain an investment rate between 35 and 40% of GDP to achieve the country's economic ambitions. Yet the investment rate declined after the GFC and was only beginning to recover when the Covid-19 pandemic hit. Moreover, the recovery relied heavily on foreign direct investment, which is expensive and generates foreign liabilities. Identifying sustainable sources of development finance, and rebalancing investment toward domestic sources, will be a top priority of the Government for the rest of this decade.

Until recently, a consensus had formed among economists that development finance was essentially a matter of matching supply and demand, and that this function was best carried out by private markets unfettered by government regulation. Freeing up interest rates, bank licensing and controls on capital mobility were the order of the day. Equilibrium real interest rates would encourage saving, and markets would allocate capital to the most efficient and profitable projects. But the results of financial liberalization were disappointing. Domestic saving did not increase, investment rates languished, and banks continued to favor short-term lending. The developing world experienced a series of financial crises brought on by over-leveraging, speculation in property and financial assets, connected lending and unpredictable shifts in foreign capital flows. Flexible exchange rates—a core tenet of liberalized finance—tended to overshoot, destabilizing corporate balance sheets and trade flows.

In the wake of the Mexican Tequila Crisis, the East Asian financial crisis and finally the GFC in 2008, skepticism regarding the growth and stability implications of financial liberalization moved from the fringes of the economics profession to the mainstream (Jeanne et al., 2012). From “an idea whose time is past” (Dornbusch, 1998), capital controls have been accepted by the international financial institutions as a legitimate instrument to manage surges of short-term capital flows (Ostry et al., 2010). Unremunerated reserve requirements, taxes on portfolio inflows, minimum stay or holding periods and restrictions on foreign borrowing are now common (Akyüz, 2017, p. 71). Financial liberalization was partly reversed in the OECD countries, with increases in statutory capital requirements, new lending curbs and renationalization of banks. There was less change in policy in developing countries, where banks are more strictly regulated than in North America and Europe (Denki & Gomes, 2017).

It is now widely accepted that government has an important role to play in stabilizing the financial system and intervening when necessary to ensure that financing is available for investments that serve important national economic and social objectives. This does not mean that governments are prepared to simply turn back to the clock to the days before financial globalization. New solutions are required to meet today's challenges that both learn from successful and unsuccessful policy experiments of the recent past.

Increasing the supply of long-term finance

Access to stable, long-term sources of financing is a key development challenge. Most countries, including developed countries with deep financial markets, have concluded that left to their own devices markets will undersupply long-term credit to important classes of borrowers such as small businesses, homeowners, infrastructure development projects and export industries. Interest in national development banking surged after the GFC because of the capacity of these institutions to ramp up investment in a timely manner to support aggregate demand as the crisis unfolded. Recognition of the scale of investment required to adapt to and mitigate the effects of climate change has prompted governments to enlist the support of national development banks to convert energy systems from fossil fuel dependence to renewable sources.

National development banks take many forms, and outcomes have varied with technical and managerial capacity, quality of governance and the volume of resources at their disposal. The most successful institutions have played a transformative economic role. They usually work in tandem with other financial institutions in the public and private sectors, providing second tier loans and loan guarantees. Banks that separate loan decisions from political considerations and are financially self-sufficient—meaning that they manage to turn a profit and do not rely on support from the national treasury—have had the greatest impact.

Viet Nam has two policy banks, both of which underperform and are not sufficiently transparent in their operations. Reform of these institutions is an essential component of industrial policy given the central role of finance and constraints on the use of traditional tools like local content requirements and trade protection imposed by multilateral and bilateral trade and investment treaties. Viet Nam can learn important lessons from the reform of the China Development Bank, and the experience of KfW, BDNES and the Korean Development Bank. This must be given top priority.

Sovereign wealth funds are another government financing vehicle that have moved from the periphery to the mainstream. Once the preserve of resource rich countries building up global investment portfolios, SWFs have diversified funding sources and investment outlets. Countries that record persistently large current account surpluses have repurposed a portion of their exchange reserves to SWFs to earn a higher rate of return on national assets and to provide long-term financing to projects of national importance.

Mobilizing public resources

Developing countries need to raise more revenue to sustain higher levels of public investment. Governments rely heavily on broad-based taxes like value added tax and payroll taxes because they cover the largest volume of transactions and do not discourage private investment. Collecting these taxes is difficult when many businesses and workers are informal or unenumerated. Therefore, formalizing businesses and labor relations should be a priority for governments seeking to stabilize public finances. Government must work to convince informal businesses that the benefits of formalization outweigh the burden of taxation, even if this means helping them to meet the costs of abiding by labor and environmental laws and regulations. While access to formal credit is an advantage, it is

not sufficient to persuade informal businesses to register with the authorities. Informal businesses are more likely to respond to concrete benefits, for example assistance with training, marketing and distribution and access to infrastructure. In this sense, widening the tax base needs to be linked to strategies to develop the productive capacity of firms in the informal sector.

Property taxes are another source of revenue that most development countries underexploit. Land and buildings tax is an important source of funding for local government and has the potential to reduce the burden of inter-government transfers on the central government. Property taxes are unpopular with elites, which makes raising them and expanding coverage politically difficult. But this is a hurdle that must be overcome, not only as an important source of revenue but as an instrument to discourage speculation in land and financial assets. As with widening the tax base, property tax increases are much more likely to be supported by elites if they are linked to concrete economic benefits like improvements to infrastructure, schools and other services.

Together with increasing the volume of public investment, governments must use these resources more efficiently. Public-Private Partnerships have been encouraged by international organizations but getting the incentives and financing right are major hurdles. In Viet Nam, excessive decentralization of public investment allocation and implementation has reduced completion rates and efficiency and has contributed to delays in implementing projects of national importance. More rigorous appraisal and selection, and tighter monitoring of implementation, are urgently needed to restore the link between public investment and economic growth.

Another development since the GFC is the increasing willingness of foreign investors to acquire government bonds denominated in domestic currencies. Once considered too risky (tainted by “original sin”), foreigners flocked to domestic currency assets in search of yield as the advanced countries endured many years of historically low interest rates. Foreigners’ appetite for domestic currency bonds is something of a chicken and egg situation: the larger the share of foreign ownership of domestic currency bonds, the less latitude the government (or independent central bank) has when it comes to managing the domestic currency. For foreign investors there is safety in numbers, but for governments the large-scale participation of foreigners in domestic public bond markets narrows the space for an independent monetary policy. Governments need to decide whether opening domestic currency bonds to foreigners is worth loss of control over the level of the exchange rate and interest rates.

[Prioritizing domestic finance](#)

Countries that rely more on domestic finance grow faster. This is an empirical regularity that economists have often found puzzling. But the reasons are not difficult to fathom. Countries pursuing a strategy of export-led growth record trade surpluses and thus are net capital exporters in some form. On average, they invest a larger share of national income than capital importing countries. Since international capital flows tend to be pro-cyclical, countries that depend on foreign capital inflows are prone to overheating during periods of rapid growth and deeper recessions during slowdowns.

Developing countries need to monitor capital inflows and their effects on domestic credit growth to protect themselves from the negative effects of global credit cycles. Permanent capital controls on specific types of liabilities and temporary limits on the volume of inflows during the boom phase of the cycle can restore some policy space. Regulatory limits on the ability of domestic banks to increase leverage are important instruments in the developing country context.

Foreign direct investment contributes to growth when it is export-oriented and opens access to foreign markets. At the early stages of development, FDI creates formal sector jobs for workers with relatively low skills, which raises productivity and contributes to poverty reduction. However, policymakers should recognize that the real differences between FDI and portfolio flows are often exaggerated. FDI is not necessarily less risky than loans, and it creates liabilities that can weigh heavily on the balance of payments. Moreover, as a source of finance it is expensive, and much of it is derived from profits rather than inflows of new capital. Most studies have failed to detect significant technological transfers (spillover effects) from foreign to domestic firms. In this light, it is not surprising that most innovative and successful export firms in developing countries are domestically owned business rather than subsidiaries of foreign firms.

In the long term, the impact of FDI depends on whether it crowds in or crowds out domestic investment. Studies have failed to detect significant linkages between FDI and domestic firms in most products and most locations, and the scope for productivity growth in labor-intensive assembly operations is limited. Multilateral and bilateral trade and investment agreements close off most avenues that developing countries have used in the past to compel foreign firms to integrate local companies into supply chains. However, governments have other tools at their disposal to encourage FDI firms to deepen forward and backward linkages to domestic firms such as infrastructure development, research and development policy, training programs and finance. Targeted industrial policies can help domestic firms improve quality and reduce production costs.

[Learning from the past, looking to the future](#)

Responding to the chaos and uncertainty of the East Asian financial crisis and Global Financial Crisis was a chastening experience for policy makers. The twin crises were a reminder that financial markets are prone to herd behavior and over-leveraging, leading to instability in the absence of borrowing limits. East Asian governments also learned that foreign exchange markets do not adjust seamlessly to shocks, and that a sudden shift in sentiment—even if unrelated to macroeconomic fundamentals—can in a short period of time annihilate billions of dollars in assets and leave the government to pick up the bill. Positions fervently held before the twin crises—for example, that asset bubbles are rational because markets are efficient, or floating exchange rates reduce the need to hold foreign exchange reserves—are heard less frequently today.

However, as much as we would like to learn from history, the lessons of the past often seem irrelevant in a context of rapid change. Each era brings with it a unique constellation of circumstances and considerations. Returning to policies that have worked in the past is not a realistic option given the vast changes in technology, economic structure and the

geopolitical context. Globalization is here to stay, but the precise form that it takes is impossible to know in advance. Technology will also play an important role. Blockchain, cryptocurrency, peer-to-peer lending and other innovations create opportunities but are also sources of risk. The realities of today—a lingering, global pandemic, rising levels of poverty and inequality and “the unprecedented challenge” of climate change—could not have been imagined just a few years ago. No doubt the coming decade has a few more surprises in store.

In this environment of immense uncertainty, developing countries need to formulate development financing strategies that accord with their level of development, demographic trends, trade patterns and industrial structures. There is no “one size fits all” solution to the problem of development finance. Nor is our multi-polar world of divergent financial interests likely to produce a consensus for root and branch reform of global financial institutions. National policies will need to take heed of, but not necessarily conform to, developments in international finance, whether driven by technology, politics or markets. Crucially, the national financial framework must be consistent with and supportive of national development strategies and plans. Financial, sectoral and regional policies must share a common vision for economic and social transformation, with clear priorities, approaches and benchmarks.

The objectives of development finance policy are clear: Increasing access to long-term finance for infrastructure, industry and other classes of borrowers including small and medium sized businesses; maintaining macroeconomic stability by reducing the procyclicality of finance; discouraging investment in unproductive, speculative activities; and reducing the probability and severity of financial crisis. However, the means to achieve these objectives will differ from place to place and over time. The strength of Viet Nam’s economic recovery from the Covid-19 pandemic and prospects for realizing national development goals and the SDGs will to a significant extent be determined by the country’s ability to formulate a coherent and workable development finance strategy, to create new institutions capable of generating stable, long-term finance and to reform existing institutions that have chronically underperformed in carrying out these essential tasks.

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