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Review of Business and Economics Studies

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CONTENTS

Vietnam – little ‘tiger’ with big possibilities

Zbigniew Mierzwa5

Impacts of monetary policy on asset markets:

The case of Vietnam

Thanh Nhan Nguyen, Hai Yen Vu and Ngoc Huong Vu39

Semi-strong form efficiency: Market reaction to dividend and earnings announcements in Vietnam stock exchange

Tran Thi Xuan Anh, Nguyen Thanh Phuong, Pham Tien Manh53

Organizational aspects of the internal audit of Italian corporate groups

Alessandra Tafuro, Antonio Costa, Alma Fanelli68

* Note. Coauthor of article “Secrets and perspectives of Uzbekistan’s industrial policy”, Review of Business and Economics Study, No 1/2016 is Anis Chowdhury.



Вестник исследований бизнеса и ЭКОНОМИКИ

№ 3, 2016

СОДЕРЖАНИЕ

Вьетнам – малый «тигр» с большими возможностями

Збигнев Межва 5

Влияние монетарной политики на рынки активов: пример Вьетнама

Тхань Нан Нгуен, Хай Иен Ву, Нгоц Хуонг Ву 39

Средняя степень эффективности рынка: реакция рынка на сообщения о дивидендах и доходах на бирже ценных бумаг во Вьетнаме

Тран Тхи Хуан Ань, Нгуен Тхань Пхуонг, Пхам Тиен Мань 53

Организационные аспекты внутреннего аудита в итальянских корпоративных группах

Алессандра Тафуоро, Антонио Коста, Альма Фанелли 68

* *Примечание.* Соавтором статьи «Секреты и перспективы промышленной политики Узбекистана», Review of Business and Economics Study, № 1/2016 является Анис Ховдури.

Vietnam – little ‘tiger’ with big possibilities

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Abstract. In the first issue of journal (1/2016) we said we are convinced that Russia is not alone in the world. Thus, the theme of our inquiry will be searching for friendly-oriented countries—economically and politically as well. In the second part of our inquiry, we present the success story of Vietnam. Country’s transition from low- income to middle-income countries per capita was amazing. Vietnam is placed among those countries with the best indicators of economically sustainable and politically friendly-oriented countries. Russia and Vietnam are connected with strategic partnership but it is insufficient for further development of economic relationships. It is urgent need to intensify the penetration Vietnamese market, searching for mutually beneficial partnership and long-lasting cooperation.

Keywords: Vietnam, World Bank, World Economic Outlook, Asian Development Bank.

Вьетнам – малый «тигр» с большими возможностями

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Аннотация. В № 1/2016 журнала в статье «Россия в поисках дружественно ориентированных стран» были поставлены вопросы: какие страны из числа дружелюбно относящихся к России сегодня можно рассматривать в качестве ее потенциальных партнеров; какие критерии необходимы для этого выбора? Учитывая неиспользованные пока возможности для плодотворного сотрудничества, наш выбор пал на одно из наиболее динамично развивающихся государств – Вьетнам. В статье представлен обзор социально-экономического развития Вьетнама и планы на ближайшую и дальнюю перспективу. По нашему мнению, Вьетнам является надежным экономическим партнером, о чем свидетельствует растущий интерес к этой стране международных организаций и ряда стран. Поскольку свято место пусто не бывает – не упустить бы России этот шанс. Тем более что Вьетнам традиционно принадлежит к странам политически дружелюбным по отношению к России. Стратегическое партнерство с Вьетнамом требует и всесторонней интенсификации экономических отношений.

Ключевые слова: Вьетнам, World Bank, World Economic Outlook, Asian Development Bank.

Vietnam is a development success story. After 30 years of political and economic reforms since the launch of *Đôì Mới* (renovation) in 1986, have transformed the country from one of the poorest in the world, with per capita income around US \$ 100, to lower middle income

status within a quarter of a century with per capita income of around US\$ 2,100 by the end of 2015. From a poor, war-ravaged, centrally planned economy, which was closed off from much of the outside world, Vietnam has become a **middle-income country** with a dynamic mar-

ket economy that is deeply integrated into the global economy¹.

Vietnam's economic growth has been increasing since 2011, while inflation has remained in single digits. Well-balanced macroeconomic policies have helped restore stability and investor confidence, with growth being propelled by a surge in foreign direct investment and export-oriented manufacturing. Vietnam needs to continue to develop a more dynamic market economy — one that can compete globally and deliver sustainable, equitable growth over the long term. Despite remarkable achievements in reducing poverty, serious development challenges remain, with income and other socio-economic gaps still evident in pockets of ethnic minorities and other vulnerable groups.

Vietnam's per capita GDP growth since 1990 has been among the fastest in the world, averaging 5.5 percent a year since 1990, and 6.4 percent per year in the 2000s. Vietnam's economy continued to strengthen in 2015, with GDP growth rate of 6.7 percent for the whole year. Social outcomes have improved dramatically across the board. Using the US\$ 1.90 2011 PPP line, the fraction of people living in extreme poverty dropped from more than 50 percent in the early 1990s to 3 percent today. Concerns about poverty are now focused on the 15 percent of the population who are members of ethnic minority groups, but account for more than half the poor.

Vietnam's economic growth has not only been rapid, but also stable and inclusive, translating into strong welfare gains for the vast majority of the population. This is an impressive record of success — one that the Vietnamese people take justifiable pride in, while appreciating the support of the international community.

Regarding the twin goals of eliminating extreme poverty (living on less than US\$ 1.25 per day) by 2030 and boosting shared prosper-

ity among the poorest 40 percent in developing countries, Vietnam is a signature example of a country in recent times that has achieved rapid growth without a large increase in inequality. Thus, in Vietnam, the twin goals agenda suggests enhanced attention to four priority themes:

- (i) supporting return to strong and inclusive growth;
- (ii) giving more focused attention to non-income dimensions of poverty;
- (iii) targeting communities that are getting left behind, notably ethnic minority communities; and
- (iv) addressing sources of vulnerability.

The recent **Vietnam Development Partnership Forum** (VDPF) 2015 agreed on the need to strengthen reform efforts, competitiveness, citizens' participation, the broader inclusion agenda, the unfinished poverty agenda — particularly relating to ethnic minorities — and the increasing vulnerability of a growing number of people who live close to the poverty line. The 2015 VDPF also discussed the effective use and mobilization of development resources, which to some extent depend on implementing market institutions reforms. The VDFP, co-organized by the Ministry of Planning and Investment and the World Bank, is a platform for high level dialogue between the Government of Vietnam and Development Partners.

The World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.

a. GDP at market prices and expenditure components are measured in constant 2010 U. S. dollars. Excludes American Samoa and Democratic People's Republic of Korea.

b. Non-oil GDP. Timor-Leste's total GDP, including the oil economy, is roughly four times the non-oil economy, and highly volatile, sensitive to changes in global oil prices and local production levels.

<http://www.worldbank.org/en/publication/global-economic-prospects>

But 30 years of success from reforms raises expectations for the future. The country's am-

¹ See: "Overall strategy for international integration through 2020, vision to 2030" (Part I, Part II, Part III). Approved on January 7, 2016 by VGP — PM Nguyen Tan Dung. See also: "The Socio-Economic Development Plan 2016–20" (forthcoming, draft available) and "The Socio-Economic Development Strategy 2021–30", "Viet Nam Sustainable Development Strategy for 2011–2020". Decision No. 432/QĐ-TTg on approving the Viet Nam Sustainable Development Strategy for the 2011–2020 signed on April 12, 2012 by Prime Minister Nguyen Tan Dung.

Table 1. GDP growth in Vietnam 1986–2015

(constant LCU)

Indicator Name	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
GDP growth (annual %)	2.79	3.58	5.14	7.36	5.10	5.96	8.65	8.07	8.84	9.54
GDP per capita growth (annual %)	0.43	1.07	2.62	4.86	3.12	4.03	6.73	6.22	7.03	7.76
Indicator Name	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
GDP growth (annual %)	9.34	8.15	5.76	4.77	6.79	6.19	6.32	6.90	7.54	7.55
GDP per capita growth (annual %)	7.61	6.48	4.15	3.21	5.37	4.86	5.10	5.66	6.26	6.30
Indicator Name	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
GDP growth (annual %)	6.98	7.13	5.66	5.40	6.42	6.24	5.25	5.42	5.98	6.68
GDP per capita growth (annual %)	5.80	5.98	4.54	4.29	5.31	5.12	4.12	4.31	4.85	5.55

Source: The World Bank. World Development Indicators, 22 July, 2016.

bitions are aptly captured in the Vietnamese constitution, which sets the goal of “a prosperous people and a strong, democratic, equitable, and civilized country.” There is a firm aspiration that by 2035, Vietnam will be a modern and industrialized nation moving toward becoming a prosperous, creative, equitable, and democratic society.

Not only are incomes higher, but the Vietnamese population is better educated and has a

higher life expectancy than most countries with a similar per capita income. The maternal mortality ratio has dropped below the upper-middle-income country average, while under-five mortality rate has fallen by half, to a rate slightly above that average. Access to basic infrastructure has also improved substantially. Electricity is now available to almost all households, up from less than half in 1993. Access to clean water and modern sanitation has risen from less

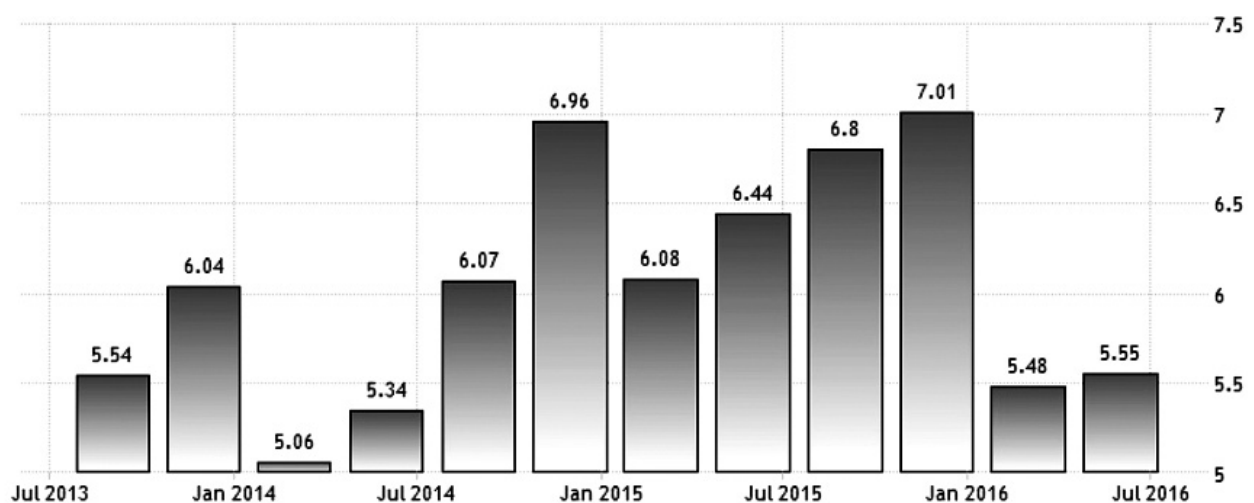


Figure 1. Vietnam's GDP growth rate

Source: [www.tradingeconomics.com/General Statistics Office of Vietnam](http://www.tradingeconomics.com/General-Statistics-Office-of-Vietnam).

Table 2. East Asia and the Pacific country forecasts

(Real GDP growth at market prices in percent, unless indicated otherwise)

Country	2013	2014	2015	2016	2017	2018
Cambodia	7.4	7.1	7.0	6.9	6.8	6.8
China	7.7	7.3	6.9	6.7	6.5	6.3
Fiji	4.6	5.3	4.0	2.4	3.8	3.5
Indonesia	5.6	5.0	4.8	5.1	5.3	5.5
Lao PDR	8.5	7.5	7.0	7.0	7.0	6.8
Malaysia	4.7	6.0	5.0	4.4	4.5	4.7
Mongolia	11.6	7.9	2.3	0.7	2.7	6.2
Myanmar	8.5	8.5	7.0	7.8	8.4	8.3
Papua New Guinea	5.5	8.5	8.6	3.0	4.1	2.9
Philippines	7.1	6.1	5.8	6.4	6.2	6.2
Solomon Islands	3.0	1.5	3.3	3.0	3.3	3.0
Thailand	2.7	0.8	2.8	2.5	2.6	3.0
Timor-Leste ^b	2.8	6.0	4.3	5.0	5.5	5.5
Vietnam	5.4	6.0	6.7	6.2	6.3	6.3

Source: The World Bank. World Development Indicators, 22 July, 2016.

than 50 percent of all households to more than 75 percent.

In addition to the elaboration of three SEDS breakthrough areas, the five-year Socio-Economic Development Plan 2011–2015 focused on three critical restructuring areas – the banking sector, state-owned enterprises and public investment. The recent draft of the SEDP 2016–2020 acknowledges the slow progress of the reform priorities of the SEDP 2011–2015 and emphasizes the need to accelerate these reforms in 2016–2020 to achieve the targets set in the 10-year “Viet Nam Sustainable Development Strategy for 2011–2020.”

Vietnam also faces an unfinished economic modernization and structural transformation agenda. Part of this relates to maximizing the gains from the ongoing structural transformations that have been a major contributor to growth since the early 2000s.

With agriculture still accounting for almost half the labor force and with significantly lower labor productivity than in the industry and services sectors, future gains from structural transformation could be substantial. The transformation from

state to private ownership of the economy is even less advanced. The state also wields too much influence in allocating land and capital, giving rise to heavy economy wide inefficiencies. So, adjusting the role of the state to support a competitive private sector-led market economy remains a major opportunity. This will be important for enhancing productivity growth which has been stagnating for a long time. Vietnam needs more rapid productivity growth to underpin sustained rapid growth in order to achieve its objective of reaching upper middle income status in the next few decades.

Vietnam has boosted its international economic integration as it enters into more free trade agreements with the Eurasian Economic Union, the European Union, South Korea and the Trans-Pacific Partnership. At the same time, the ASEAN Economic Community was established on December 31, 2015, and is likely to create more opportunities for the country to integrate into regional and global economies. But while global integration has advanced well, with Vietnam embedding itself in global value chains, the benefits are constrained by the absence of linkages with domestic firms.

VIETNAM'S ECONOMY IN TRANSITION (1986–2016)

A Record of Strong and Equitable Growth, with Emerging Concerns

Vietnam is a major development success story. Its per capita GDP growth since 1990 has been among the fastest in the world, surpassed only by China. Growth has also been remarkably *stable* and *inclusive*, which, with major gains on *human development*, has contributed to impressive progress in alleviating poverty and improving non-income dimensions of welfare. But declining productivity growth, insufficient progress in including marginalized groups in the country's development (ethnic minorities in particular), and degradation of the environment call into question the durability of the current development model. Vietnam's governance structure could also be at an inflection point. The institutions that were adequate to carry the country to its lower-middle-income level are now exposing gaps that, unless addressed with boldness and urgency, are likely to impede the journey to upper-middle-income status.

In 1986 an impoverished Vietnam, on the brink of an economic crisis, embarked on a path of economic renovation (*Đổi Mới*). It was an explicit recognition that the “fence-breaking” reforms of the previous decade — opportunistically initiated to test the limits of central planning — had shown promise and that the situation was dire enough to demand a more systematic approach. *Annual inflation* was running at more than **400 percent**, the real economy on a downward slide and heavily dependent on foreign aid, food in short supply, the budget chronically short of resources, and the vast majority of the population in poverty.

Thus *Đổi Mới* began a process of macroeconomic stabilization, unshackling the economy from state controls and gradually but steadily integrating with the global economy. More durable foundations for a market economy were built over time. And in competently managing the transition from a planned to a market-economy structure, Vietnam succeeded where many countries that had been part of the former Soviet Union have failed.

The transition economy of Vietnam enjoyed remarkable achievements in the first 20 years

of economic renovation (*Đổi Mới*) from 1986 to 2006. Notably, the economy grew at an average annual rate of **7.5%** in 1991–2000 period. Vietnam's Amended Constitution 1992 recognized the role of private sector in the economy. *U. S.-Vietnam Trade Bilateral Agreement (US-BTA)* was signed in 2001. The country's stock market made debut trading in 2000. Vietnam became a member of *Association of Southeast Asian Nations (ASEAN)* in 1995, then proceeded to full membership of the *World Trade Organization* in 2007, following which registered *foreign direct investment (FDI)* reached an all-time high of **US \$71.7 billion** in 2008. Together with the impressive economic achievements, Vietnam also saw its diplomatic and political status constantly improved in the international arena. The country has established diplomatic relations with more than 170 countries in the world, *strategic partnerships* with 12 important economies, both developed and emerging, namely China, Japan, Russia, India, England, France, North Korea, Italy, Germany, Indonesia, Malaysia and Thailand. The country also successfully hosted important events including the *Asia Pacific Economic Cooperation (APEC)* in 2006.

Upbeat sentiment helped to send Vietnam's stock market index (**VN-Index**) to its peak of 1,170 in March 2007 before its nosedive to 250 in February 2009, auguring an imminent crisis. Since 2008 Vietnam's GDP pace of expansion has slowed down markedly, with 2012 rate declining to 5%, the lowest level in 13 years, while the macro economy faced paramount turbulence, large trade deficit, high inflation, overwhelming business closures, rampant corruption and transparency problems, demonstrations of enraged citizens, downgrading environment, and sovereignty confrontation with China.

Since the world's geo-economics and geopolitics are entering an uncharted territory of evolving complication and rising uncertainty, not only Vietnamese entrepreneurs and households but also economists and policy makers are puzzled about what have happened, although the government has made a ten-year plan for 2011–20 socio-economic development. The ruling elites appear to have written this plan based more on ‘the desirable’ than ‘the achievable’ while a clear vision for farther future based on careful projections and profound solutions is

needed. Vietnamese and outsiders have been increasingly aware of noticeable gaps between the country's promising potential and actual realization. As Vietnam has been considered somehow an entrance geopolitical game of East Asia and a 600-million population ASEAN market, the keen eye of international players sticks to the Vietnamese political economic scene of the country, which will most likely define the economic and diplomatic paths in the coming years.

The four characteristic sub-periods of post- *Đổi Mới* transition

From the adoption of *Đổi Mới* in 1986 by the CPV's Sixth National Congress to present day, Vietnam's economy has transformed from a centrally-planned model to market oriented with four characterized sub-periods. We divide the sub-periods based on the economy's entrepreneurial perspectives, emerging cultural values, the building of market economy, and attitude toward global geopolitics and economics.

The period of "entrepreneurial policy-makers" (1986–1994)

In its history, Vietnam barely had economic prosperity that lasted for decades. Until early twentieth century, the feudalist nation was a small and outdated agrarian country with continuous wars and invasions from the North (China and Mongolia) and conflicts with the Southwest neighbor (Cambodia). In the 20th century, the French and American wars drew most national efforts to serve the combats. From the national unification in 1975 to 1985, the nation struggled with its five-year plans on collectivization of agricultural and industrial production. However, the real results were often far behind expectation because the guiding principles 'violated the most important motivation for production development, that it is worked against the working people's vital vested interests'.

Upon the failure of the 1985 price-wage-currency adjustment scheme, a severe economic crisis followed, resulting in **hyperinflation of 775%** in 1986, scarcity of staples and consumer goods, impoverished living conditions, industrial stagnation, and mounting foreign debts. The situation worsened as Vietnam could barely trade with the West due to the U. S.'s trade embargo. The chaos had put the CPV under immense pres-

sure to get the country out of the crisis, and *Đổi Mới* policies were an answer introduced in 1986, with which it is believed that there was no "political revolution or ideological conversion on the part of the leadership". The socialist ideology remained and was reiterated by the political leader of *Đổi Mới*, the Communist Party of Vietnam (CPV) General Secretary Nguyen Van Linh that "It is not objectively necessary to establish a political mechanism of pluralism and multiparty government. Socialism is the only right decision".

However, *Đổi Mới* leaders demonstrated some remarkable entrepreneurial characteristics in their economic thinking and implementation as economic crisis and harsh realities were neither necessary nor sufficient conditions for the reform to take place which enabled an undertaking process that had brought about the long-awaited extensive reforms, learning lessons of economic policies from Ho Chi Minh's times, 1945–1969, about the adoption of a multi-sectoral economy based on different types of ownership, encouraging for foreign investments, foreign trade.

Before *Đổi Mới*, Le Duan, CPV General Secretary from 1960 to 1986, was already critical of economic models taught by the Soviet Union and China for chronic economic malaise and blunders, although despite some innovative thinking Le Duan himself was a strong opponent of market economy and much of his policy turned out counter-productive. But in his time, Kim Ngoc, Party Secretary of Vinh Phuc province from 1966 to 1967, was an accomplished entrepreneurial politician who soon recognized problems of the mass collectivization, which resulted in poor agricultural production, and the need to have property right in farm household. He 'invented' a pilot plan called *Khoán*, which had granted a certain degree of economic freedom to farmers, leading to remarkably higher rice yield and pig herds during the American war. Ngoc's innovative ideas were basically not accepted by the North's collectivism, and for a moment was regarded as an offensive to the prevailing socialist ideology.

After the death of Le Duan, Truong Chinh, a high-ranked politburo member and who would then briefly serve as CPV General Secretary (July-December 1986), was another highly influential leader and the one who laid down the

first brick for the House of Reform of Vietnam, by launching the program of extensive reforms during the 6th CPV Congress in December 1986. As Truong Chinh stepped down, Nguyen Van Linh, CPV General Secretary 1987–91, continued to bring concepts of reforms to the nation's economic life through a nationwide reform program with sweeping changes. The old-fashioned centrally-planned economy was replaced with socialist market mechanism, which promoted the concept of a multi-sectorial economy, open-door policies towards international trade and investment, and recognized private property rights.

The new Law on Foreign Investment initiated in 1987 enabled a surge of the first wave of foreign direct investments (FDI) flowing into Vietnam, which then reached 10% of GDP in 1994. Vietnam was the largest FDI recipient among developing countries and economies in transition in proportion to the size of its economy thanks to its macroeconomic stabilization resulting from *Đổi Mới* and investor expectations of continuing reforms and improvements in the general investment climate. Corporate Law and Private Enterprise Law in 1990 'broke ground' the national private growth engine. From the old Confucian view imposed by the feudal elites, which favors "educated scholars serving the government", by 1994 over 17,400 entrepreneurial firms started up. The 1992 Constitution extended human rights and recognized the multi-sectorial economy. Land Law in 1987 (revised in 1993) granted farmers land use rights. The milestones of *Đổi Mới* from 1987 to 1994 can be summarized in the following table.

Vietnam quickly grew to become the world's third largest rice exporter in 1989 (approx. 1.2 million tons exported), after China and the United States. The entrepreneurial policy-makers had been the core element to bring about change in macroeconomic management in 1990s although the CPV reserved status quo as the unique ruler.

Economic integration and adaption of market economy (1995–1999)

An eminent reformer, Prime Minister Vo Van Kiet came in office from 1992 to 1997, and continued to advocate extensive reforms. Vietnam sought further economic integration and diplomatic relations within the region and the world. From 1995 to 1999, the normalizing of diplomat-

ic and trade relations with the United States was among the most remarkable for Vietnam, opening up opportunities to work with the world's developed economies and international organizations around, including multi-lateral donors such as the World Bank and ADB.

While the conservative in the CPV may have been afraid of losing their control over economic development and the national politics, generally speaking the CPV adopted open policies as they saw benefits for the country while no direct threats to their power were seen. Despite existence of conflicting views within the CPV, *Đổi Mới* momentum was retained for almost two decades with political consensus over three major principles: a) Political stability is a prerequisite of economic development, and the CPV remains to be the unique power; b) To achieve economic goals, Vietnam must keep its door open to foreign trade and investment; and, c) Gradualism is preferred to avoid deviation from the socialist path. These principles have been preserved and implemented explicitly through the CPV and government's socio-economic and foreign policies.

The U.S. also had some commercial interest in Vietnam's growing economy and strategic political interest to work with allies and friends "to promote stability and development by integrating Vietnam more fully into the existing East Asian order." Over US\$ 10 billion of FDI entered the country in 1996 together with billions of dollars of ODA coming from the World Bank and Asian Development Bank. FDI enterprises played an important role in creating jobs, paying corporate taxes, encouraging consumption and competition, and contributing to export growth. Vietnam's GDP grew at 9.5% and 9.3% annually in 1995 and 1996 respectively, the highest rates recorded in the post-*Đổi Mới* period.

The country also expanded its diplomatic relations within the region becoming member of ASEAN (1995), APEC (1998). The U.S. and Vietnam then expanded the relation into a US-Vietnam bilateral trading agreement (the BTA was later signed in 2001). The US-Vietnam BTA had an important political economy impact by spurring political will to speed up negotiations on Vietnam's accession to WTO in later years.

Integrating in international markets has brought about new market opportunities and helped the country to deepen its reform, but at

the same time exposed the country to contagious risks. Although less hurt by the Asian financial crisis in 1998 than other major Asian economies due to its young markets, Vietnam experienced GDP growth decline to 4.77% in 1998 and committed FDI fell by half in 1997–1998 to approximately US\$ 5 billion, compared to US\$ 10 billion in 1996. When the Asian financial turmoil broke out, Vietnam was still a nascent market model, without stock market; and the fledgling banking system was controlled by the state-run powerhouses who occupied 75% of assets and credit portfolio. Inefficient SOEs still accounted for 50% of the country's output.

Economic boom and emerging cultural values (2000–2006)

Succeeding Vo Van Kiet, Prime Minister Phan Van Khai (1997–2006) continued to pursue further integration into the world economy, especially from 2000 to 2006. In 2005, Mr. Khai was the first Vietnamese leader visiting the U. S., strengthening diplomatic relations between the two countries. The U.S. then supported Vietnam's accession to WTO in early 2007. Under Khai's leadership, Vietnam's economy experienced economic prosperity, quickly expanding financial markets and GDP, low inflation, surging FDI inflows and faster pace of privatization of SOEs. The capitalist symbolic finance machine — the stock market — was born in July 2000.

By the end of 2000, Vietnam stock market's capitalization was negligible in economic terms, less than 1% of GDP. But by the end of 2006, the figure rose to 22.7%. In 2006 VN-Index rose 150%. From 2006 to early 2007, investors considered stock markets a 'money machine,' and herd mentality triggered huge market bubble risks. Despite immense risks, the market continued to go high as capital gains were still made easily, and macro prospects looked bright with Vietnam joining WTO soon.

An average GDP growth of 7.5% in 2000–2005 period and the economy ranked at 58th largest in the world in 2006 made Vietnam like a little tiger economy in Southeast Asia. However, the rapid rate succumbed to 'resource curse' problem as there appeared more evidence that economic growth heavily relied on overconsumption of physical assets or/and capital endowments while innovation and productivity were not the main

emphasis, leading to a decline of competitiveness. Vietnam's high *incremental capital to output ratio* (ICOR) of 7–8 times, compared to other Southeast Asian economies of 3–4, and rising investment to GDP over years, i.e., 4.9% (from 1996 to 2000) to 39.1% (2001–05) to the staggering 43.5% (2006–10) show its propensity to consume more resources while seeking growth. The absence of innovation and creativity together with resource curse will be destructive in the long run. Worse, the curse is more severe in the state-owned sector whose ICOR is two or three times higher than that in non-state sector.

Under P.M. Phan Van Khai's leadership, although the state-led model was still advocated, he did not vow to establish the state-run conglomerates. (There were only two state-run conglomerates established under Khai's tenure that are Vinacomin and Vinashin) In a stark contrast, his successor P.M. Nguyen Tan Dung established other eleven conglomerates within a few years after he took office. The breakdown of investment capital of the state-owned behemoths showed remarkably greater state budget investment in SOEs in 2008–09.

Still, combining the rapid growth and booming markets, Vietnam was successful in reducing *poverty rate* from 28.9% in 2002 to 18.1% in 2004 and 15.5% in 2006. Inflation was kept under check with average CPI in the period at 4.5%, a remarkable achievement as inflation has always been a chronic disease of the post-*Đôì Mới* period.

The US-Vietnam BTA and investors' projections that Vietnam would enter WTO in 2006 and China plus one strategy contributed to make Vietnam an attractive destination for FDI. Political and social stability played a significant role in facilitating economic development and attracting FDI. FDI started to recover from 2003 (US\$ 3.2 billion registered capital) to 2006 (US\$ 12 billion), generating growth and employment.

Privatization (politically correct: '*equitization*') of SOEs also saw improvement in the 2002–06 period with 2,813 enterprises being privatized, compared to a handful in 1990s, 60 in 2011, and 16 from 2012 to 2013Q1.

Globalization and attitudes toward global geopolitics and geoeconomics (2007–present)

After two decades of growth, the engine started to lose its steam in late 2000s. The con-

temporary state-run conglomerate model has shown serious problems ranging from poor efficiency and corruption to crony capitalism. The macro economy again experienced a period of high inflation, budget deficit, declining foreign exchange reserve, mismanaged fiscal and monetary policies, high unemployment and sluggish commercial activities.

Vietnam's unstable macroeconomics with two-digit inflation in 2008 together with spillover effect of the global crisis had made the stock bubble burst in 2009. The VN-Index went down to less than 250 in February 2009 from the peak of 1170 in March 2007; and it has never regained the expected 600-point level that experts, policy makers and investors had desperately looked for while the downtrend became unavoidable in mid-2008.

In a more complex financial system with interconnected stock markets, real estate markets and money market, the problems do not just stay with stocks. It can be argued that there was an inter-connectedness between Vietnamese stock market, properties market and money market, showing rising complexities. After the boom of stock market and skyrocketing stock prices, many realized capital gains and speculated on real properties. This had led to a boom on real estate market from 2007 to 2010 where home prices went exponential. A free fall in prices by almost 30% in 2012Q2, coupled with no liquidity, made speculators panic. The continuous fall of property prices by another 30% in 2013Q2 killed most speculators and developers. The government admitted that VND 108 trillion (\$ 5.1 billion) worth of real property become non-tradable in the second quarter of 2013.

The banking sector immediately suffered, as about 50% of credits had been extended to real estate speculations and developments. Bad debts mounted, stifling credit flows to the economy and dragged production, businesses and consumption. Tightened banking credits then triggered informal credits and hyperactivity of 'loan sharks' to the extent that the government was worried about social unrest caused by rampant financial failures in information economy and households. Government's stimulus package of US\$ 8 billion in 2008 and 2009 had temporarily backed GDP growth at 6.78% in 2010 before inflation threat became real in 2011. The growth

rate fell to 5.03% in 2012, the lowest within 13 years. From 2011 to 2012, the economic crisis has pushed approx. 100,000 firms out of business, ~20% of the enterprise population. Consumer price index (CPI) only slowed down in the recent years as a result of falling domestic demand.

From 2007 to present, the government's policies to use state-run conglomerates as the chief force to propel Vietnam's economy have degraded into problems of crony capitalism, interest groups and corruption, which induce rent-seeking and exacerbate the 'resource curse' problem in Vietnam. The state sector only creates 10% employment but consumes 70% total social investment, 50% total state investment, 60% commercial credit, and 70% of ODA.

The problems prevailed in banking industry and other essential industries of the country. A typical example is tycoon Nguyen Duc Kien, a senior commercial banker, who had manipulated the banking industry and gold market before being arrested in August 2012. His arrest sent a chill through the Vietnamese stock markets for three consecutive days, during which most stocks lost 20% of their value, and almost created a bank run at ACB that forced the State Bank to directly inject liquidity into the bank. Many state-run conglomerates, the government's expected to be their 'iron fists,' now turned out to be debt-stricken patients generating overwhelming losses, debt burdens or scandalous corruption worth billions of U. S. dollars, i.e. Vinashin, and Vinalines, Vietnam Electricity Group (EVN), Vietnam National Coal and Mineral Industries Group (Vinacomin). In Vietnam, when the rule of law does not catch up with the expansion of the financial sector, political connections are used to channel loans toward unprofitable sector, hindering impact of finance on investment growth.

Although Vietnam's GDP per capita reached US \$ 1,555/year in 2012 and \$ 1,700 in 2013, the new millennium's setting is far different from that of the 1990s. Vietnam is now part of the world's bigger game, in which it has passed the point of no return. The economy has been becoming more open and engaged in international affairs. Vietnam has started to acquire important positions in United Nations and shown its interest in world geopolitical issues by joining the *UN Peace Keeping Operation* in

early 2014. Vietnam's participation is prepared with the help of the United States, who supports the UN operation by its **Global Peace Operation Initiative**. The country's joining into UN peace keeping force may potentially open new possibilities for U. S.-Vietnam relation, a meaningful event in global geopolitics. The CPV and the government have tried to preserve political stability through domestic policies (despite the successes and failures) and seeking foreign supports via foreign relations. For these hard, expensive and painful lessons about market mechanism and ideology, the 'little tiger' has not roared yet.

2016–2020 SOCIO-ECONOMIC DEVELOPMENT PLAN

Vietnam aims to become an industrialized country by 2020 with GDP per capita of at least \$3,200 in its latest plan. In the **Socio-Economic Development Plan** (SEDP) for 2016–2020 the government set 21 macroeconomic, social and environmental targets. The plan is based on the socio-economic development strategy for 2011–2020 which lays out the path towards industrialization by the end of the decade through a socialist-oriented market economy model.

They include average GDP growth of 6.5 to seven percent per year, with 85 percent of output coming from the industrial and service sectors by 2020. Given the target for GDP growth, total GDP at current prices over the five year period is estimated to be over VND30,600 trillion (\$1.37 trillion).

The SEDP draws on Vietnam's stable economic growth in recent years, its commitment to **United Nations Sustainable Development Goals** and increased international integration as reflected in free trade agreements signed with ASEAN, the TPP, and others. However, it also takes into account Vietnam's low competitiveness, poor infrastructure², climate change implications (especially in the Mekong delta), weak institutions, transition towards an aging population phase and increasingly complex situation in the East Sea. Vietnam expects major advances in strengthening its institutions and legal system,

increasing human capital and improving the transport network.

Recent developments

Vigorous expansion of manufacturing and construction in 2015 spurred the fastest economic growth in 7 years. Foreign direct investment is seen supporting strong growth through the forecast period. Inflation will revive but remain relatively modest. The current account is forecast to slide into a small deficit. Reforms to banks and state enterprises continue to make gradual progress, but an emerging need is better management of rapid urbanization.

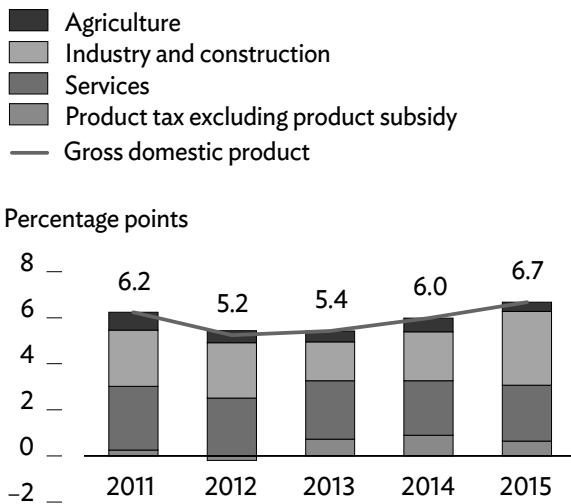
Economic growth accelerated to 6.7% in 2015, the fastest clip since 2008. *Industry* expanded by 9.6% and contributed nearly half of total growth (Figure 2). Powered by high foreign direct investment (FDI), the *manufacturing subsector* rose by a rapid 10.6%, and construction grew by 10.8% on foreign investment in factories, a recovery in the property market, and higher spending on infrastructure. FDI disbursements, which have increased substantially over the past decade, swelled by 17% to \$14.5 billion in 2015 (Figure 3).

Growth in *services* was maintained at 6.3% last year. Wholesale and retail trade grew by 9.1% on strong private consumption, and banking and finance expanded by 7.4% as growth in credit quickened. However, a 0.2% decline in tourist arrivals dampened growth in tourism-related services. Agriculture recorded lower growth at 2.4% as global food prices fell and El Niño brought drought.

By expenditure, private consumption accelerated to 9.3%, spurred by rising employment and incomes and lower inflation. Investment also strengthened as buoyant FDI inflows and expansion in credit supported a 9.0% rise in gross capital formation. Net external demand weighed on GDP growth, though, as imports of goods and services in real terms rose faster than exports.

Notwithstanding stronger domestic demand, inflation slowed to average just 0.6% last year, the lowest since 2001, mainly on lower food and fuel prices (Figure 4 3.31.3). The State Bank of Vietnam, the central bank, kept policy interest rates steady in 2015 after reducing them over recent years, but commercial banks trimmed lending rates by 0.2–0.5 percentage points on aver-

² See, for example, "Efficient Logistics. A Key to Vietnam's Competitiveness" Eds. Luis C. Blancas, John Isbell, Monica Isbell, Hua Joo Tan, Wendy Tao, 2014, International Bank for Reconstruction and Development/The World Bank.



Source: General Statistics Office of Viet Nam.

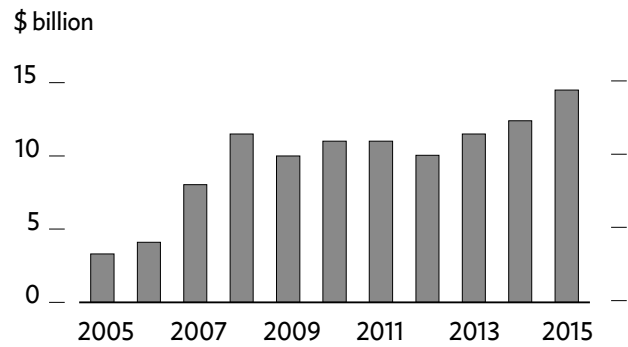


Figure 3. Disbursed foreign direct investment

Figure 2. Supply-side contributions to growth

Source: General Statistics Office of Vietnam. Source: General Statistics Office of Vietnam.

Table 3. Supply-side contributions to GDP growth (percentage points)

Year	Gross domestic product	Services	Industry and construction	Agriculture	Product tax excluding product subsidy
2011	6.2	2.8	2.4	0.8	0.3
2012	5.2	2.5	2.4	0.5	-0.2
2013	5.4	2.5	1.7	0.5	0.7
2014	6.0	2.4	2.1	0.6	0.9
2015	6.7	2.4	3.2	0.4	0.6

Source: General Statistics Office of Vietnam.

age. Lending rates have dropped by half since 2011. Lower rates for borrowers complemented recovering consumer and investor confidence to spur credit growth to an estimated 18%, exceeding the government’s initial target of 13–15%. Broad money supply increased by an estimated 14%.

To support exports, and in response to depreciation affecting other Asian currencies, the central bank devalued the Vietnam *dong* against the US dollar three times in 2015, adjusting the reference rate by 1% each time. The central bank also moved to enhance exchange rate flexibility by expanding the trading band from 1% to 3% on either side of the reference rate and changing to a daily reference rate announcement system. The monetary authority tightened regulations on foreign currency and discouraged foreign currency hoarding by mandating zero interest rates

for US dollar deposits. Over 2015, the *dong* depreciated by 5% against the US dollar.

After several years of large external surpluses, the current account came under pressure in 2015 as imports rose faster than exports.

Merchandise imports rose on a balance-of-payments basis by an estimated 12% to \$155 billion. Imports of machinery, equipment, and electronic components surged by more than 25%, reflecting strong demand for capital goods and inputs into export-orientated manufacturing. Imports of consumption goods rose by 10%, lifted by buoyant consumer spending.

Merchandise exports increased by an estimated 7.9% to \$162 billion. Customs data show that the biggest gains were in exports of mobile phones and their components, which jumped by 30% and comprised 19% of total exports. Vietnam’s imports and exports together now exceed

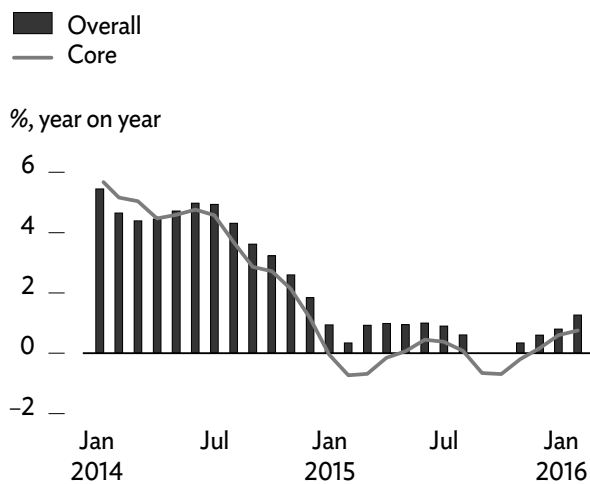


Figure 4. Inflation, % year on year

Note: Core excludes food inflation.

Source: General Statistics Office of Vietnam.

165% of GDP, compared with less than 70% when the government started economic reforms in the mid-1990s.

The result was a 39% fall in the trade surplus, which, along with an estimated 17% decline in remittances, cut the current account surplus to an estimated 0.3% of GDP from 4.9% in 2014. After taking into account a smaller surplus in the capital account and sizable negative net errors and omissions, the overall *balance of payments* recorded a deficit equal to 3.1% of GDP (Figure 5). Foreign exchange reserves fell to an estimated 2 months of import cover (Figure 6).

Efforts to rein in the fiscal deficit had limited impact last year. The government reported that the budget deficit equaled 5.4% of GDP, narrowing slightly from 5.7% in 2014. Revenue rose by

10.0% and would have increased faster if not for lower oil prices and a cut in the corporate income tax rate. Government expenditure grew by 7.3%. Public debt, including debt guaranteed by the government, was projected to equal a record 62% of GDP, approaching a 65% limit set by the National Assembly (Figure 7).

Progress on economic reform remains slow. The government sold minority equity stakes in some 160 state-owned enterprises in 2015, well below its target of 289. Many individual equitizations fell short of targets. As for banking reforms, the central bank supported the mergers of several banks, following through on its plan for banking sector consolidation. Reported nonperforming loans (NPLs) declined to 2.7% of outstanding loans by the end of 2015, largely through their transfer from banks to the Vietnam Asset Man-

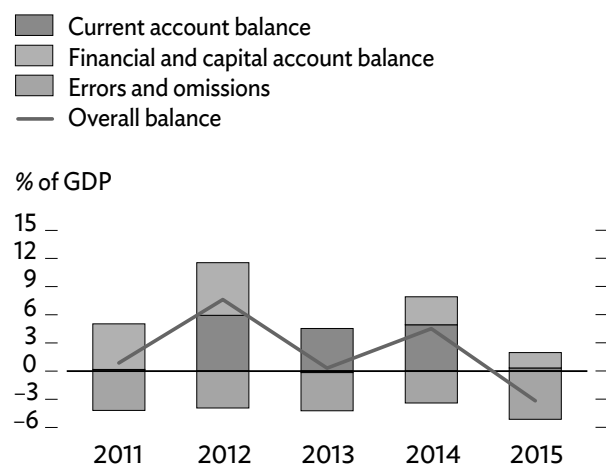


Figure 5. Balance of payments indicators

Sources: State Bank of Viet Nam; International Monetary Fund; ADB estimates.

Table 4. Inflation, % year on year

2014														
	I	II	III	IV	V	VI	VII	VII	IX	X	XI	XII		
Core	5.7	5.2	5.0	4.5	4.6	4.8	4.6	3.7	2.9	2.7	2.1	1.2		
Overall	5.5	4.7	4.4	4.5	4.7	5.0	4.9	4.3	3.6	3.2	2.6	1.8		
2015												2016		
	I	II	III	IV	V	VI	VII	VII	IX	X	XI	XII	I	II
0.0	-0.7	-0.7	-0.1	0.1	0.4	0.4	0.1	-0.7	-0.7	-0.2	0.2	0.6	0.8	
0.9	0.3	0.9	1.0	1.0	1.0	0.9	0.6	0.0	0.0	0.3	0.6	0.8	1.3	

Source: General Statistics Office of Vietnam.

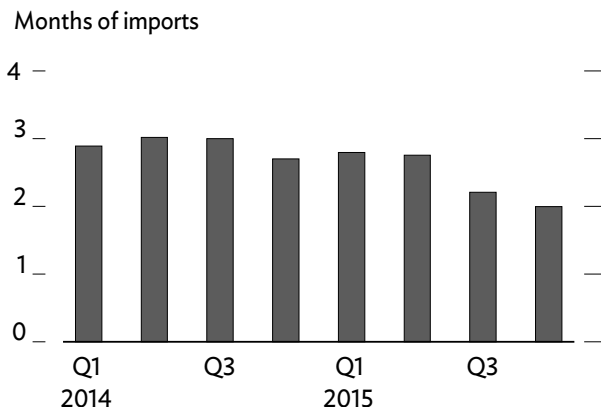


Figure 6. Gross international reserves

Sources: State Bank of Viet Nam; International Monetary Fund; Q = quarter.

ADB estimates. Note: Data exclude government foreign exchange deposits at the State Bank of Viet Nam and the foreign exchange counterpart of swap operations. Imports are on free-on-board basis.

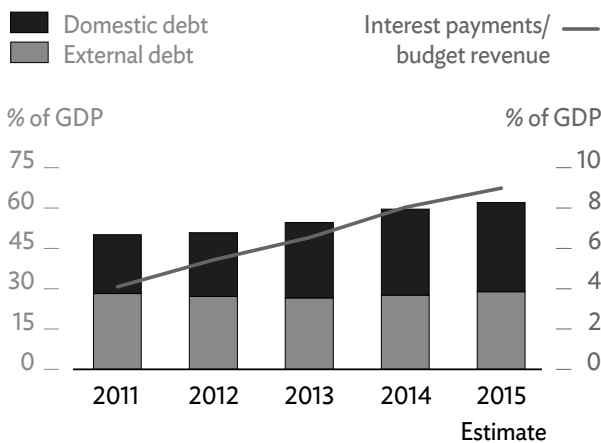


Figure 7. Public debt and debt servicing costs

Sources: Government of Viet Nam; World Bank; International Monetary Fund; ADB estimates.

agement Company. This company, established by the government in 2013 to acquire, restructure, and sell NPLs, had acquired \$ 11.0 billion in bad loans by the end of 2015, up from \$ 6.1 billion a year earlier. But with a limited capital base and lacking an adequate legal framework for resolving NPLs, it had sold or recovered by the end of December last year just 9% of the NPLs it held.

Economic prospects

The economy is projected to sustain growth at 6.7% in 2016 before the pace moderates to 6.5% in 2017 (Figure 8). Strong export-orientated manufacturing, FDI inflows, and domestic demand will be partly offset by the effect of slowing expansion

in the People’s Republic of China (PRC). New FDI commitments came in relatively flat at \$ 22.8 billion in 2015, which suggests that disbursements of FDI could level out this year and decline in 2017. About 60% of the FDI commitments are for export-orientated manufacturing.

Rising incomes and modest (though quickening) inflation are expected to buoy private consumption. Sharply rising sales of automobiles — up by 55% in 2015 — illustrate the recovery in consumer confidence. Viet Nam has become the fastest-growing auto market in Southeast Asia. Business sentiment is similarly buoyant. A survey in December 2015 showed that 41% of businesses expected conditions to improve in 2016, and a further 40% expected stable conditions.

Prospects for growth in private investment are enhanced by a proliferation of trade and investment agreements concluded over the past 18 months. These include trade agreements with the European Union and the Republic of Korea, and commitments to participate in both the Trans-Pacific Partnership led by the US and the Eurasian Economic Union led by the Russian Federation. Viet Nam is expected to benefit as well from the ASEAN Economic Community, whose members in the Association of Southeast Asian Nations collectively form Viet Nam’s third-largest export market after the US and the European Union.

These agreements will be implemented over several years but are expected to stimulate investment in the near term as businesses prepare for expanded trade opportunities. The agreements also signal to the business community the government’s renewed commitment to liberalize

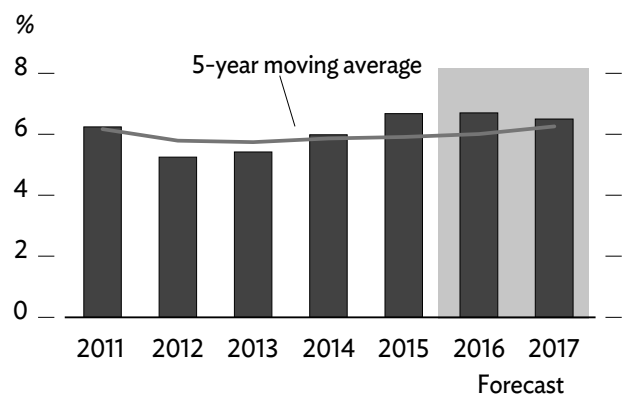


Figure 8. GDP growth forecast

Source: Asian Development Outlook database.

the economy. In recent years, it has eased restrictions on foreign ownership of property and corporate shares and has said it would reduce from 51 to 6 the number of industries closed to foreign ownership. The VN Index of share prices rose by 6.1% in 2015, building on 8.1% gain in 2014.

Manufacturing and construction are projected to maintain solid expansion. The purchasing managers' index showed in the first 2 months of 2016 improving business conditions for manufacturers, including a rise in new orders. Services are projected to expand at a robust pace, though prospects have dimmed for tourism from the PRC, the source of one-quarter of Viet Nam's inbound tourists. Visitor arrivals from the PRC fell by 8.5% in 2015. Subdued growth will continue for agriculture in the near term under soft global food prices and the effects of El Niño.

Inflation picked up to average 1.3% in the first 3 months of 2016 and is forecast to average 3.0% this year and 4.0% in 2017 (Figure 9). The government is expected to raise administered prices for education and health care and boost public sector minimum wages. Import prices will rise this year with dong depreciation, and higher global food and fuel prices in 2017 will add to inflation next year.

The central bank targets credit growth at 18–20% in 2016 to accommodate strong economic growth. Lending interest rates might come under upward pressure in the forecast period as inflation gradually turns up and rising demand for credit collides with tighter bank liquidity.

Fiscal policy looks set to tighten gradually but to remain supportive of growth. The government aims to narrow the budget deficit to 4.9% of GDP in 2016 and 4.0% in 2017. Continuing a shift started in 2015, the budget for 2016 puts greater emphasis on capital expenditure, which is slated to rise by 25.5%. Current expenditure is set to rise by a more modest 6.5%.

Plans for fiscal consolidation are at risk, however, from shortfalls in revenue. Over the past 5 years, reductions in corporate income tax rates, the removal of tariffs, and tax exemptions for favored firms have eroded the tax base. Low oil prices are dragging on resource tax revenue, which comprises 10% of the total. Central government revenue and grants fell from the equivalent of 27.6% of GDP in 2010 to 22.0% in 2015.

The government could use funds from the equitization of state-owned enterprises and issue more short-term securities to support the budget in the near term, but achieving a more sustainable fiscal position is likely to require tax reform to reverse falls in the ratio of tax to GDP.

Merchandise exports are seen rising by 10% in US dollar terms this year and by 14% in 2017 as new production from foreign-invested factories comes online and trade agreements take effect. Imports will also continue to grow in response to strong demand for both consumption and capital goods, and to supply inputs for manufacturing. Modest recovery is expected in remittances. The current account is forecast to slip into deficit this year and recover to balance in 2017 (Figure 10).

Sluggish progress on reforming banks and state-owned enterprises poses risks to the outlook. Undercapitalized banks with deficient financial transparency remain exposed to shocks. The upswing in credit growth could spark a new round of speculation in risky real estate. To mitigate such risks, the central bank took steps early in 2016 to tighten lending requirements for real estate and reduce the potential for maturity mismatch in bank lending. Further progress on bank consolidation and enhanced transparency, asset classification, NPL resolution, and disclosure requirements will be vital for strengthening the sector.

From desirability into reality

The Vietnamese government's development strategy is based on a series of 10-year socio-economic development strategies (SEDS). Viet Nam's Socio-Economic Development Strategy (SEDS) 2011–2020 gives attention to structural

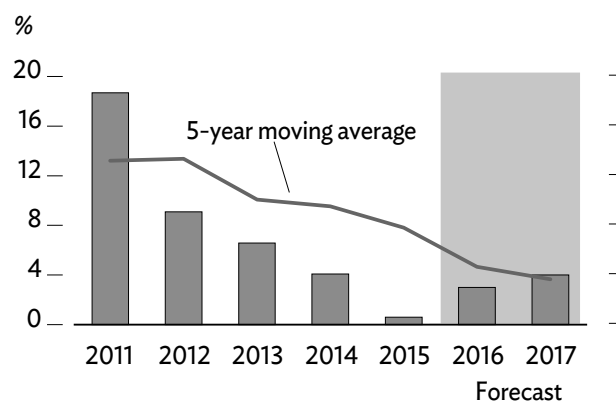


Figure 9. Inflation forecast

Source: Asian Development Outlook database.

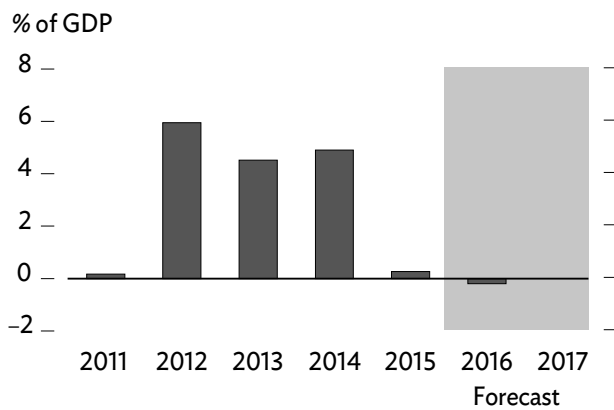


Figure 10. Current account balance forecast

Source: Asian Development Outlook database.

reforms, environmental sustainability, social equity, and emerging issues of macroeconomic stability. It defines three ‘breakthrough areas’:

(i) promoting human resources/skills development (particularly skills for modern industry and innovation);

(ii) improving market institutions, and

(iii) infrastructure development.

The five year socio-economic development plan lays out the actions needed to translate the strategies into reality. The SEDP provides a framework and direction for ministries and sectors to develop their own plans. In “Viet Nam Sustainable Development Strategy for 2011–2020”. *Decision No. 432/QĐ-TTg on approving the Viet Nam Sustainable Development Strategy for the 2011–2020 signed on April 12, 2012 by Prime Minister Nguyen Tan Dung* the Vietnamese government set 21 macroeconomic, social and environmental targets as showed in Table 5.

Given that, the government set out 12 solutions that will guide Vietnam’s socio-economic development for the next five years.

1. Development of a socialist oriented market economy, macroeconomic stability and a positive environment for socio-economic development

This includes institutional reforms towards freer markets and further privatization. Instead of direct provision, the government will support the development of a market for public services. More emphasis is also put on greater coordination among monetary, fiscal and other policies. By 2020, Vietnam hopes to have a coherent, transparent and effective legal system.

2. Economic restructuring, increase in productivity and competitiveness

Vietnam plans to promote entrepreneurship, including setting up start-up training centers and venture capital funding. Businesses are to receive support in research and development and public private partnerships (PPP) will be prioritized.

Vietnam is aiming for **agriculture** to develop at a rate of 2.5 percent to three percent per year with up to 50 percent of communes meeting the new rural standard by 2020.

Application of biotechnology and information technology in production, management and agricultural extension services is encouraged. The country is also determined to ensure food safety.

Regarding **industry**, Vietnam eyes growth of eight percent to 8.5 percent per year. By 2020, industry is set to account for 40 percent of GDP.

Particular focus is put on high tech industries. Industries that serve agriculture will be prioritized, especially agricultural product processing and manufacturing of agricultural equipment and machinery. Vietnam will also support development of renewable energy sources, especially wind and solar power. In parallel, it will invest in oil and gas extraction and processing.

Services are set to grow 6.6 percent to 7.1 percent per year and by 2020 make up **45 percent** of GDP.

Vietnam hopes to develop tourism into the leading service sector. Meanwhile, priority is also given to intellectual and technology linked services with high added value. Key service sectors include transport, ecommerce, telecommunications, wholesale and retail distribution and branding of Vietnamese products.

3. Development of economic regions and clusters

Development of business clusters based on regional master plans is high on the agenda, noting the importance of connectivity. Emphasis is put on key economic regions, economic zones and industrial parks.

4. Construction of urban and infrastructure systems

Key construction projects planned to help upgrade and improve the connectivity of Vietnam’s infrastructure include:

Table 5. Main indicators of 2016–2020 Socio-Economic Development Plan

	Indicator	2016–2020 Target
1	Average GDP Growth	6.5–7.0%/year
2	Annual GDP per capita	3.200–3.500 USD
3	Industry, Construction & Services' share of GDP	85%
4	Total average social investment over 5 years	32–34% GDP
5	Budget deficit by 2020	4% GDP
6	Total factor productivity's contribution to economic growth	30–35% GDP
7	Average increase in productivity	5%/year
8	Decrease in power drain as share of GDP per capita	1–1.5%/year
9	Urbanization rate by 2020	38–40%
10	Share of agricultural workforce by 2020	40%
11	Trained labour	65–70%
12	<i>of which has</i> degree, certificate	25%
13	Urban unemployment	<4%
14	Number of doctors per 10,000 people	9–10
15	Number of hospital beds per 10,000 people	>26.5
16	Health insurance coverage	>80%
17	Reduction in poverty rate	1–1.5%/year
18	Hazardous waste treated 85%	85%
19	Hospital waste treated	95–100%
20	Forest coverage	42%
21	Access to clean water by 2020	90% in rural areas 95% in urban areas

North-South roads

Upgrade existing railroad gauge from one meter to 1.435m

Phased construction of a North-South high speed train

Construction of international sea ports in the North and South, and mobilization of funding for an international transit port

Phasing of investment for Long Thanh International Airport

Completion of the irrigation system in the Mekong Delta to prevent flooding, alkaline soils and salinity.

In addition, infrastructure projects to respond to climate change and sea level rise will be prioritized.

5. Mobilization and effective use of resources

Vietnam continues to re-structure investment, especially public investment in order to improve quality, effectiveness and competitiveness. Emphasis is put on saving, ensuring trade and budget balances and expanding the scope and opportunities for private investments.

The legal framework for public private partnerships will be further improved for greater transparency, stability and fairness to encourage businesses to invest in infrastructure projects.

Vietnam will promote cooperation with FDI companies (FDI – foreign direct investment) to facilitate technology and knowledge

transfer. However, it will “not attract FDI at all costs”. Legislation will be revised to attract foreign investment, especially high tech, environmentally friendly and value adding projects. Meanwhile, projects that widen the trade deficit are energy intensive and extract resources without processing will be curbed. In addition, projects which waste resources, use outdated technology and pollute the environment will not be permitted.

Vietnam will continue to improve relevant legislation on managing and usage of **Overseas Development Assistance**. Procurement will be fairer and more transparent, minimizing pre-assigning contractors and using land of high commercial value. Priority will be given to projects in large scale economic and social infrastructure, agricultural development, improving modern market economy institutions, human capital (especially development of a skilled workforce), environmental protection, climate change, green growth strategy and others. Inspection and monitoring of investment projects will also be strengthened.

6. Improvement in human capital and strengthening the potential of science and technology

Vietnam plans educational reform towards a more open and comprehensive approach that has a greater emphasis on life skills, reduces workload in pre-tertiary education and encourages self-study and creativity. Emphasis is given to developing a knowledge economy with a high quality workforce in science and technology.

7. Cultural development, implementation of social progress and justice, and improving living standards in harmony with economic development

Vietnam is committed to integrating United Nations Sustainable Development goals into the country’s socio-economic programs and plans.

8. Active response to climate change, disaster prevention, resource management and environmental protection

The country plans to improve regulations, policy and coordination of solutions for climate change, disaster risk reduction, natural resource management, environmental protection and land

use. Matters that require immediate attention include the drought in the Central Highlands and the Southern Central region and urgent projects to prevent salinity and retain freshwater.

9. Anti-corruption, thrift and anti-wastefulness

Vietnam continues to improve relevant regulations, focusing on areas easily prone to corruption. They include asset declaration by government officials and limiting cash transactions. Inspections, auditing and prosecution are to be strengthened. The monitoring role of publicly elected bodies and the Fatherland Front in reporting corruption will be promoted.

10. Enhancing effectiveness and efficiency of state management, ensuring public freedom and democracy in socio-economic development coupled with compliance with the law

Government processes are set to be simplified and less bureaucratic. There will be clear distinctions between the functions of government agencies and the market, whereby the government only manages and provides directions for socio-economic development through legislation, planning and regulatory instruments appropriate for the market economy. Administrative intervention is to be minimized.

11. Strengthening national defense and security, fighting to preserve independence and sovereignty and ensuring political security, social order and safety

The SEDP stresses effective implementation of the strategy to protect the country under changing circumstances.

12. Improving effectiveness of external relations, active international integration, peaceful environment and favorable conditions for the country’s development

Vietnam wants to improve effectiveness of multilateral relations, especially within ASEAN and the United Nations. International cooperation to ensure regional and national defense, security and sovereignty is to be strengthened. Sea disputes are to be resolved by peaceful means in line with international law and regional code of conduct. Furthermore, Vietnam intends to ac-

tively negotiate and sign new generation free trade agreements.

We will discuss nine economic indicators have been assigned targets for 2020 by the National Assembly, covering topics from GDP growth to urbanisation (see Table 6) and set out how likely they are to be achieved.

1. Average annual GDP growth between 6.5% and 7.0%

This would represent an acceleration of growth from the previous five-year period (5.9% average), but given that the global economic environment was challenging in 2012 and 2013 such stronger growth could be achievable if supported by an improved global environment, as was the case in 2015 when a 6.7% expansion was recorded. This positive outlook is of course reliant on global conditions remaining stable or improving, any global downturn over the next five years would clearly knock the target off course. Another reason for optimism is that the Trans-Pacific

Partnership (TPP) trade agreement should be brought into force within the five-year period, and is expected to be a real benefit for the Vietnamese economy.

2. GDP per capita between \$3,200 and \$3,500 in 2020

The chances of meeting this target are a little more challenging than the first. GDP per capita in Vietnam in 2015 was \$2,109, with an average growth rate over the past five years of 9.7%. If this growth rate were repeated over the next five years it would take GDP per capita to \$3,350 in 2020, within the target range. However, growth has slowed considerably in recent years (to 2.8% in 2015) and the fact that the target is set in US dollars makes it vulnerable to a strengthening dollar. The Vietnamese dong fell 5.1% against the dollar during 2015, thereby hitting the rate of growth in GDP per capita in dollar terms. An example of this effect is shown below:

Table 6. Assessment of indicator achievability

Indicator	Topic	Target	Latest Year	Recent Trend (Average)	Achievability*
1	Average annual growth of GDP	6.5–7%	6.7%	5.9% (past 5 years)	2
2	GDP per capita in 2020	\$3,200–\$3,500	\$2,109	9.7% growth (past 5 years)	3
3	Proportion of GDP in Industry and Services	85%	68%	66% (past 5 years)	4
4	Total Social Investment Capital as % of GDP	32–34%	32.6%	32.4% (past 5 years)	1
5	State budget deficit as % of GDP in 2020	4%	4.4%	3.0% (past 5 years)	2
6	Fall in Energy Consumption as a % of GDP	1–1.5%	5.1%	1.3% (past 5 years)	2
7	Rate of Urbanisation by 2020	38–40%	33.0%	2.1% growth (past 5 years)	4
8	Total Factor Productivity (TFP) contribution to growth	30–35%	Unable to source data		
9	Average annual increase in labour productivity	5%	6.4%	5.4% (past 2 years)	3

*Scale of 1 to 5 where 1 is the most achievable.

	2015	2016 (with 9.7% growth, constant exchange rate)	2016 (with 9.7% growth, 5% dong depreciation)
Vietnamese dong	45.700.000	50.132.900	50.132.900
US\$	2.109	2.230	2.123

Sources: General Statistics Office, with Markit calculations.

3. Industry and Services to account for 85% of GDP in 2020

Table 7. GDP per capita (PPP) in selected Asian region countries

Cambodia	\$ 3.500 (2015 est.) \$ 3.300 (2014 est.) \$ 3.100 (2013 est.)
China	\$ 14.100 (2015 est.) \$ 13.300 (2014 est.) \$ 12.400 (2013 est.)
Fiji	\$ 9.000 (2015 est.) \$ 8.700 (2014 est.) \$ 8.300 (2013 est.)
Indonesia	\$ 11.100 (2015 est.) \$ 10.800 (2014 est.) \$ 10.400 (2013 est.)
Laos	\$ 5.300 (2015 est.) \$ 5.100 (2014 est.) \$ 4.800 (2013 est.)
Malaysia	\$ 26.300 (2015 est.) \$ 25.400 (2014 est.) \$ 24.500 (2013 est.)
Mongolia	\$ 12.100 (2015 est.) \$ 12.100 (2014 est.) \$ 11.300 (2013 est.)
Myanmar	n/a
Papua New Guinea	\$ 2.700 (2015 est.) \$ 2.500 (2014 est.) \$ 2.400 (2013 est.)
Philippines	\$ 7.300 (2015 est.) \$ 7.000 (2014 est.) \$ 6.700 (2013 est.)
Solomon Islands	\$ 1.900 (2015 est.) \$ 1.900 (2014 est.) \$ 1.900 (2013 est.)
Thailand	\$ 16.100 (2015 est.) \$ 15.700 (2014 est.) \$ 15.700 (2013 est.)
Timor-Leste	\$ 5.600 (2015 est.) \$ 5.500 (2014 est.) \$ 5.300 (2013 est.)
Vietnam	\$ 6.000 (2015 est.) \$ 5.700 (2014 est.) \$ 5.400 (2013 est.)
World	\$ 15.800 (2015 est.) \$ 16.700 (2014 est.) \$ 16.400 (2013 est.)

Note: data are in 2015 US dollars

Source: CIA – The World Factbook. 2016. <https://www.cia.gov/index.html>.

This target looks some way off at present, with the combined sectors accounting for 68% of GDP in 2015 (28% Industry, 40% Services). Furthermore, the trend does not show a rapid increase in the share of the economy accounted for by these sectors.

Composition by sector of GDP:

agriculture: 19.3%

industry: 38.5%

services: 42.2%

(2013 estimate)

agriculture: 17.4%

industry: 38.8%

services: 43.7%

(2015 estimate)

(Source: CIA – World Fact Book)

4. Total Social Investment Capital between 32% and 34% of GDP in 2020

This target should be achievable given that it was met in 2015 (32.6%) and the average over the past five years is also within the target range. There is also the opportunity for the state to directly influence the figure given that around one-third of social investment capital emanates from sources related to the public sector (see Table 8).

5. State budget deficit of 4% of GDP in 2020

Success in achieving this target will depend to some extent on global economic conditions and the effect they have on the Vietnamese economy. Should conditions be relatively benign the target looks reachable. The target has only been breached four times in the past 15 years, but these include 2013 and 2014 (the latest available data, Figure 12) and so some improvement will be needed to reduce the deficit by the end of the decade.

Vietnam recorded a Government Budget deficit equal to 4.40 percent of the country’s Gross Domestic Product in 2014. Government Budget in Vietnam averaged –3.65 percent of GDP from 1988 until 2014, reaching an all-time high of 1.30 percent of GDP in 2006 and a record low of –9.90 percent of GDP in 1988. Government Budget in Vietnam is reported by the *Asian Development Bank*.

6. Fall in energy consumption as a % of GDP of between 1% and 1.5% per year

While the data on energy usage can be volatile, the recent trend is in favor of the target being met. In the three years to 2013 (the latest year

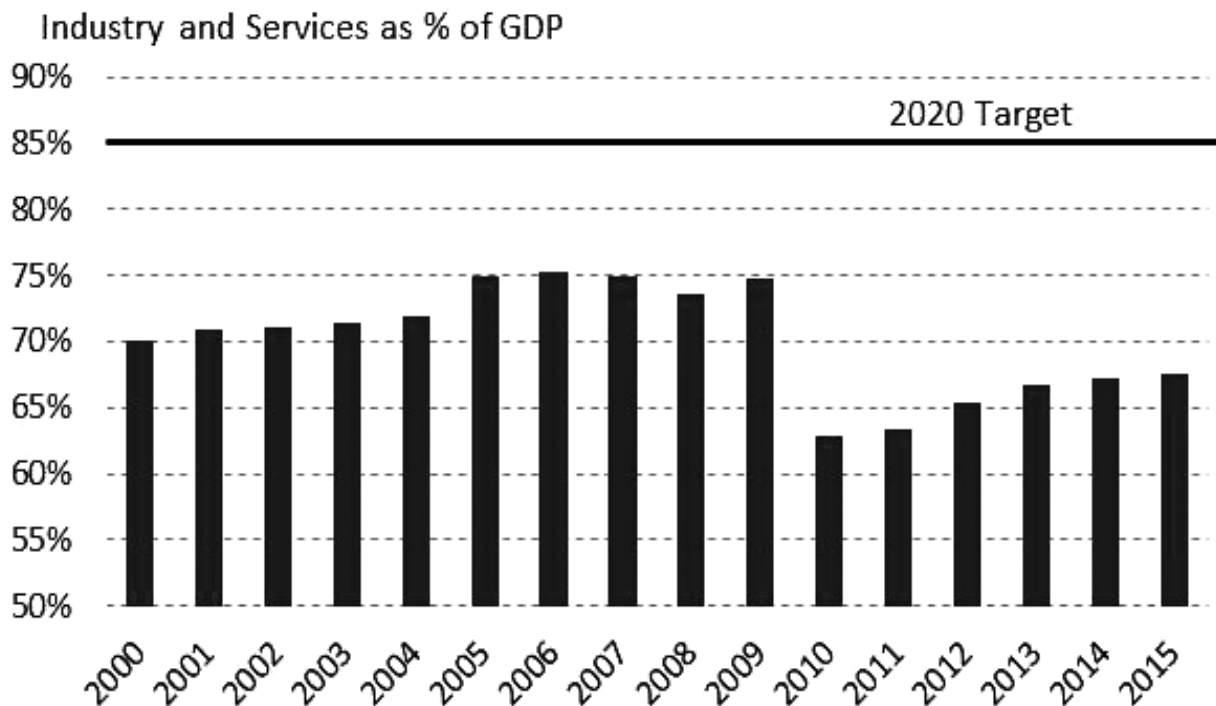


Figure 11. Contribution of industry and services to GDP

Source: General Statistics Office of Vietnam.

Table 8. Social capital expenditure

	Trillion dong	% of Total
State budget	220.40	16
Government bonds	61.70	5
Investment capital credit under state plan	62.50	5
Loan from other sources (of state sector)	86.80	6
Equity of State-owned Enterprises	66.90	5
Capital of households and private individuals	529.60	39
Foreign Direct Investment	339.30	25
Total	1,367.20	

Sources: General Statistics Office of Vietnam, with Markit calculations.

for which data are available) consumption fell at a faster pace than required by the target. However, before that usage was rising, thereby adding an element of doubt to the optimistic prediction.

7. Urbanization rate of between 38% and 40% by 2020

Based on recent trends this target looks like it will be tricky to meet. Currently, the urban population makes up 33% of the total (Figure 13), and if the proportion continues to rise at current

rates it will only be at 37.3% by 2020, short of the lower band required by the target.

Urbanization has been relatively recent in Vietnam. Until the 1980s, the government’s focus on agriculture encouraged workers to stay in rural areas, and as late as 1990 only 20% of the population lived in cities (Figure 13). Deeper economic reform and less-constrained rural — urban migration from the mid-1990s triggered rapid growth in cities, which developed as centers for services and manufacturing. Over the past 2 decades, the number of urban dwellers

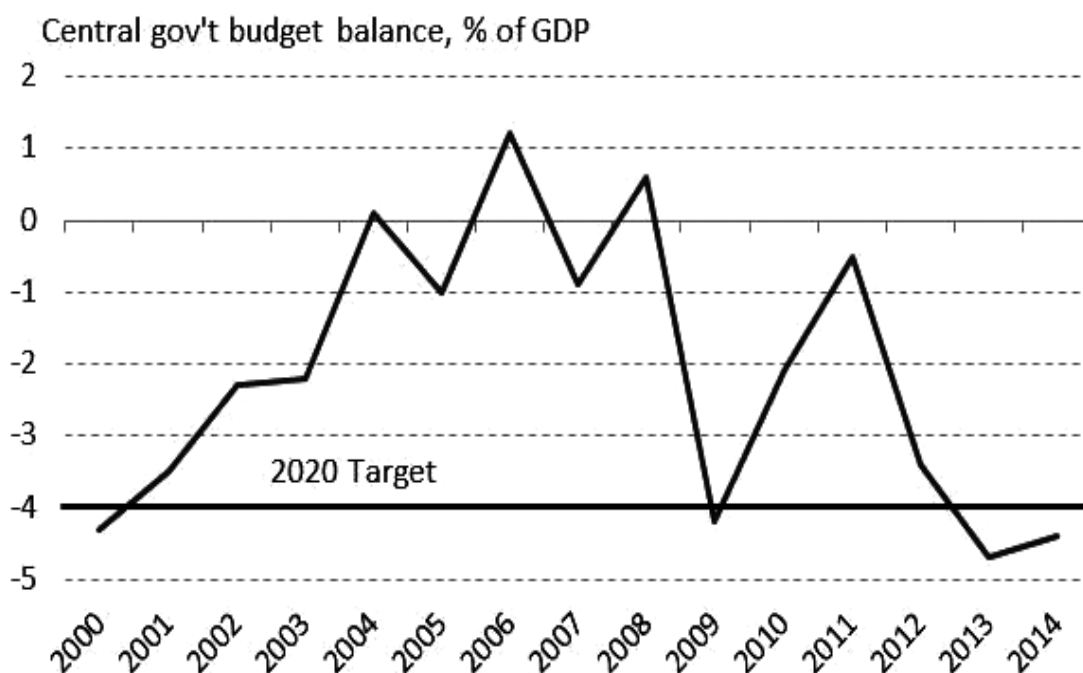


Figure 12. Central government budget balance, % of GDP

Sources: General Statistics Office of Vietnam.

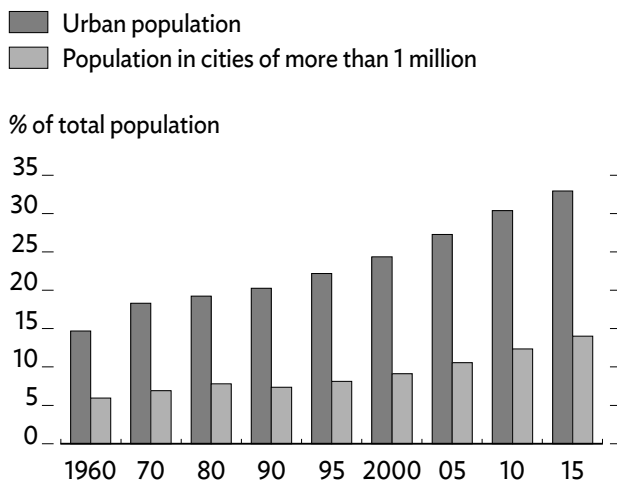


Figure 13. Urban population in Vietnam

Source: The World Bank, World Development Indicators online database (accessed 26 August, 2016).

has jumped to 31 million, or 34% of the population, and is projected to reach 46 million, or 44%, by 2030.

Growth in urban centers and formal employment are important drivers of the economy, as illustrated by estimates that show at least 70% of GDP is now generated in cities. However, urban transportation networks, water and sanitation systems, health and education services, and other physical and social infrastructure have struggled to keep pace. Moreover, rapidly rising urban populations strain natural resources and pollute the environment. To remain a vibrant industrializing economy, Viet Nam will need to develop more efficient urban centers that can support

much larger populations. Achieving this will require progress on three fronts.

The first is urban planning. The current planning law stresses decentralized urban planning and stakeholder consultation, which requires more urban planning and management capacity in provincial and local governments. Too often, master plans are idealized visions of future cities that do not take into account the real needs of households, businesses, or local governments.

Second is the funding of urban infrastructure. Outside of Ha Noi and Ho Chi Minh City, few urban governments can raise enough revenue for infrastructure on their own, leaving many heavily dependent on the central government annual budget. This inhibits infrastructure development because local governments need multiyear funding commitments to complete projects such as upgrades to citywide drainage systems. Funding can be even more difficult for critical projects that generate little revenue, such as sewerage, which typically require significant official development assistance from abroad.

For lack of own-source funding, urban authorities sometimes rely on private developers to provide infrastructure through land-for-development deals. Such deals can undervalue public land and build low-quality infrastructure. Further, a model of urban development driven by developers can distort supply by, for example, overinvesting in higher-end housing and underinvesting in homes for the urban poor.

Table 9. Urban population % of total population

Year	Urban population	Population in cities of more than 1 million
1960	14.7	5.9
1970	18.3	6.9
1980	19.2	7.8
1990	20.3	7.4
1995	22.2	8.1
2000	24.4	9.1
2005	27.3	10.6
2010	30.4	12.4
2015	33.0	14.0

Source: World Bank, World Development Indicators online database (accessed 26 August, 2016).

These issues can be addressed by strengthening provincial planning, creating medium-term frameworks for funding urban services, and encouraging provincial governments to deemphasize their role as investors and focus more on planning and regulating urban services, land use, and the stewardship of natural resources.

In northern and central Vietnam, over 3,200 km of rural roads were rehabilitated between 2006 and 2014, and the share of people living within 2 km of an all-weather road increased from 76 percent to 87 percent.

Finally, urban development needs to take the environment into account. Land-for-development deals often create urban sprawl and build inappropriately in high-risk areas, including floodplains. Moreover, the present planning system does not encourage governments to effectively incorporate climate change into urban plans. As a result, cities often focus on expansion and give inadequate attention to climate and disaster risks.

Targets 8 and 9: Total Factor Productivity contributing 30% to 35% of growth, with labour productivity increasing 5% per year on average

Limited data availability regarding these targets makes them difficult to evaluate. Labour productivity grew above target (6.4%) in 2015, but below (4.3%) in 2014. Overall, most of the named targets look to be achievable, particularly if global economic conditions are stable and the TPP comes into effect as planned. The biggest challenges look to be around the proportion of GDP accounted for by industry and services and the rate of urbanisation. Meanwhile, PMI data will provide a useful monthly signal as to how the economy is faring over the five-year period.

SEPARATE LEAF FISCAL DECENTRALIZATION IN VIETNAM

Report “*Making the Whole Greater than the Sum of the Parts: A Review of Fiscal Decentralization in Vietnam*”, prepared by The World Bank in Vietnam, 2015, provides a review of fiscal decentralization policies in Vietnam and their impact on the Government’s development objectives. It aims to inform reform of central-local fiscal relations in Vietnam to further promote growth and poverty reduction. Study of fiscal decentraliza-

tion therefore is central to understanding government spending in Vietnam and its significant impact on the country’s successful record on economic growth and poverty reduction.

Local authorities have been granted increasing levels of fiscal responsibilities since the adoption of the *State Budget Law (2002)*. It has enabled decentralization of important fiscal responsibilities to local authorities over the past ten years. The *SBL 2002* establishes the key principles for spending assignments, revenue arrangements, and intergovernmental fiscal transfers. It also grants provincial authorities a fair degree of autonomy to determine fiscal relationships with districts and communes within their jurisdiction. The current system allows a reasonable level of differential treatment across provinces to take account of their specific circumstances.

There is general acknowledgement that the *SBL 2002* has provided a solid framework for public finance management including intergovernmental fiscal relations. At the same time, after 10 years of implementation a number of issues arise such as: clarity of spending responsibilities and local level accountability including for national priorities and objectives; spending performance of local authorities; the effectiveness of local revenue arrangements in meeting spending needs and the potential for increased revenue autonomy for provinces; the extent to which provincial authorities are promoting or impeding central government’s redistribution efforts; and the potential for increased debt financing for local authorities.

Local authorities in Vietnam are responsible for over half of total government spending, thanks to fiscal decentralization policies implemented over the past eighteen years. Total government spending in Vietnam is close to 30 percent of Gross Domestic Product; local authorities’ spending is close to 17 percent of GDP. So, local fiscal policies have a significant impact on Vietnam’s development. Thus it is necessary to look at the extent to which fiscal decentralization policies have achieved their development objectives.

Local fiscal policies in Vietnam determine decisions on public service delivery, and therefore the overall development trajectory of the country. Poor spending or revenue decisions at

Table 10. Emerging Market and Developing Economies: Consumer Prices¹
(Annual percent change)

	End of Period 2															
	Average								Projections							
	1998-2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2021	2015	2016	2017	
Cambodia	3.8	25.0	-0.7	4.0	5.5	2.9	3.0	3.9	1.2	2.1	2.8	0.2	2.8	2.4	2.9	
China	1.1	5.9	-0.7	3.3	5.4	2.6	2.6	2.0	1.4	1.8	2.0	3.0	1.6	1.8	2.0	
Fiji	3.0	7.7	3.7	3.7	7.3	3.4	2.9	0.5	2.8	3.3	2.8	2.8	2.8	3.3	2.8	
Indonesia	14.1	9.8	5.0	5.1	5.3	4.0	6.4	6.4	6.4	4.3	4.5	4.0	3.4	4.5	4.4	
Lao P.D.R.	24.0	7.6	0.0	6.0	7.6	4.3	6.4	5.5	5.3	1.5	2.3	3.1	5.5	1.2	2.3	
Malaysia	2.4	5.4	0.6	1.7	3.2	1.7	2.1	3.1	2.1	3.1	2.9	3.0	2.7	3.1	2.9	
Mongolia	7.3	26.8	6.3	10.2	7.7	15.0	8.6	12.9	5.9	1.9	4.3	6.4	1.1	3.7	6.5	
Myanmar	23.4	11.5	2.2	8.2	2.8	2.8	5.7	5.9	11.5	9.6	8.2	6.4	10.5	8.7	7.7	
Papua New Guinea	8.6	10.8	6.9	5.1	4.4	4.5	5.0	5.3	6.0	6.0	5.0	5.0	6.0	6.0	5.0	
Philippines	5.2	8.2	4.2	3.8	4.7	3.2	2.9	4.2	1.4	2.0	3.4	3.5	1.5	2.9	3.2	
Solomon Islands	8.7	17.3	7.1	0.9	7.4	5.9	5.4	5.2	-0.4	2.1	2.6	3.1	2.2	2.9	2.6	
Thailand	2.8	5.5	-0.9	3.3	3.8	3.0	2.2	1.9	-0.9	0.2	2.0	2.5	-0.9	1.6	1.8	
Timor-Leste...		7.4	-0.2	5.2	13.2	10.9	9.5	0.7	0.6	1.5	3.8	4.0	-0.6	3.6	4.0	
Vietnam	4.9	23.1	6.7	9.2	18.7	9.1	6.6	4.1	0.6	1.3	2.3	4.0	0.6	2.0	2.6	

1. Movements in consumer prices are shown as annual averages.

2. Monthly year-over-year changes and, for several countries, on a quarterly basis.

For many countries, inflation for the earlier years is measured on the basis of a retail price index (CPI) inflation data with broader and more up-to-date coverage are typically used for more recent years.

Source: *World Economic Outlook*, April 2016. International Monetary Fund.

local level, coupled with lack of transparency can lead to inefficient spending, unequal development across the country and reversal of the country's successful record of growth and poverty reduction. Despite the importance of fiscal decentralization in Vietnam's development, there has been little study on the successes and failure of policies and institutions in this area. The report responds to demands for more analysis of fiscal decentralization policies in Vietnam and the extent to which these have delivered on their intended objectives of equity and efficiency to promote economic growth and poverty reduction. It aims to inform future changes to the system of intergovernmental fiscal relations through revisions to the *SBL 2002* and adoption of **2016–20 Stability Period regulations**. The *SBL 2002* establishes the key principles for spending assignments, revenue arrangements, and intergovernmental fiscal transfers. It also grants provincial authorities a fair degree of autonomy to determine fiscal relationships with districts and communes within their jurisdiction. There is general acknowledgement that the *SBL 2002* has provided a solid framework for public finance management including intergovernmental fiscal relationships.

The report responds to demands for more analysis of fiscal decentralization policies in Vietnam and the extent to which these have delivered on their stability, equity and efficiency objectives. It builds on existing research and aims to provide new analysis and perspectives on the above areas through extensive study of available data, consultations with central and local authorities, and reviews of laws, regulations and policies at central and local levels. It covers the following five pillars of fiscal decentralization:

- (i) expenditure decentralization and accountability;
- (ii) expenditure performance of local authorities;
- (iii) local revenue arrangements;
- (iv) intergovernmental fiscal transfers; and
- (v) local borrowing.

Study of fiscal decentralization therefore is central to understanding government spending in Vietnam and its significant impact on the country's successful record on economic growth and poverty reduction. To date however there has been little analysis of how fiscal decentrali-

zation has enabled local authorities to effectively, efficiently and accountably spend money on public services for development. Spending decentralization has grown more quickly than information and knowledge on local fiscal policies in Vietnam.

After 10 years of implementation of the *SBL 2002*, a number of issues arise in relation to the system of intergovernmental fiscal relations. These include:

- clarity of spending responsibilities and local level accountability including for national priorities and objectives; spending performance of local authorities;
- the effectiveness of local revenue arrangements in meeting spending needs and the potential for increased revenue autonomy for selected provinces;
- the extent to which provincial authorities are promoting or impeding central government's redistribution efforts; and the potential for increased debt financing for local authorities within prudent limits.

To date however there has been little analysis of how fiscal decentralization has enabled local authorities to effectively, efficiently and accountably spend money on public services for development. Spending decentralization has grown more quickly than information and knowledge on local fiscal policies in Vietnam. This has prompted a number of questions from the National Assembly, the Central Government, and other stakeholders including:

How are local spending choices aligning with national level objectives?

How much spending responsibility do local authorities actually have?

Are current policies and institutions sufficient to ensure that the money is spent well and in line with citizens' needs?

How much do provinces spend on delivering a given level of public services and what might explain the differences?

What results are being achieved?

How effectively are local authorities able to raise revenues to finance local spending?

Are fiscal transfers sufficient to effectively cover all local spending needs?

Are transfers being equitably distributed?

Are there more opportunities for provinces to borrow to meet investment needs?

These are some of the questions that report tries to answer to help inform future changes to central-local fiscal relations. The report finds that fiscal decentralization policies have helped to channel more spending to the poorest parts of the country where development needs and costs of service delivery are higher. There is fairly wide variation in spending efficiency across provinces. Some of it is due to factors outside of local authorities' control (e.g. population density, geographic location). But the report also finds that money could be better spent through improvements in budget management and accountability.

The level of local revenue has increased over time, and the evidence suggests that the current policies do not impact negatively on revenue collection efforts. Another positive feature is that revenue and fiscal transfers have on the whole been quite equitable. However, local authorities currently have little to no autonomy over revenue policy and administration. Some autonomy over revenue can increase accountability between state and citizen and promote better use of the resources. It can also enable certain provinces to better meet their investment needs. The study finds that the latter can be complemented with some increase in local borrowing levels.

A combination of these measures should help to maintain the government's successful redistributive policies to meet social objectives, and enable high economic potential provinces to invest in growth enhancing initiatives, whilst enhancing transparency to ensure accountability. Lack of transparency and coordination in inter-governmental fiscal relations can lead to fragmentation and unequal development across the country. Intergovernmental fiscal relations should ensure that development efforts of all provinces exceed the sum of their individual parts so that they can help eliminate extreme poverty and promote shared prosperity in Vietnam.

FREE TRADE AGREEMENTS

Trade contributes to economic performance by improving productivity and by giving producers and consumers access to greater varieties of goods at lower prices³. It also stimulates com-

³ The relationship between trade and economic performance has been widely studied; see, for example, WTO and World Bank (2015), OECD and WTO (2013), Stone and Shepherd (2011), Wacziarg and Welch (2008), and Sachs and Warner (1995).

petition and encourages technology and investment flows. Countries have long pursued these benefits by gradually reducing tariffs through the General Agreement on Tariffs and Trade (GATT) and World Trade Organization (WTO) agreements, enabling world trade to grow twice as fast as output. In recent years, however, global negotiations have ebbed, NTBs have become more prevalent⁴, and world trade growth has slowed.

Since the rebound from the great trade collapse of 2008–09, when world trade fell by much more than GDP, global trade growth has slowed notably, both in absolute terms and relative to world GDP growth. This slowdown has been more pronounced in emerging market and developing economies, where it intensified in 2015. In the two decades leading up to the global financial crisis, international trade expanded rapidly, at a pace roughly double that of world GDP. World trade volume growth, however, has moderated notably in recent years, both in its level and relative to GDP growth. As a result, the increase in trade as a share of global GDP has decelerated.

The slowdown in trade has been remarkably widespread. An analysis of recent trade patterns of 174 individual countries reveals that trade growth has weakened in an overwhelming majority of countries.

This holds true even after the weak growth in income and the decline in trade prices are taken into account. Most countries have been importing less, relative to their incomes during 2012–15, than in the years leading up to the global financial crisis. For 65 percent of the countries, accounting for 74 percent of global imports, the ratio of average import volume growth to GDP growth (a simple measure of the income elasticity of import demand) observed during 2012–15 was below that during 2003–06.

The observed slowdown in import income elasticity has been more pronounced in emerging market and developing economies than in advanced economies⁵.

⁴ Evenett, Simon J., and Fritz, Johannes. 2015. *The Tide Turns? Trade, Protectionism, and Slowing Global Growth: The 18th Global Trade Alert Report*. Geneva: Centre for Economic Policy Research. Available at: www.voxeu.org/sites/default/files/file/GTA18_final.pdf.

⁵ World Economic Outlook, April 2016. *Too Slow for Too Long*. World Economic and Financial Surveys, International Monetary Fund, 2016.

Today's lower tariffs, improved logistics, and better information systems enable firms to exploit gains from international specialization far more extensively than they did in the past. Firms in the United States and elsewhere have developed complex global value chains, often focused on the Asia Pacific, to raise productivity. These systems, along with new areas of economic integration made possible by technology, have stimulated demand for still lower trade barriers, better connectivity through ports and communications, and clearer, more coherent rules to facilitate international business operations.

Global trade negotiations have failed to keep pace with these trends. To fill the vacuum, more than 220 free trade agreements (FTAs) have been signed and in effect in the Asian region alone (see Table 11). Yet bilateral or small regional FTAs are 'second-best' strategies for deeper integration. To take advantage of an FTA, exporters have to prove that they meet 'rules of origin' (ROO)⁶ and often cannot do so in an agreement that does not cover complete supply chains. Also, smaller FTAs tend to focus on narrow, regional goals and have little influence on global rules. They also tend to be inefficient, as they encourage the use of costly products from FTA partners instead of those efficiently produced by non-partners.

Absent effective global negotiations, large and ambitious regional agreements — frequently called megaregional agreements — offer a way forward. They can include a sufficient number and range of partners to limit the costs of trade diversion and to have an impact on global rules. Yet their membership can be small enough to reach compromises on difficult issues. The TPP is the first megaregional agreement concluded in over two decades (the European Single Market and the North American Free Trade Agreement were similar in ambition) and could have large, systemic effects.

Global Economic Prospects, June 2016. *Divergences and Risks*. A World Bank Group Flagship Report, International Bank for Reconstruction and Development/The World Bank, 2016.

⁶ Rules of origin ensure that only goods primarily produced in an FTA zone are eligible for tariff preferences. A producer might have to prove, for example, that inputs in the production process that originate outside the zone fall below a percentage limit or consist of different products in terms of the customs classification.

After years of negotiations, agreement on the TPP trade deal was reached on October 5th, 2015. Vietnam is one of 12 countries (Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, United States of America, Vietnam) currently part of the agreement which now passes on to the signing and ratification stage. This is potentially a lengthy process with the possibility of political difficulties in a number of countries. For example, the new Canadian government has expressed some scepticism about the deal in the past, while doubts are also present in the US and Japan. However, if and when it is finally implemented, the deal has the potential to provide a major boost to export trade at Vietnamese manufacturing firms.

The Trans-Pacific Partnership (TPP), concluded on October 5, 2015, reflects inevitable compromises but appears to have met its two key objectives: to establish new, market-oriented rules in a host of rapidly changing areas of international commerce and to reduce trade and investment barriers among TPP countries to yield considerable gains for the United States and its 11 partners.

The TPP is a landmark accord. In 2014 its member countries had combined GDP of \$ 28 trillion, or 36 percent of world GDP, and accounted for \$ 5.3 trillion in exports, or 23 percent of the world total⁷. They are unusually diverse, comprising low-, middle-, and high-income countries with varied economic systems. The agreement itself is deep and comprehensive, targeting economic integration with provisions that range from goods, services, and investment to critical new issues such as the digital economy, intellectual property rights, regulatory coherence, labor, and the environment. The role of the TPP in launching international cooperation on so-called *next-generation trade rules* cannot be assessed at this time, but it may prove to be its most valuable contribution in the long run.

Economic modeling can show, however, the effects of the scheduled liberalization elements of the TPP, provided it is ratified by its members. The estimates reported here suggest that the TPP will increase annual real incomes in the

⁷ Data from the World Bank's World Development Indicators database.

Table 11. FTA Status by Country/Economy, 2015 (as of February 2016)

COUNTRY/ ECONOMY	Under Negotiation		Signed but not yet In Effect	Signed and In Effect	TOTAL
	Framework Agreement signed	Negotiations launched			
Afghanistan	0	0	1	1	2
Australia	0	5	0	12	17
Bangladesh	0	2	1	3	6
Bhutan	0	1	0	2	3
Brunei Darussalam	0	2	0	8	10
Cambodia	0	2	0	6	8
China, People's Republic of	0	7	0	16	23
Fiji	0	2	0	3	5
Hong Kong, China	0	1	0	4	5
India	1	14	0	13	28
Indonesia	0	7	1	9	17
Japan	0	8	1	14	23
Korea, Republic of	0	8	1	15	24
Lao PDR	0	2	0	8	10
Malaysia	1	5	1	14	21
Mongolia	0	0	1	0	1
Myanmar	1	3	0	6	10
Nepal	0	1	0	2	3
New Zealand	0	5	0	11	16
Pakistan	0	6	2	10	18
Papua New Guinea	0	2	0	4	6
Philippines	0	4	0	7	11
Singapore	0	8	1	20	29
Sri Lanka	0	2	0	5	7
Taipei, China	1	1	0	7	9
Thailand	1	8	0	13	22
Viet Nam	0	5	1	9	15
TOTAL	5	111	11	222	349

Notes:

1. *Framework Agreement signed*: The parties initially negotiate the contents of a framework agreement (FA), which serves as a framework for future negotiations.

2. *Negotiations launched*: The parties, through the relevant ministries, declare the official launch of negotiations or set the date for such, or start the first round of negotiations.

3. *Signed but not yet in effect*: Parties sign the agreement after negotiations have been completed. However, the agreement has yet to be implemented.

4. *Signed and in effect*: Provisions of FTA come into force, after legislative or executive ratification.

Source: Asian Development Bank. Asia Regional Integration Center: <https://aric.adb.org/fta> (accessed on August 26, 2016).

United States by \$ 131 billion⁸, or 0.5 percent of GDP, and annual exports by \$ 357 billion, or 9.1 percent of exports, over baseline projections by 2030, when the agreement is nearly fully implemented. Incomes after 2030 will remain above baseline results by a similar margin. Both labor and capital will benefit, but labor will get a somewhat more than proportionate share of the gains in total.

Given these benefits, delaying the launch of the TPP by even one year would represent a \$ 94 billion permanent loss, or opportunity cost, to the US economy as well as create other risks. Postponing implementation will give up gains that compound over time and defer or foreclose new opportunities for the United States in international negotiations. Unexpected political challenges or competing trade projects may also erode decisions in partner countries, further increasing the costs from delaying TPP ratification. While the United States will be the largest beneficiary of the TPP in absolute terms, the agreement will generate substantial gains for Japan, Malaysia, and Vietnam as well, and solid benefits for other members.

Given these wider objectives, TPP negotiators sought to eliminate traditional barriers as well as update rules to meet business and social goals. In the event, the tariff reductions in the TPP are deeper and wider than anticipated, including in 2012 study⁹. The TPP will eliminate three-quarters of nonzero tariffs immediately on entry into force (EIF), and 99 percent when fully implemented¹⁰. However, it will include some divergences even among intraregional tariffs: Although most of its tariff schedules treat partners equally, some schedules, includ-

ing those of the United States, retain differences among them.

Comprehensive rules are the most distinctive aspect of the TPP. In some areas the agreement builds on the WTO rulebook but tightens disciplines and creates new mechanisms to improve implementation. It includes more comprehensive rules for service trade and investment than were in WTO agreements and allows exceptions only on a negative-list basis. It improves mechanisms for setting food standards and technical barriers and for assessing the conformity of products with them, and begins to cut through the 'spaghetti bowl' of overlapping trade agreements by establishing a single set of ROO that allows inputs produced in any TPP member to count toward meeting ROO standards. The TPP also strengthens intellectual property (IP) rights and prescribes greater commitments toward enforcing them¹¹, and it has more comprehensive and enforceable rules on labor and the environment than previous agreements.

In other areas the TPP breaks new ground with provisions that were absent from or tangentially addressed by prior agreements. It sets new standards for access to telecommunication networks, prohibits tariffs on electronic commerce, limits restrictions on cross-border data transfers, and rules out data localization requirements. It also brings state-owned enterprises (SOEs) more clearly under international rules, ensuring that their purchases and sales are on a commercial basis, including their service exports and foreign investments. It has special chapters on trade facilitation and small and medium enterprises (SMEs) in order to improve access to online platforms and to make regulations simpler and easier to meet. Many of these provisions are enforceable under a new dispute settlement mechanism.

Large gains are also projected for Japan, Malaysia, and Vietnam. Japan benefits from improved market access throughout the TPP region, including early liberalization of auto imports in markets other than the United States,

⁸ Peter A. Petri and Michael G. Plummer. *The Economic Effects of the Trans-Pacific Partnership: New Estimates*. Working Paper series, WP 16-2, January, 2016. Estimates are in constant 2015 dollars. The apparent precision of the estimates should not be misinterpreted. Exact numerical results are provided to help readers compare relative magnitudes and check the internal consistency of results, but estimates could be one-third larger or smaller — as sensitivity analyses indicate— due to uncertainties in data and assumptions.

⁹ Petri, Peter A., Plummer, Michael G., Zhai, Fan. (2011). *The Trans-Pacific Partnership and Asia-Pacific Integration: A Quantitative Assessment*. East-West Center Working Papers, Economics Series, No. 119, October 24, 2011.

¹⁰ Freund, Caroline, Tyler Moran, and Sarah Oliver. 2016 (forthcoming). *Tariff Liberalization*. In *Assessing the Trans-Pacific Partnership*, volume 1. PIIE Briefing 16-1. Washington: Peterson Institute for International Economics.

¹¹ Additional areas covered in the IP chapter include explicit coverage of state-owned enterprises so that they cannot evade IP rules, enhanced penalties for counterfeits that threaten public health and safety, and digital copyright policies. Data exclusivity for biologic products was set at five years, with additional measures to reach eight-year effective protection (but not 12 years, as US negotiators had sought).

and from domestic reforms that reduce distortions in its protected service and investment sectors. Percentage gains are especially large for *Vietnam* and *Malaysia*, where the agreement should also stimulate domestic reforms and provide access to protected foreign markets. Other significant percentage gains are projected for the smaller economies of Brunei, Peru, Singapore, and New Zealand.

The TPP is not generally estimated to have large income effects on nonmembers. Some gain and others lose, the latter to the extent that the TPP diverts trade from nonmembers to members or erodes previous preferences in TPP markets. Losses are tangible for China, India, and Thailand, which compete with TPP members for TPP markets, and for Korea, because the TPP will erode that country's advantage in US markets under KORUS. But except for Thailand, these losses are small compared with GDPs. Some nonmembers, including the European Union and Hong Kong, experience net gains, in part because of the assumption that TPP provisions liberalize some trade with nonmembers.

As the TPP awaits ratification, the timing of its implementation is uncertain. The central results assume EIF in 2017. In an alternative simulation, we repeat the TPP experiment but delay the launch of implementation — the start of staged reductions of trade barriers — to 2018, keeping other assumptions unchanged.

In the simulation of a one-year delay, the benefits in every future year are lower than in the central scenario with EIF in 2017. Given that gains consist of a stream of future benefits, the «value» of the agreement can be calculated as a present value, the discounted sum of future benefits. This is similar to the calculation a business would apply in determining the value of an investment project. Table 5 shows the present value of the TPP with several plausible discount rates, ranging from \$961 billion to \$2,316 billion for the United States if the TPP is implemented in 2017, and across lower values if it is delayed. A one-year delay thus results in permanent losses from \$77 billion to \$123 billion for the United States and \$308 billion to \$525 billion for the world.

Delaying the TPP could generate still further, unquantified risks for the conduct of US commercial diplomacy. Given political uncertainties

in many TPP member economies, some that are prepared to ratify the TPP now may be unwilling to do so later, and in that case the benefits to be realized will shrink. The benefits might be also reduced if, while waiting, TPP members choose to advance alternative free trade arrangements to hedge their bets. And other trade and investment initiatives that the United States is or could be involved in — including high-valued negotiations with Europe and on the enlargement of the TPP itself — would have to be delayed or possibly abandoned, with corresponding costs.

Once in place, the TPP is likely to promote additional integration in the Asia-Pacific region and beyond, with larger attendant gains. It is potentially a pathway to the Free Trade Area of the Asia-Pacific (FTAAP), which could include all APEC members and, based on our earlier studies, more than double the gains for the United States. The *Transatlantic Trade and Investment Partnership*, in negotiation since 2013, would also have large effects. And broader global negotiations may pick up steam. These and other initiatives would benefit from competitive pressure from the TPP.

Once fully implemented, the Trans-Pacific Partnership (TPP) trade agreement should greatly benefit exporting manufacturers in Vietnam as barriers to trade are removed, aiding their competitiveness overseas. Let's look at some of the reasons for optimism among Vietnamese firms.

One of the key tenets of the deal (the details of which are largely secret at this stage) will revolve around the removal of trade barriers between the participating nations. The removal of tariffs on Vietnamese goods exports to countries such as the US would boost the price competitiveness of Vietnamese producers, particularly compared with competitors who aren't part of the agreement, notably **China**. Moreover, a number of commentators, including ratings agency Fitch¹², estimate that Vietnam will be the biggest gainer of the 12 countries currently part of the agreement. One of the reasons for optimism among Vietnamese firms revolves around the types of goods they produce.

Vietnam could see a significant boost to long-term economic growth, investment and exports, should the Trans-Pacific Partnership (TPP) agreement drafted on 5 October be ratified, says

¹² <https://www.fitchratings.com/site/pr/992111>

Fitch Ratings. Of the 12 countries that are party to the TPP, models suggest Vietnam would see the biggest benefits in terms of economic impact.

Vietnam could see a positive economic growth effect in excess of 10% over the 10 years to 2025 under the TPP agreement, according to the estimates of one study by Petri, Plummer and Zhai¹⁵. Fitch believes that the agreement would have significant impact on two key areas in Vietnam — trade and domestic economic policy.

The free trade elements of the TPP will lower tariff barriers, giving Vietnam greater access to large consumer markets in the US, Japan, Canada and Australia. TPP signatories accounted for 39% of Vietnam's total exports and 23% of imports in 2014. The potential positive effect on trade could be transformative, with the aforementioned study estimating the TPP will boost Vietnam's exports by over 37% over 10 years. Notably, Vietnam in August also concluded the terms of a free trade deal with the European Union, putting it on course to complete free trade agreements with three of its four largest export destinations — the EU, Japan and the US.

The agreement does much more than just lower tariff barriers — it also aims to address wide-ranging barriers to trade by setting rules governing intellectual property rights, business competition policies including those related to state-owned enterprises, public procurement policies, supra-national dispute resolution, and labour standards. As such, the TPP has the potential to act as a key policy anchor for structural reforms and economic liberalization that could bolster productivity and foreign investment for Vietnam.

Vietnam already benefits from high GDP growth and stable FDI inflows. GDP growth accelerated to 6.5% over the first three quarters of 2015, implying a 3Q growth rate of 6.9% yoy versus 6.5% in 2Q. Strong and improving macro-economic stability was a key driver of Vietnam's upgrade to 'BB-' in November 2014.

But further upside for Vietnam's rating will likely continue to be challenged by wide fiscal deficits and high public debt. Fitch estimates the

general government deficit will rise to 6.9% of GDP in 2015 from 6.1% in 2014. Public debt levels (excluding guarantees) have grown to 45% of GDP, though this is broadly in line with the 'BB' peer median of 41%. External finances have been strength for Vietnam in recent years, but a pick-up in credit growth thus far in 2015 has spurred demand for imports and squeezed the trade account. Fitch estimates this will likely drag the current account surplus to under 1% in 2015 from 5% in 2014.

Implementation risks could be significant as the TPP agreement heads to national legislatures for ratification. Opposition in the US from Congress and leading presidential candidates in the lead up to the 2016 elections there could yet scupper or delay the TPP. Within Vietnam, while ratification is more likely, there could be difficulties in implementing some areas of structural reform.

Data suggest that the Textiles and Apparel sector has been one of the main areas of negotiation, an important area for manufacturers in Vietnam with textiles and footwear combined accounting for almost one-fifth of their exports.

TPP membership will also provide a meaningful boost because Vietnamese firms will be able to leverage existing established trade relationships, which are by no means confined to its near neighbors. The other TPP members currently account for around two-fifths of Vietnam's exports, with 17% to the US alone. With trade set to become easier with these countries, their importance as export destinations will likely increase.

Aside from the potential benefits from the removal of barriers to trade, the TPP also covers some elements that might prove problematic for Vietnam to implement. Protection for labour rights, particularly with regards to industrial relations, would require a loosening of central control. Meanwhile, stricter environmental standards could add to costs for firms as they are forced to adapt. However, the overall impacts of the deal should be positive and any reforms in the aforementioned areas will help the economy in the longer term. The fact that the government has agreed to a deal which will reduce some of their own control highlights how positive they perceive the overall agreement to be.

With Vietnam currently one of the best-performing Asian emerging markets, the country

¹⁵ Petri, Peter A., Plummer, Michael G., Zhai, Fan. (2011). *The Trans-Pacific Partnership and Asia-Pacific Integration: A Quantitative Assessment*. East-West Center Working Papers, Economics Series, No. 119, October 24, 2011.

Table 12. Key Export Goods for Vietnam

Sector	Share of Vietnam export, %
Textile, sewing products	13
Electronic parts (including TV parts), computer and their parts	7
Footwear	6
Fishery products	5
Wood and wooden products	4

Source: Government Statistics Office of Vietnam.

Table 13. Exports to other TPP countries

Country	Share of Vietnam exports (2012), %
USA	17
Japan	11
Malaysia	4
Australia	3
Singapore	2
Canada	1
Mexico	1
New Zealand	0
Chile	0
Peru	0
Brunei	0

Source: Government Statistics Office of Vietnam.

is well placed to build on this strength once the benefits of the TPP are realized. The government will therefore hope that the ratification process will run smoothly and without too much delay. Once more details on the agreement are released it will be easier to determine how firms will be able to gain from its eventual implementation and what pitfalls might lay ahead.

TOWARDS 2035

Vietnam is transitioning to a market-based economy. Since the launch of *Đổi Mới* in 1986, Vietnam has recorded significant and historic achievements. Success from reforms raises expectations for the future, and there is a firm aspiration that by 2035, Vietnam will be a modern and industrialized nation moving toward becoming a prosperous, creative, equitable, and democratic society. Motivated by these aspirations, the Government of Vietnam and the World Bank Group jointly prepared the “*Vietnam 2035: Toward Prosperity, Creativity, Equity and Democracy*” report that gives further shape to Vietnam’s aspirations, highlights the key development challenges that remain, and outlines a series of policy recommendations to help Viet-

nam achieve its 2035 goals. Vietnam 2035 report recognizes six key transformations:

- (1) to enable economic modernization with a competitive private sector firmly in the lead;
- (2) to improve the country’s technological and innovative capacity;
- (3) to reshape urban policies and investments for more dynamic cities and urban centers;
- (4) to chart an environmentally sustainable development path with increasing adaptation and resilience to changing climate patterns;
- (5) to promote equality and inclusion among marginalized groups for the development of a harmonious middle-class society; and
- (6) to establish a modern rule of law state and a democratic society.

Vietnam 2035 report structures these transformations and the reform agenda around **three key pillars**:

- balancing economic prosperity with environmental sustainability;
- promoting equity and social inclusion; and
- enhancing the capacity and accountability of the state.

Besides advisory work, as of March 2016, the World Bank has provided almost US\$ 21 billion

in grants, credits and concessional loans to Vietnam. Vietnam's existing portfolio consists of 45 IDA/IBRD projects and trust funds operations, with total net commitments of US\$ 8,745 billion.

Vietnam received the first loan from the IBRD, the Bank's lending arm for middle-income and poorer creditworthy countries, in 2009, to support a program of public investment reforms. By now, IBRD has committed over 2.8 billion USD to Vietnam, helping the country advancing quicker in its development path.

Four aspects of the approach to reforms proved most effective. *First*, Vietnam chose to be pragmatic and flexible, both in the sequencing and the pacing of reforms. Reforms were introduced incrementally, after extensive consensus building, and wholesale shock therapies were avoided. And

if internal or global experience suggested course correction, the system proved adaptable. *Second*, Vietnam played to its strengths by focusing on labor-intensive production and agriculture. *Third*, the emphasis on building human capital was early and effective. Vietnam already had relatively high levels of literacy and life expectancy. The human-capital base was further expanded following *Đôì Mới*, enhancing the returns on the market-oriented reforms that followed. *Fourth*, where a domestic consensus was harder to forge, Vietnam used its commitments under external trade agreements to good strategic effect, particularly to usher in some of the more complex enterprise reforms. Each of these four aspects of the approach remains important for the next generation of reforms.

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Impacts of monetary policy on asset markets: The case of Vietnam

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Abstract. Monetary policy, which is implemented by central banks by influencing money supply, usually has important impacts on market interest rates, exchange rates, asset prices and the public's expectations, thereby affects the macro economy. In this paper, impacts of the Vietnamese central bank's monetary policy (i. e. the State Bank of Vietnam or SBV) on asset markets will be studied. The paper includes two main parts: (i) Fundamentals of asset prices in monetary transmission mechanism clarifying different effects that might be caused by central banks' monetary policy on asset markets; and (ii) Empirical impacts of SBV's monetary policy on asset markets including stock market, gold market and real estate market in Vietnam. The paper concludes that these markets are influenced by many factors, and SBV's monetary policy might not be the key factor determining their volatilities. This paper was prepared for webinar held in March 14, 2016, with the attendance of professor Marina Fedotova, Financial University under the Government of Russian Federation; Irina Melnikova – head of the self-regulatory organizations, agencies and actuarial rating activities, Development of financial markets Department, Bank of Russia; Nguyen Thanh Nhan – Deputy Dean, Faculty of Banking, Banking Academy, Hanoi, Vietnam.

Keywords: monetary policy, asset prices, stock market effects, real estate market effects, exchange rate effects.

Влияние монетарной политики на рынки активов: пример Вьетнама

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Аннотация. Монетарная политика, применяемая центральным банком, через регулирование предложения денег обычно имеет сильное влияние на рыночные процентные ставки, обменные курсы валют, цены акций и ожидания инвесторов, затрагивая, таким образом, всю экономику. В этой статье исследуется монетарная политика Центрального банка Вьетнама (Центральный банк Вьетнама – SBV) на рынок активов. Статья состоит из двух основных частей: (1) основы движения цен активов как различные последствия монетарной политики SBV на рынке активов; (2) эмпирические свидетельства влияния политики SBV Вьетнама на рынок активов, включая рынок капитала, рынок золота и рынок недвижимости во Вьетнаме. Сделаны выводы о том, что данные рынки подвергаются влиянию многих факторов и что политика SBV не всегда является основной причиной нестабильности этих рынков.

Ключевые слова: монетарная политика, цены акций, рынок капитала, рынок недвижимости, обменные курсы валют.

FUNDAMENTALS OF ASSET PRICES IN MONETARY TRANSMISSION MECHANISM

Monetary policy is a macroeconomic policy in which Central Bank will use their instruments in hands to influence interest rate or money supply with the aim of controlling inflation and promoting economic growth. This adjustment, which is conducted through a transmission mechanism, affects macroeconomic variables such as inflation or output. One of the channels of monetary transmission is through asset prices in the market. Excluding the impact on bond prices through the interest rate channel, according to Mishkin (2013), there are three other asset price channels which consist of stock market, real estate market and exchange rate effects.

Stock market effects

When Central Bank decides to adjust interest rate or money supply, stock prices will be affected in four ways.

Investment effects

Based on Tobin's q -theory (Tobin, 1969), Tobin's q is defined as the market value of firm divided by the replacement cost of capital. When Central bank implements expansionary monetary policy, there is a flow of fund pouring into stock market, leading to an increase in stock prices. As a result, the market value of firms raises relatively to the replacement cost of capital, and increases Tobin's q ratio. Enterprises tend to expand their business by increasing investment spending, thereby raising aggregate demand and economy's output.

Firm balance-sheet effects

The second effect of monetary policy on stock prices is through the balance sheets of firms. Loose monetary policy from Central bank makes stock prices increase and so does net value of firms. This helps to reduce adverse selection and moral hazard problem and then lead to an increase in lending. It comes from the fact that because of the presence of asymmetric information, banks are reluctant to lend money to firms. The lower net worth of firms, the higher level of risk banks have to face and conversely, the higher net value, the easier access bank loans for firms. The amount of funds from banks help

businesses to increase investment and aggregate spending also.

Household wealth effects

An increase in stock prices not only leads to the rise in net value of firms but also appreciates value of households wealth, particularly for those who hold common stocks. Therefore, expansionary monetary policy will help to increase consumption.

Household liquidity effects

The effect of this transmission channel is conducted through household balance sheets, especially impacted consumer durable and housing expenditures. Mishkin (2013) argued that, consumer durable and housing are considered illiquid assets. Therefore, under financial distress circumstances, households will find it difficult to sell these assets to get cash. Even if they accept to bear a loss, they still cannot obtain the full value of these assets. Meanwhile, they can easily sell financial assets because these assets have higher liquidity. That is the reason why households prefer to hold more financial assets and less consumer durable assets in their portfolio. The households, however, often estimate that the likelihood of financial distress will be lower when the value of financial assets increase. Thus, they have more secure financial position, then they are willing to spend money on consumer durable assets. Finally, if Central bank implements expansionary monetary policy, financial assets such as stock prices will increase, expectation on likelihood of financial distress will reduce, expenditure on durable consumer and housing assets will rise, and as a result, aggregate demand will expand.

Real estate effects

The second asset price which is influenced by monetary policy is real estate price. This market can affect aggregate demand and output through three channels.

Housing expenditure effects

Expansionary monetary policy will reduce market interest rates, thereby causing the cost of housing to reduce and the house prices to go up. As house prices increase relatively to the construction cost, the real estate companies will put

more fund on housing projects, then increase housing expenditure and output.

Household wealth effects

Another impact of expansionary monetary policy is that it increases the value of households' wealth and makes them become richer. As a result, they will spend more.

Bank balance sheet effects

This impact is shown through the role of banking system in providing fund to the economy. In a bank's portfolio, a large proportion is mortgage loans—/+loans used to buy a house which will then be used as a collateral. When house prices rise because of easing monetary policy, bank loans losses will reduce and bank's capital will rise. An increase in capital will enable banks to expand lending, therefore firms will have more fund for investment and the economy will grow.

Exchange rate effects

Net exports effect

Loose monetary policy leads to a reduction in domestic interest rates, which will then depreciate domestic currency. A decrease in domestic currency helps to increase export as domestic goods become cheaper relatively to foreign goods. Eventually, net export increases and so does output.

Balance sheets effect

This transmission mechanism will express its effect through the impact on the balance sheets of firms, especially those which have foreign debts. Depreciation of domestic currency due to

easing monetary policy will increase the value of foreign debt in local currency, net worth of firms therefore will diminish. Firms therefore will have difficulty to access bank loans, which leads to the decrease in investment and aggregate spending.

EMPIRICAL IMPACTS OF SBV'S MONETARY POLICY ON ASSET MARKETS

Stock market

Vietnam stock market is considered as a young market when it has just operated for 16 years with the establishment of Hochiminh Stock Exchange in April 2000. This is also the breaking point for Stock market since the first dealing session was executed at that time. Five years later, Hanoi Stock Exchange was established. The year 2007 was marked as an important highlight when the Law on Security which regulates the operations of market as well as individuals and organizations was officially issued. In that year, Vietnam's stock market also hit a record when the Vietnam Index (VN Index) reached to the peak of 1,170 points. The market, however, collapsed quickly thereafter and fell to the lowest value of 235.5 points in February 2009. As planned, by 2016, the derivatives market will be established and put into operation.

Before 2005, the stock market worked quietly with small volume and low value of transactions since this period is early stage, the number of investors and the listed securities are limited. The next period of time, 2005–2015 witnessed a significant change in operation of the market in terms of volume and value of transactions, the active participation of both domestic and for-

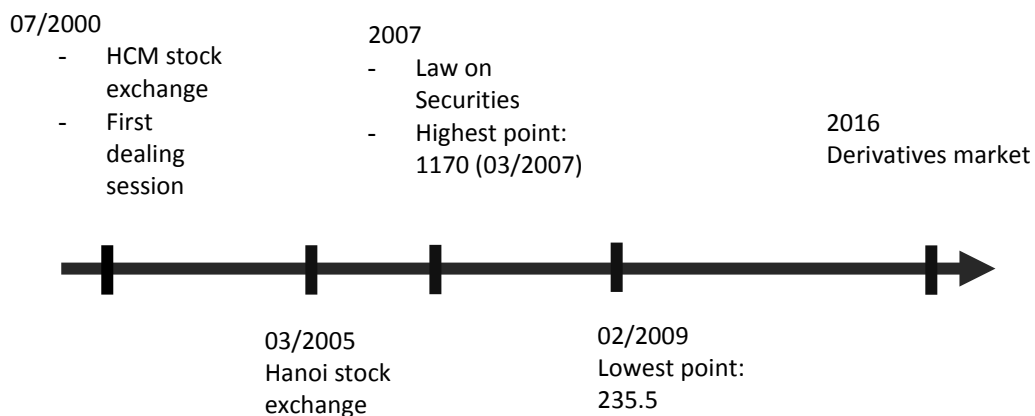


Figure 1. A historical timeline of Vietnam stock market



Figure 2. The movement of VN Index during 2006–2015

Source: VNDirect.

foreign investors. Based on the change in VN Index in Figure 2, the development of Vietnam’s stock market can be divided into three stages: booming, recession and recovery.

Booming period (2006–2007)

The period of 2006–2007 was considered as a booming stage of Vietnam’s stock market. VN Index increased sharply from 300 points at the



Figure 3. VN Index during 2006–2007

Source: vndirect.com.vn.

beginning of 2006 to the peak of 1,170 points in 2007. There are three main reason can be explained for this strong development.

First, prospects for Vietnam’s economic growth after participating into WTO. In 2007, Vietnam officially became the 150th member of the World Trade Organization and this is the turning point which marked the international integration of Vietnam’s economy. This event has made Vietnam become one of most the attractive investment destination for investors all over the world. And as a result, a large amount of fund has been poured into newly established stock market.

Second, strong herd instinct is typical feature of Vietnamese investors. Herd instinct is meant to be a mentality characterized by a lack of individual decision-making or thoughtfulness, causing people to think and behave in the same way as the majority of those around them. Basically, a large number of Vietnamese investors make investment decisions based on the behavior of the majority rather than the analysis of companies’s performance. Therefore, many of them invest money massively into stock market and make it grow rapidly.

Third, expansionary monetary policy from State Bank of Vietnam. This is expressed through high growth rate of money supply. Figure 4 illustrates that money supply has increased strongly from 30% in 2006 to 46% in 2007. This, however, is not the main reason explained for the sudden

growth of stock market because even SBV still maintained money supply growth rate at a high level (over 25% p. a) for the next period, the market still declined sharply.

Recession period (2008–03/2009)

Unfortunately, the sharp development of Vietnam’s stock market did not take long since the next period of 2008–03/2009 witnessed the stock bubble burst. The stock market dropped dramatically from more than 1,000 points to 235 points in February 2009 (Figure 5). The stock crisis came from several reasons as following:

Firstly, the massive flow of funds poured into stock market in the previous stage, made stock prices to overestimate than their true value. This meant that securities price would fall to the true value when flow of funds was diminishing.

Secondly, the global financial crisis in 2008 affected strongly expectations and sentiment of foreign investors and this, in return, influenced domestic investors. As concerning about the negative impacts of financial crisis on financial market, they had sold a large quantity of securities, made prices to fall sharply.

Thirdly, State Bank of Vietnam implemented contractionary monetary policy to reduce the inflationary pressure in the economy.

Fourthly, some self problem of stock market had been shown in terms of new establishment, not working under the market rules: speculation, manipulation, too much margin lending, etc.

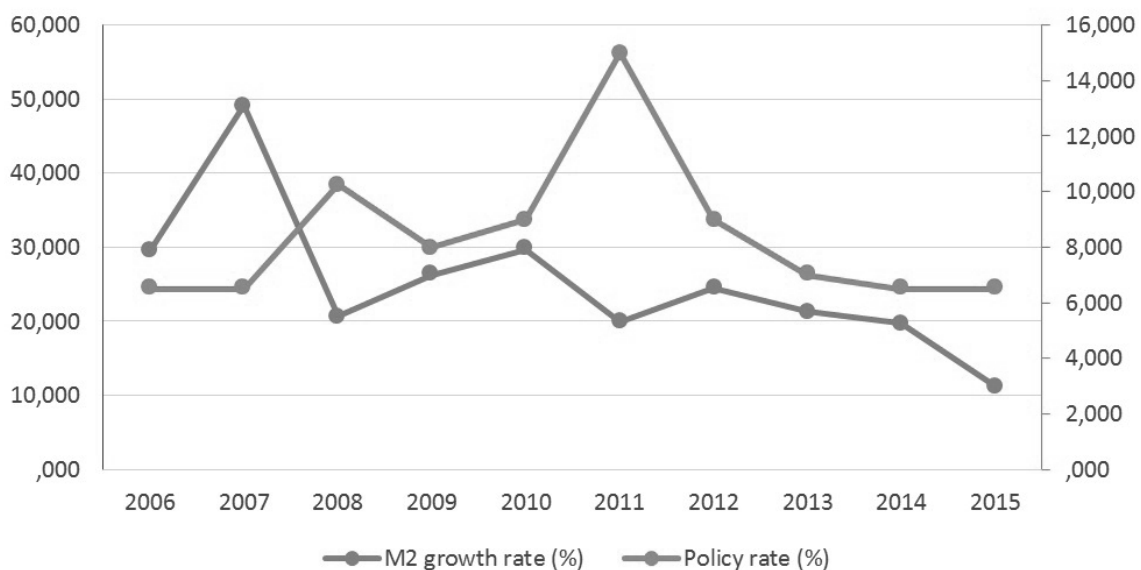


Figure 4. Policy rate and money supply growth rate in Vietnam during 2006–2015

Source: IMF.



Figure 5. VN Index during 2008–03/2009

Source: vndirect.com.vn.

Recovery period (04/2009–2015)

This period witnessed the recovery of the stock market, VN Index bounced back to 500 points

and fluctuated around this level. It is hard for the market to achieve higher level because of some challenges in macroeconomic conditions



Figure 6. VN Index during 04/2009–2015

Source: vndirect.com.vn.

such as low economic growth, high rate of public debt and non performing loans in banking system... Another issue which will impact the market comes from Central bank's policy. In 2014, SBV has issued a new Circular which reduce limits for securities lending in banking system from 20% to 5% of charter captial. The aim of this policy is to guide the flow of capital into the manufacturing industries instead of into the financial market.

Thus, it can be concluded that Vietnam's stock market is influenced by many factors, but the Central bank's monetary policy is not the key factor determining the volatility of market. This is proved through study of Nguyen Phuc Canh et al (2014). By employing SVAR model to analyze the effectiveness of asset price channel through stock price in Vietnam during 2000–2012, they concluded that the change in policy rate does not has effects on stock prices but money supply does. Ha Thanh Viet (2015) also agreed that stock price is driven by many other factors rather than the influence of monetary policy from SBV.

Gold market

A timeline of SBVs interventions

Although the Vietnam's domestic gold market was subject to the Government and Central bank regulations during the early 2000s, such as the licensing requirements for gold fabrication and gold imports and exports, the market was relatively free for the Vietnamese population to buy and sell gold and even gold deposit taking by banks, in which they would provide interest on the deposited gold, became popular.

In the early 2008, a number of gold trading floors were launched by Vietnamese commercial banks, such as Viet A Bank, Southern Bank, Asia Commercial Bank, etc. These trading floors allowed retail clients to speculate on the domestic gold price, often with the use of bank loans, and thus offered customers a high degree of leverage and encouraged risk-taking. Obviously, both Vietnamese banks and retail investors had their own incentives to engage in these trading floors. For commercial banks, they entered this business area after SBV implemented a contractionary monetary policy in order to control inflation, which tightened lending criteria on the banks' traditional lending activities. On the other hand, retail investors, also known as speculators, were

willing to participate in gold trading floor operations which provided their affinity to gold, and created another potential investment opportunity when the Vietnam stock market experienced a deep recession during 2008.

However, in 2010, the Vietnamese government issued a directive order to close all gold trading floors in an attempt to reduce risky trading operations, which was the first moves in a new round of the Government's anti-gold regulations lasted from 2010 to 2014. On the other hand, SBV also required all bank loans that had been used for speculators to trade gold had to be repaid. This repayment policy and the deadline to close the floors by 30 March 2010 actually caused a plummet in trading volumes on all floors in early January 2010, and led to some operators closing their gold trading operations far ahead of the Government's official deadline.

In April 2011, SBV issued Circular 11/2011/TT-NHNN which prohibited credit institutions from engaging in gold lending and deposit taking in gold with any individuals or institutions, and thus contributed to target gold price speculation in the Vietnam gold market. In May 2011, Saigon Jewelry Company (SJC) was appointed as the sole entity authorized to produce gold bars in Vietnam, which was expected to help the State control and intervene more effectively in the domestic gold market. Furthermore, the SJC branded gold bars were allowed to be channeled through other producers such as Sacombank Jewelry, Agribank Jewelry, Bao Tin Minh Chau and Phu Nhuan Jewelry.

In April 2012, the Vietnamese government issued Decree No. 24/2012/ND-CP covering gold trading management. This Decree specifically banned gold bars as a means of payment, took control of gold bar production into the hands of the State, and implemented a government monopoly on gold import and exports. It also directed that gold bar trading could only be carried out by licensed entities, and SBV could hold gold bullion as part of its official reserves.

In January 2013, trading licensing rules came into effect with only 22 banks and 16 non-bank companies licensed to act as authorized bullion traders. From that time on, it became illegal for all other gold traders in Vietnam to trade in gold, and SJC brand became the only gold bar brand accepted in the Vietnam gold market. Moreover,

gold auctions were also organized by SBV to regulate the supply of gold to the domestic market, in an attempt to smooth the domestic gold price and stabilize the market.

SBV's impacts on gold market

It is obvious that the legal ownership of gold by entities and individuals in Vietnam are acknowledged and protected in accordance with laws. Therefore, organizations and individuals engaged in the business of gold must comply with the Government's regulations and other relevant provisions. The State bank of Vietnam, on behalf of the Government, manages gold trading for the aim of developing a stable and sustainable domestic gold market. Furthermore, the SBV have the rights and obligations to conduct the inspection and supervision of the production of gold jewelry; gold bullion and jewelry trading; the export and import of raw gold and other gold trading. Despite some mixed opinions, it cannot be denied that these interventions have brought positive results to the gold market in Vietnam.

First, *the legal framework and management system have been gradually improved*. This could be seen through numerous policies of SBV including the prohibition of gold lending and deposit taking in gold, thereby reducing gold

speculation and preventing credit risk. SBV also prohibited credit institutions from providing loans for the purpose of trading gold bars, and made requirements for their gold reserves (less than 2% of bank capital and more than zero) in order to stabilize the domestic gold market. Some examples of these policies include Circular 22/2010/TT-NHNN, Circular 12/2012/TT-NHNN and especially Decree 24/2012/ND-CP, etc.

Second, *gold supply and demand have been stabilized, while budget revenues have increased through gold auctions*. In 2013 only, SBV held more than 70 gold auctions, through which provided around 70 tons of gold to the market. This was considered to be an effective solution in balancing domestic gold supply and demand, thereby contributed to stabilize the gold market. Furthermore, the amount of money collected from auction operations was used to increase Vietnam's foreign reserves and regulate money supply according to the central bank's objectives. Profits from these activities also supported the state budget and economic development, especially in the context of a developing country with the state budget deficit in a number of years like Vietnam.

Third, *the problem of "goldization" has been repelled, contributing to stabilize Vietnam's money*

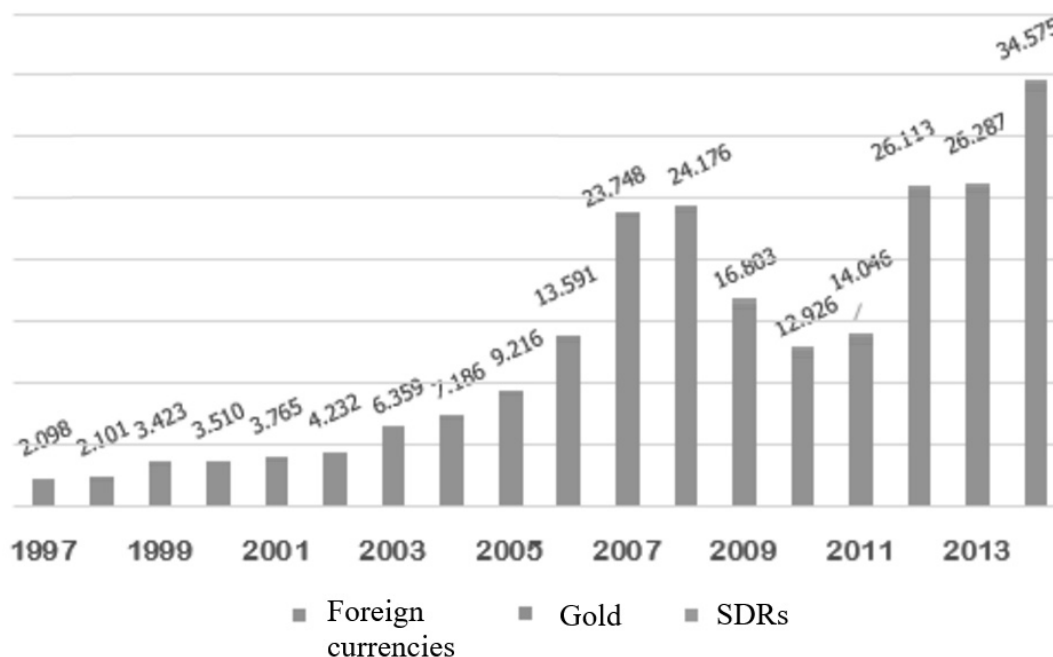


Figure 7. Vietnam's foreign reserves from 1997 to 2014

Unit: Million USD.
Source: ADB, 2015.

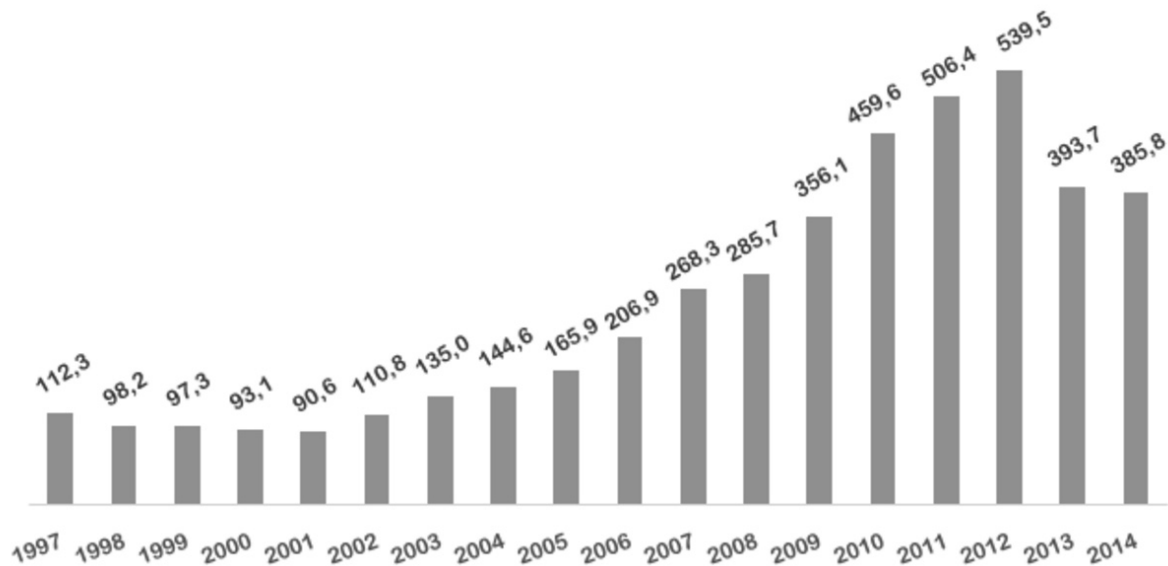


Figure 8. Vietnam's gold reserves from 1997 to 2014

Unit: Million USD.
Source: ADB, 2015.

market and macro economy. The imbalance between domestic gold supply and demand has significantly narrowed, thereby stabilized domestic gold price and effectively eroded investors' incentives in gold speculating. Moreover, with the prohibition of gold lending and deposit taking in gold, credit risk for commercial banks, gold speculation and goldization problems have been reduced. As the result, negative effects of

global gold price fluctuations on exchange rate, inflation and the macro economy of Vietnam have been considerably prevented.

Fourth, the Vietnam's gold market has been basically rearranged with a gradually established discipline system. Accordingly, instead of a complex trading network with more than 12,000 transaction points across the country, there are around 2,500 transaction points and

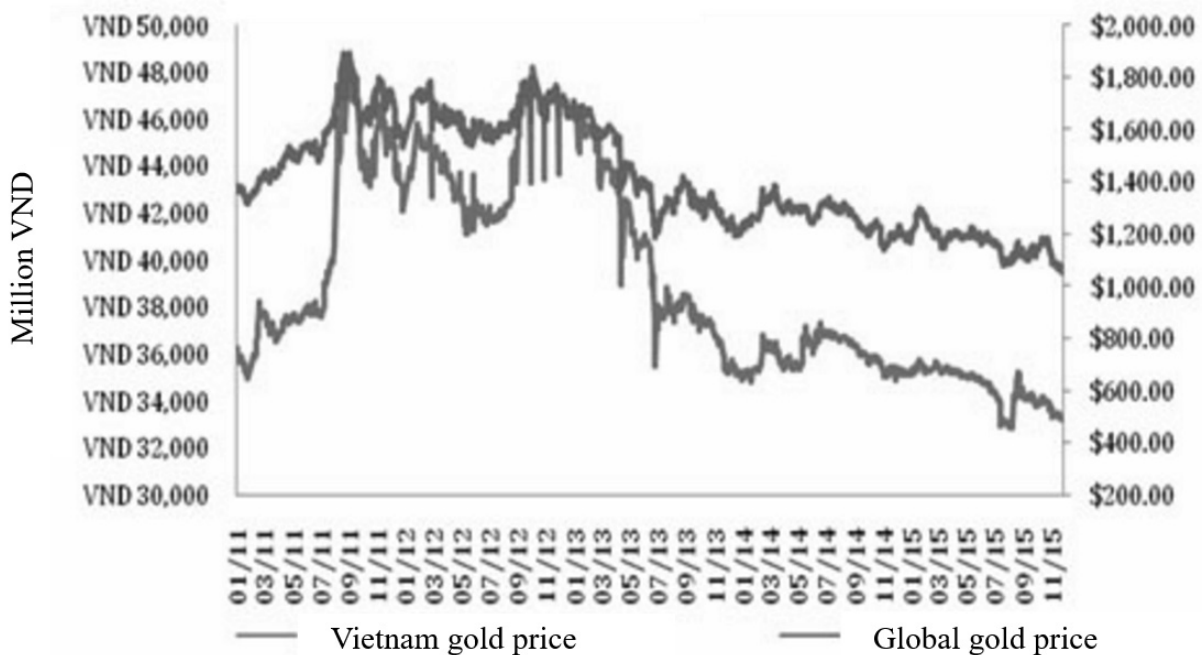


Figure 9. Gold price from January 2011 to November 2015

Source: The State bank of Vietnam, 2015.

38 credit institutions with gold trading licenses. Although the number of these trading points sharply decreased, the domestic gold market has not experienced any inadequacies or disturbance. Furthermore, these entities are required to publicly announce selling and purchasing gold bullion prices; to comply with regulatory provisions on accounting system, invoice establishment and usage; as well as to be inspected regularly by SBV. On the other hand, the central bank's strict control over gold bullion producing activities could also prevent the problem of gold smuggling.

Fifth, *SBV has been successful in preventing market chaos*. By controlling gold supply and narrowing the spread between global and domestic gold prices, SBV has succeeded in creating psychological stability for almost market participants, who used to be manipulated by temporary gold price fluctuations. Recently, despite changes in global gold price, the domestic gold market has been relatively stable, speculators could hardly find opportunities to create virtual waves or manipulate the market to make profits.

Real estate market

The history of Vietnam real estate market

The history of Vietnam real estate market is divided into seven main phases, including:

Before 1990: In this period, Vietnam's economy was underdeveloped, the urbanization process was slow, as well as individuals and organizations' demand for real estates was trivial. Therefore, the Vietnam real estate market was considered to be almost non-existent with some implicit and non-marketable transactions only.

The first fever (1993–1994): In the two years 1993 and 1994, Vietnam real estate market experienced the first fever in the segment of Land and Land-use rights. This was due to the significantly increasing demand for housing and producing land, especially in urban areas, in the lack of an officially legal framework.

The first freeze (1995–1999): In order to stabilize the real estate market and prevent speculation, Vietnamese government announced Decree 18/1995/ND-CP and 87/1994/ND-CP on land rents, which required land users to pay fees for renting land and transferring land-use rights. These interventions forced speculators, who used financial leverage to enter the market, to

sell off their properties with the purpose of repaying bank loans. Due to this discharging wave, real estate supply suddenly increased and well exceeded demand, making the market plummet. Furthermore, the Asian economic crisis negatively affected foreign investments in Vietnam's housing sector, contributing to the market recession.

The second fever (2001–2002): After a long quiet period, in 2000, housing prices began to fluctuate, then continuously increased and reached a peak in the second quarter of 2001. The main reason related to the government's policy allowing Oversea Vietnamese to buy houses and announcing new prices for land, which brought huge prospects to the real estate market and encouraged investments to flow into this area.

The second freeze (2002–2006): From late 2002 to 2006, the real estate market operated quietly with little transaction volume. It was reported that successful real estate transactions fell by 28%, 56%, and 78% in 2003, 2004, and 2005 respectively. This was due to the Vietnamese government's administrative measures including Land Law 2003 and Decree 181/2004/ND-CP which strongly reduced incentives for speculation in land. However, because the majority of investments came from the private sector rather than public sector, these measures effectively stopped the second fever without pushing the real estate market to plummet as much as it did in the period of 1995–1999.

The third fever (2007–2008): Unlike the previous fevers, this period experienced a huge investment flow into the segment of luxury apartments and villas. Two main reasons included: (i) Significant FDI inflows created impressive growth for the Vietnam's economy in 2003–2007; and (ii) The booming period of Vietnam's stock market (2006–2007) brought investors huge profits which partly flowed into the high-end real estate segment and contributed to a strong fever in this area.

The third freeze (2008–2012): In the context of an inflationary economy and a serious bubble in the real estate market, SBV drastically tightened monetary policy to control credits to the economy, especially non-production credits. Right after these measures came into effect, the real estate market was strongly affected,

leading to significant declines in transaction volume and real estate prices. The issuance of Decree 69/2010/ND-CP and Decree 71/2010/ND-CP guiding the implementation of the amended Land Law 2009, the application of land-use tax, and especially the announcement of Resolution 11/2011/NQ-CP were considered as key reasons of this freezing period. Particularly, in 2011, the limit for credit growth was set at 20%, while outstanding credit growth for non-production sector must not exceed 16%, which made the real estate market gloomier. The next year, 2012, experienced fierce competition between real estate businesses for surviving, and the closure of many companies lacking financial capacity.

From 2012 until now, more open regulations announced including amended Land Law and Construction Law 2013, and especially some stimulus packages for housing sector (e. g. the 30 trillion VND package) were expected to promote the recovery of this area.

SBV's impacts on real estate market

SBV is responsible for the financial stability and soundness of the housing finance sector with lending standards, prudential regulations and

management of interest rates. Furthermore, SBV engages commercial banks and non-bank financial institutions (e. g. microfinance institutions) in housing sector lending and supports development and manages housing finance subsidy programs. SBV also develops measures to encourage commercial banks to scale and diversify housing finance products and provides oversight toward the national credit information aggregator, the Credit Information Center. Therefore, differing from gold market with direct interventions and managements, SBV usually affects real estate market, particularly housing sector credit, through its monetary policy.

In fact, monetary policy directly impacts total credit to the economy in general, and credit to real estate market in particular, thereby promotes or hinders the development of the real estate market. In the context of low inflation and stable economic development, the central bank might implement expansionary monetary policy to promote economic growth. By contrast, under the condition of inflationary and instable economy, tightening monetary policy might be needed.

In the period from 2005 to 2007, the Vietnamese macro economy was stable and money

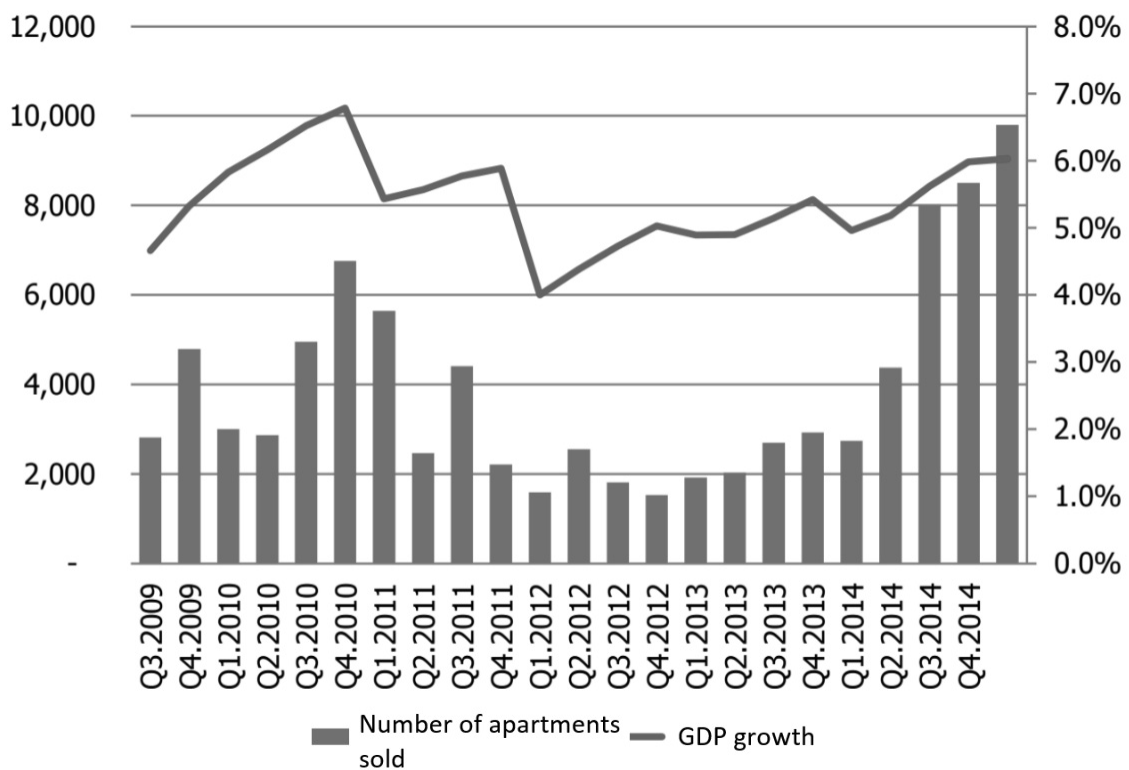


Figure 10. Number of apartments sold and GDP growth in Vietnam

Source: Savills, MBS, 2015.

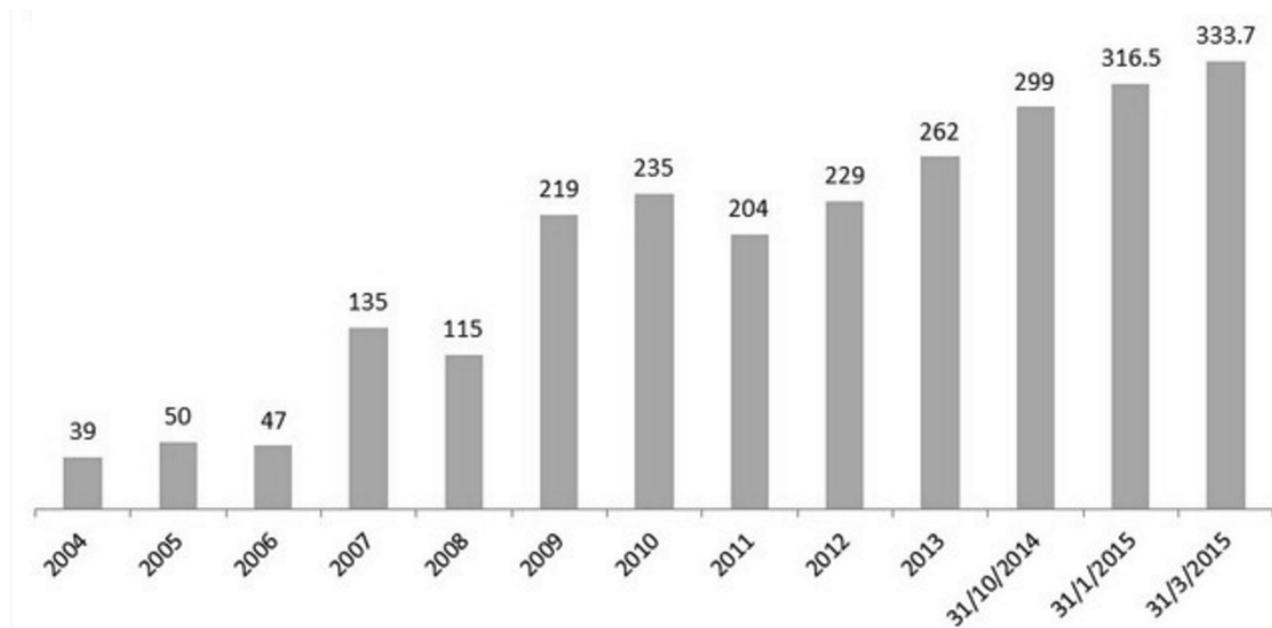


Figure 11. Outstanding real estate credits from 2004 to March 2015

Source: BSC, 2015.

supply (M2) grew at a high speed, which promoted the expansion of credits to the economy in general, as well as credits to the real estate market in particular. On the other hand, the rapid economic growth during several years played an important role in increasing asset values, especially real estates, leading to the explosion of this market in 2007. However, from late 2008 to 2012, in the context of an inflationary and uncertain macro economy, SBV intensely tightened monetary policy to control inflation and credit growth. Particularly, money supply experienced a downward trend in 2008, while credit growth in the real estate sector remained at relatively high levels before slowing down in 2009 and reaching a low in 2012. As a result, the real estate market experienced the third freeze during this period. Therefore, it could be concluded that the relationship between M2 growth, real estate credit growth and real estate prices are generally positive. Changes in M2 growth rate has a direct impact on the growth rate of real estate credits, with a lag of about one year, thereby affecting the development of the real estate market.

According to Ha, D. et al. (2013), the relationship between credit growth in the real estate sector and real estate prices has a two-way interaction. On one hand, continuously rising real estate prices might create the expectation that they will continue to increase in the future,

leading to speculative activities and growing demands for loans. On the other hand, the growth of real estate credits has a strong effect on the development of real estate market and real estate prices as well. However, the interaction of each parameter occurs at different time and different degree. Based on historical data, the authors found that real estate prices often fluctuate sooner and have a stronger impact on real estate credit growth than the other way around. For example, in 2007, when the average real estate prices increased by more than 35%, real estate credits rose by 18% only. In the following year, real estate credit growth surged and peaked at 36.78% while real estate prices slightly increased by 15.47% and the market was entering a downturn period.

From 2012, thanks to stimulus packages for the real estate sector and the decline of lending interest rates, this market has experienced a slow but stable recovery. According to Savills (2016), the Q4/2015 residential indexes in Hanoi and Ho Chi Minh City were 108.2 and 90.2 respectively, slightly higher than previous periods. The overall absorption rate in Hanoi was 40%, decreasing 5 ppts quarter-on-quarter but increasing less than 2 ppts year-on-year, while the rate in Ho Chi Minh City was 21%, up 4 ppts quarter-on-quarter but down 1 ppt year-on-year. Generally, the absorption rates in both cities show positive signs

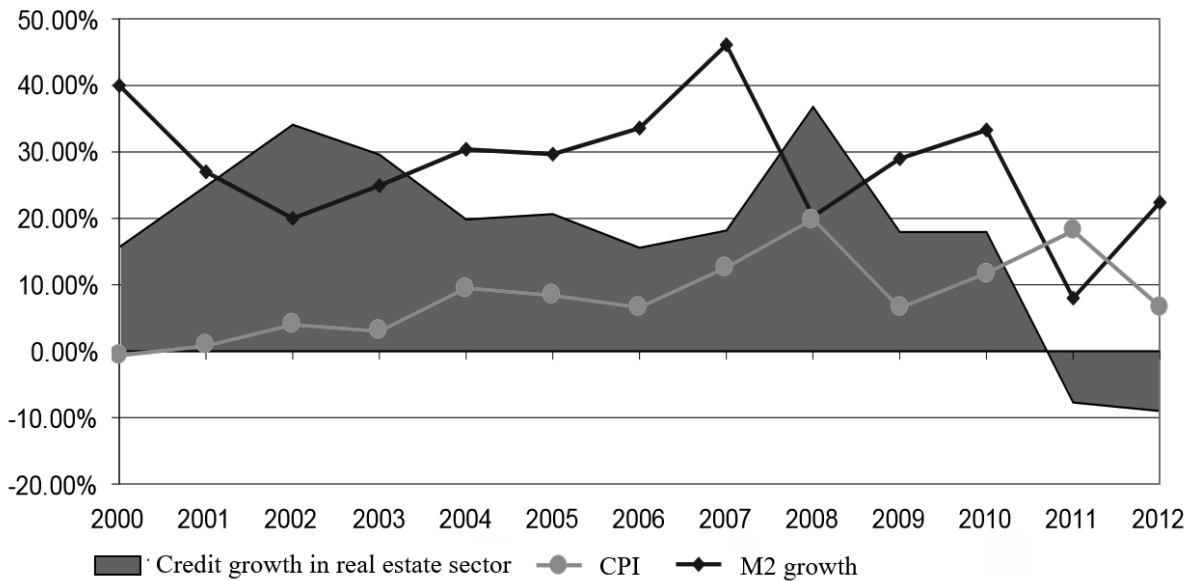


Figure 12. Money supply, Consumer Price Index and Credit growth in real estate sector

Source: Ha, D., Ngoc, L., 2013.

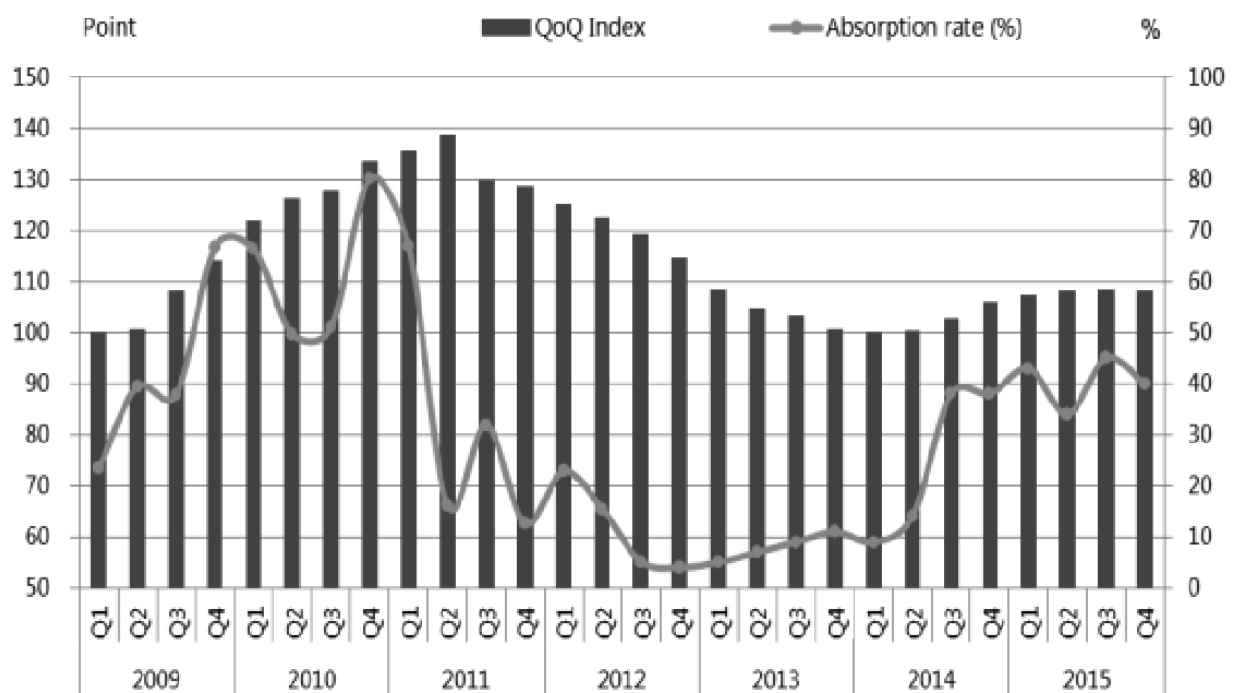


Figure 13. Residential price index in Hanoi – Q4/2015

Source: Savills Research & Consultancy, 2016.

of a gradual recovery in the real estate market. A number of factors including better financial support, construction commitment from developers and diversified products targeting various buyer groups, has resulted in better sales and price movements. However, the potential of a rise in interest rates may pressure prices, especially for active projects.

CONCLUSION

SBV’s monetary policy has a strong impact on Vietnam’s asset markets including stock market, gold market and real estate market. When money supply rises, the increasing inflow of capitals into these markets might significantly affect asset prices, especially stocks and real estates. However, in gold market where SBV takes

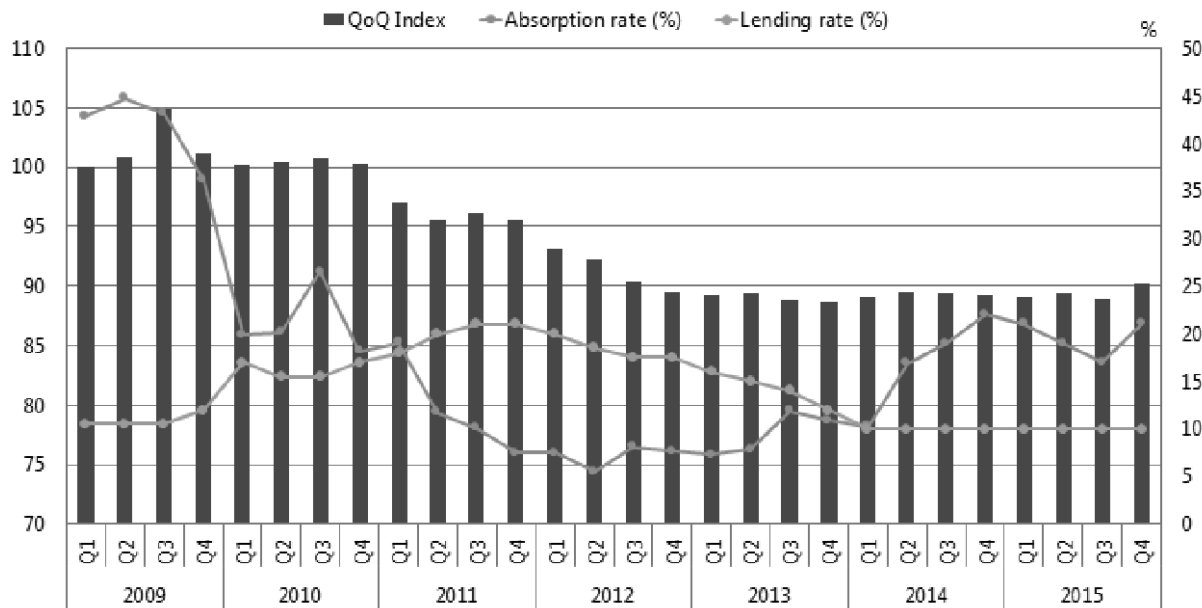


Figure 14. Residential price index in Ho Chi Minh City – Q4/2015

Note: Base Index in Q1 2009 = 100.

Source: Savills Research & Consultancy, 2016.

control of gold bar production and regulate gold supply, changes in gold prices might not exactly reflect SBV's monetary policy. To summarize, by studying the three asset markets in Vietnam, it

could be concluded that they are influenced by many factors, and the Central bank's monetary policy might not be the key factor determining the volatility of these markets.

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Semi-strong form efficiency: Market reaction to dividend and earnings announcements in Vietnam stock exchange

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Abstract. The paper seeks an answer to whether Vietnam is efficient in semi-strong form by identifying the market's reaction to publicized information and events. With a sample covering all listed companies on Ho Chi Minh Stock Exchange from 2014 to 2015, we investigate whether announcements of earnings and dividend changes provide any signaling effect to the share price movements. It is observed that there is insignificant reaction on the dividend announcement day itself and also in the few days around it. In addition, from the market reactions to both dividend and earnings announcements, it concludes that both announcements have significant effects on the stock price with relative significantly abnormal return surrounding announcement date. However, changes in cash dividends do convey more useful information to the market. Therefore, Ho Chi Minh stock exchange has not fully achieved at its efficient level.

Keywords: stock exchange, signaling effect, price movements, Efficient Market Hypothesis, Semi-strong form efficiency.

Средняя степень эффективности рынка: реакция рынка на сообщения о дивидендах и доходах на бирже ценных бумаг во Вьетнаме

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Аннотация. Авторы статьи ищут ответ на вопрос: является ли рынок ценных бумаг Вьетнама эффективным в условиях средней степени эффективности путем идентификации реакции рынка на публичную информацию и события? Используя данные с биржи ценных бумаг в городе Хо Ши Мин за период с 2014 по 2015 г., авторы исследуют, являются ли сообщения об изменениях доходов и дивидендов сигналами для движения цен ценных бумаг. Замечено, что само по себе сообщение о дивидендах не имеет существенного значения в день объявления, как и в другие дни. Кроме того, наблюдения за реакцией рынка на сообщения о дивидендах и доходах привели авторов к выводу, что данные сообщения имеют существенный эффект на цены ценных бумаг с относительно значимым чрезмерным откликом в дни, предшествующие дате сообщений. Однако изменения в денежных дивидендах дают рынку больше полезной информации. Поэтому биржа в Хо Ши Мин не достигла еще полной эффективности в своей работе.

Ключевые слова: рынок ценных бумаг, информационный эффект, гипотеза эффективного рынка, средняя степень эффективности рынка.

1. INTRODUCTION

The Efficient Market Hypothesis (EMH) is one of the most important hypotheses in modern financial literature. It also called theory of stock market behavior, has inspired many researchers in the last decades. The EMH holds that new information relevant to the market will be nearly instantaneously incorporated into share prices, thus on average investors cannot consistently earn excess returns (Malkiel and Fama, 1970). Based on the identification of a set of available information, EMH considered the three degrees namely weak-form efficiency, semi-strong form efficiency and strong form efficiency.

Semi-strong form efficiency holds for a certain market if all available information is publicly reflected by current market prices. It implies that stock prices are not only reflective of past historical information, but also of all publicly available information on the market. Accordingly, the market's reaction to publicly available information should be *instantaneous* and *unbiased* in order to eliminate investors' expectations for abnormal returns. Instead of the term *instantaneous* and *unbiased*, Shleifer (2000) referred to the *speed and correctness* of the market's reaction to new information. The former means that the current market price is already incorporated all available information. The latter refers to the quality of the market's adjustment to new information.

Semi-strong form efficiency is generally tested under two approaches: the direct method supported by event studies and indirect method that conducted by performance evaluation studies. Fama (1970) argues that each individual test on semi-strong form efficiency only brings supporting evidence for the model, with the idea that by accumulating such evidence, the validity of the model will be established.

Vietnam stock market was officially put into operation on July 20th 2000 under its former name Ho Chi Minh Securities Trading Center, now known as Ho Chi Minh Stock exchange (HOSE). In March 2005, the second securities trading center of Vietnam which was Hanoi Securities Trading Center and later renamed to Hanoi Stock Exchange (HNX). During early years of establishment, with a tiny number of stocks on the market, securities trading activities in Vietnam were relatively inactive. Vietnamese investors were virtually unfamiliar and inexperienced with the mechanism of a totally new market. Although, from 2006–2007, Vietnam stock market was experienced a peak period with the name of “the new miracle Asian” (IMF's annual report, 2006). However, in the early 2008, Vietnam stock prices fell drastically from heights that are now considered the effects of a stock market bubble. During the period of 2009–2015, the value of the stock market was in its recovery, yet still sluggish.

The purpose of this paper is to test whether Vietnam is efficient in semi-strong form by identifying the market's reaction to published information and events. Specifically, the study investigates whether announcements of both earnings and dividend changes provide any signaling effects to the share price movements. Lonie et al (1996) considered those events are among the two most important signaling devices used by managers to transmit information about firm's future prospects to the public. In the other way, dividend and earning news is also taken by investors as "signals which are emitted by the managers of companies in an uncertain economic environment characterized by informational asymmetry". Therefore, if dividend and earnings news does convey useful information in an efficient capital market, then it is assumed that such news will be reflected in the stock price as soon as they are publicly released in the market. Until now, not many studies have tested how quickly stock and securities prices reflect information concerning both dividends and earnings announcements in Vietnam. Thus, results achieved from this research are expected to improve the value of current financial model and also provide useful advices for investors. The next parts of this paper are developed as follows. Part 2 briefly reviews previous experimental studies on Vietnam weak-form efficiency and semi-strong form in emerging stock markets. Part 3 describes data and develops hypotheses. Part 4 discusses the experimental results of the study. Finally part 5 draws the conclusions.

2. PREVIUOS LITERATURE

In Vietnam, empirical testing of EMH has been conducted in a variety of ways, utilizing data from different exchange, across different time period and using different event studies, thus its results have been mixed. Regarding to the weak-form efficiency, Loc et al (2010) supported the view that the Vietnamese stock market is weak-form inefficiency. It should, however, be acknowledged that such study which test the efficiency of stock market coverage utilizing daily and weekly price series of VN-Index and REE, SAM, HAP, TMS and LAF27 from July 28, 2000 to Dec 31, 2004. Vinh et al (2010) conducted a longer investigation on daily and weekly price series of VN-Index and 8 individual stocks (CII,

ITA, SJS, TDH, ABT, AGF, TS4, FMC) from 2007 to 2010. The results from all tests had failed to support the hypothesis of weak form efficiency with daily data. However, with weekly data, the results obtained from runs test and autocorrelation test do not completely reject the hypothesis of weak form efficiency.

Nhan et al (2014) applied data daily and weekly returns of VN-index and HNX-index in Ho Chi Minh and Hanoi Stock Exchange, respectively from 2000 to 2013, the results were rather consistent with previous studies of Loc et al. (2010) and Vinh et al. (2010) whereby they strongly rejected the weak-form EMH of the Vietnamese stock market. The rejection of weak-form EMH indicated significant deviations from the random walk hypothesis of the stock returns in the Vietnamese market, in which the majority of data experience is positive correlations. Furthermore, the nonparametric runs test is used to determine the randomness of a price or a return sequence as an alternative. The test once again confirms that the Vietnamese stock market is not weak-form efficiency.

Khoa & Jian (2014) checked the random walk hypothesis for weekly Vietnamese stock market returns employing three statistical techniques namely autocorrelation test, variance ratio test, and runs test. Data for analysis was collected from July 28th 2000 (the first trading session) to July 28th 2013 (13 years of market operation). Results from autocorrelation test pointed out that RWH is rejected for the full sample and the first two cycles of the market. It proves that following price changes in the market are not random. However results from the third cycle of the Vietnamese stock market alone (from February 24th 2009 to July 28th 2013) have provided evidence supporting random walk hypothesis in VN-index. It shows the fact that the efficiency of the Vietnamese stock market has gradually been improved during nearly 10 years in operation.

Recently, Nhung (2015) examines stock market seasonality in Vietnam from 2000 to 2010. Of all the months, January has the highest average return over the period. This result provides support for the January effect. However, January only has positive returns for 40 percent of the years observed. The results also provide support for the Halloween effect with the post Halloween period outperforming the pre-Halloween period

73 percent of the time. The effect primarily occurred between 2000 and 2007. After that, the results are mixed.

Considering semi-strong form efficiency, the influence of dividend & earnings announcements on share price behavior has been examined in many developed markets. Come up with Watts (1978), the paper clarified that quarterly earnings reports contain new information. Accordingly, there was a statistically significant return in the following quarter which supporting for inefficient market since abnormal returns are still there. Aharony and Swary (1980) examined dividends and earnings announcements on the New York Stock Exchange over the period 1963–1976 and concluded that both quarterly earnings announcement and dividends change announcements have significant effects on the stock prices. But more importantly, they found no evidence of market inefficiency when the two types of announcement effects are separated. Impson (1997) extended the analysis of stock market reactions to dividends by comparing share price reactions to dividend decrease announcements. By using a sample of the US stocks during the period 1974–1993, he anticipated that dividend decrease announcements of public utility holding companies to have a stronger market response, compared to unregulated companies.

Applying for Malaysian Stock Exchange, Baharuddin et al (2010) focuses on the announcement effect of both dividend and corporate earnings on stock prices based on a sample of 120 companies listed on the Main Board of Bursa Malaysia during the period January 1, 2006 to November 30, 2006. The study results support the information content of dividend theory that increasing dividend announcements, on an average, earn positive abnormal return, while decreasing dividend announcements are associated with negative abnormal return. Overall, the results provide some evidence of semi-strong form efficiency in the Malaysian stock.

We contribute to the existing literature in two ways. First of all, this study test whether Vietnamese stock exchange is efficient in semi-strong form, with earnings and dividends announcements of Vietnamese companies that are listed on Ho Chi Minh Stock Exchange are used in this study. We are not aware of any study testing in depth this hypothesis. Further investiga-

tion is the issue of dividend changing announcements from multi-industry and its price reaction together with the earning announcements.

3. DATA AND HYPOTHESES

3.1. Data set

To test whether Vietnam Securities Market is in semi-strong form efficiency, the authors will use the data from announcements of dividends and earnings of companies which are listed on Ho Chi Minh Stock Exchange (HSX) in Vietnam. The daily stock prices of each firm and VN-Index prices are collected for 20 days around the public announcement day from HSX database. In addition, the information about dividends and returns would be collected from quarterly report and websites of those companies under the research.

We use event study methodology to test the semi-strong form efficiency. There are a number of authors has tested semi-strong form efficiency such as Ball and Brown (1968), Fama et al (1969) and Brown and Warner (1980). They conclude that when the relevant information is announced publicly, the market will react in a sufficiently rapid way. According to efficient market hypothesis, when a company shows news regarding to prospect dividend payment or profits, or, in case of solving the uncertainties events such as rumor or information leakage before the announcement date, those information will affect to the companies' stock prices, and as the result, this will lead to the movement in stock price compared to the expectation. Thus, this exist abnormal return in these companies' stock price. Therefore, to prove that the market is in the semi-strong form efficiency, the abnormal returns have to not statistical different from 0 throughout the period of post-announcement date.

The data includes the announcements of dividends and quarterly earnings of companies which are listed on Ho Chi Minh Stock Exchange in Vietnam. Those companies must to have the following characteristics:

There is no other relevant company's information published on day before, during and after the dividends and earnings announcements.

These companies are listed on stock exchange where daily stock prices are available to collect.

The sample companies have to list on the stock exchange before January 2013 to have all

information needed to compare the data collect from January 2014 to December 2015.

This research focuses on 247 listed companies on Ho Chi Minh Stock Exchange, with the data is collected within 2 years, from 2014 to 2015.

3.2. Explanatory variables

Following research of Baharuddin et al (2010), our paper investigates the impact of announcements by simply assuming that:

Dividend Increase and Earning also Increases (DI-EI) – includes companies that announced both their dividends and earning increase in this period.

Dividend Increases but Earning Decreases (DI-ED) – includes firms that announced their dividend increased but Earning decreased.

Dividend Decreased and Earning also Decreases (DD-ED) – companies that announced have their dividend and earning gone down compared to the previous period.

Dividend Decrease but Earning Increase (DD-EI) – includes companies that have dividends decreased but earning went down in this period.

Dividend Unchanged but Earning Increase (DU-EI) – includes companies that have not changed in dividend payment although their earnings have increased.

Dividend Unchanged while Earning Decreases (DU-ED) – for companies that dividend payments have not changed although earning went down in this period of time.

In addition, in this research, the authors will follow the naive dividends and earnings expectation model (Aharony and Swary, 1980; Isa and Subramaniam, 1992). We have the formula:

$$E(D_{it}) = D_{i,t-1},$$

where:

$E(D_{it})$: Annual dividends expectation of firm i in the year t ;

$D_{i,t-1}$: Dividend payment in the year $(t-1)$.

The dividend model states that: if $D_{it} > D_{i,t-1}$ – Dividend Increase (DI); if $D_{it} < D_{i,t-1}$ – Dividend Decreases (DD); if $D_{it} = D_{i,t-1}$ – Dividend unchanged compares to the previous period. Furthermore, the expected earnings are also followed in a similar manner. If $EPS_{it} > EPS_{i,t-1}$ – Earning Increase (EI); if $EPS_{it} < EPS_{i,t-1}$ – Earning Decrease (ED);

To estimate the abnormal returns, the authors employed the Market-adjusted Abnormal Return Model (MAR) in order to avoid the estimate the parameters outside the long “event” window, this would happened if the more common risk adjusted models were to be used. This model is based on assume that equilibrium expected returns exist where $\alpha = 0$ and the average system risk = 1. In addition, according to Brown and Warner (1980), MAR also avoids the complications of a small sample and infrequent trading associated with our securities prices.

The Market-adjusted abnormal Returns are computed as follows:

$$AR_{i,t} = R_{i,t} - (\alpha_i + \beta_i R_{m,t}); \text{ with } \alpha = 0 \text{ and } \beta = 1; \text{ we have: } AR_{i,t} = R_{i,t} - R_{m,t},$$

where:

$AR_{i,t}$ – Abnormal returns;

$R_{i,t}$ – Returns for stock i on the event day t ;

$R_{m,t}$ – Market returns proxied by VN-Index prices on event day t .

For each stock, the daily return is followed the formula:

$$R_{i,j} = \frac{(P_{i,j} - P_{i,t-1})}{P_{i,t-1}},$$

where:

P_{it} – Closing price of stock i at day t ;

$P_{i,t-1}$ – Closing price of stock i at day $t-1$.

Regarding to the daily market returns, we also use series from Vn-index closing figure.

In the next step, we will calculate the daily cross-sectional Average Abnormal Return (AAR) for the certain event day, t , with the formula:

$$AAR_t = \frac{1}{N} \times \sum_{i=1}^N AR_{it},$$

where:

AAR_t – the average abnormal returns on day t ;

AR_{it} – the abnormal returns of company i on day t ;

N – the total number of companies in sample for each day in the period.

Then, T-test will be used to determine the standardized AAR_t , There are a number of empirical tests about information-content hypothesis such as Lonie et al (1996) show that, on average,

the shares of firms that their directors have announced dividend payment increases could earn positive abnormal returns.

Furthermore, the Cumulative daily Abnormal Returns (CAAR) for the stocks are computed with in the event window, for example, day -10 to day +10, day -3 to day +3, day -2 to day +2, day -1 to day +1 relative to the event day (day zero). The purpose of this event window is to test how sensitive the stock price is towards the appearance of new relevant information. With the formula:

$$CAAR_m = \sum_{t=1}^m AAR_t,$$

where:

$CAAR_m$ – the cumulative average abnormal returns of the m period; AAR_t – Abnormal returns.

3.3. Tested hypotheses

To test the effect of annual dividend payments and earnings announcements on stock prices, we will formulate the following hypotheses:

With the event windows are: (-1, +1), (-2, +2), (-3, +3), (-10, +10),

H1: There is no significant difference between the Cumulative Average Abnormal Returns (CAAR) before and after dividends increase and earnings increase announcements in the Vietnam stock market.

H2: There is no significant difference between the Cumulative Average Abnormal Returns (CAAR) before and after dividends increase but earnings decrease announcements in the Vietnam stock market.

H3: There is no significant difference between the Cumulative Average Abnormal Returns (CAAR) before and after dividends decrease but earnings increase announcements in the Vietnam stock market.

H4: There is no significant difference between the Cumulative Average Abnormal Returns (CAAR) before and after dividends decrease and earnings decrease announcements in the Vietnam stock market.

H5: There is no significant difference between the Cumulative Average Abnormal Returns (CAAR) before and after dividends unchanged, earnings increase announcements in the Vietnam stock market.

H6: There is no significant difference between the Cumulative Average Abnormal Returns (CAAR) before and after dividends unchanged, earnings decrease announcements in the Vietnam stock market.

To test the reaction of capital market with dividends and earnings news, we use the parametric t-test to assess the significant of CAAR to examine the hypotheses which mentioned above. The 5% level of significant with appropriate degree of freedom is used to test the null hypothesis that there is no abnormal return during the event days. This is assumed that if the market is efficient, CAAR values should be close to 0.

The t-test statistic for CAAR is calculated as:

$$t = \frac{CAAR}{\alpha(CAAR)},$$

where:

$\alpha(CAAR)$ is the standard error of cumulative average abnormal return.

The standard error is followed the formula:

$$S.E = \frac{\sigma}{\sqrt{N}},$$

where:

$S.E$ – Standard error;

σ – Standard deviation;

N – The number of observations.

4. RESULTS AND DISCUSSION

In the first step, we investigate the impact of dividend change announcements on stock price behavior as the result of Table 1. In detail, it shows the reaction of stock market to dividend announcement days in three cases: dividend increases, dividend decreases and dividend unchanged. The fluctuation of CAAR for each type of announcements is also illustrated in Figure 1. It is clearly from the Table 1 that, in the day of dividend increase announcement, the AARs for all 247 firms show a positive number of 0.074% with the corresponding t-value is 0.427. This small amount of AARs implies that the new information is not reflected fully by the market.

The significant abnormal returns are showed on day +6, day +7, day +8 and day +9 post-announcement days. More specify, the highest figures of AAR happen on day +9 and day +6,

Table 1. Stock Market Reaction to Dividend Announcements

DAY	Dividend Increase			Dividend Decrease			Dividend Unchanged		
	AAR	t-Value	CAAR	AAR	t-Value	CAAR	AAR	t-Value	CAAR
10	-0.2563	-1.0435	-1.6709	-0.4997	-1.9758	-1.2830	-0.1478	-0.4859	-1.0438
9	-0.7943	-4.0110	-1.4146	-0.4284	-1.6180	-0.7833	-0.4941	-1.1763	-0.8959
8	-0.6304	-2.9813	-0.6203	-0.6173	-1.7128	-0.3549	-1.0369	-1.6065	-0.4019
7	-0.6831	-2.8634	0.0101	-0.1780	-0.3682	0.2623	-0.4498	-1.0579	0.6351
6	-0.7909	-3.2595	0.6932	-0.8780	-2.9662	0.4404	-0.2506	-0.5295	1.0849
5	-0.4370	-2.0589	1.4840	-0.3661	-1.3404	1.3183	-0.2560	-0.7393	1.3354
4	-0.2442	-1.3088	1.9211	-0.4548	-0.9169	1.6844	0.2405	0.6168	1.5915
3	0.0218	0.1398	2.1652	0.1618	0.7386	2.1391	-0.0781	-0.2215	1.3510
2	-0.1039	-0.6348	2.1435	-0.0037	-0.0123	1.9773	-0.0480	-0.1424	1.4290
1	0.2336	1.4561	2.2474	0.7561	2.7472	1.9810	0.4969	1.7174	1.4771
0	0.0742	0.4272	2.0138	0.1945	0.7687	1.2249	0.0690	0.2133	0.9802
-1	0.2018	1.3318	1.9396	0.1893	0.9193	1.0305	0.0955	0.2646	0.9112
-2	0.3775	2.5131	1.7378	-0.1438	-0.5489	0.8412	0.0024	0.0073	0.8156
-3	0.2496	1.5653	1.3603	0.3246	1.1091	0.9851	0.6708	1.9079	0.8133
-4	0.3585	2.2203	1.1107	0.1070	0.4382	0.6604	0.3116	1.0252	0.1424
-5	0.1906	1.1651	0.7522	-0.0644	-0.3129	0.5534	-0.2070	-0.7527	-0.1691
-6	-0.0872	-0.5310	0.5615	0.2032	0.8543	0.6179	-0.0539	-0.1998	0.0379
-7	0.0491	0.3051	0.6487	0.2018	0.8901	0.4147	0.1052	0.4828	0.0918
-8	0.2657	1.7009	0.5996	0.0561	0.2116	0.2129	0.2139	0.6768	-0.0135
-9	0.2883	1.8941	0.3340	0.1922	0.8113	0.1568	-0.3543	-1.0193	-0.2274
-10	0.0456	0.3134	0.0456	-0.0354	-0.1500	-0.0354	0.1269	0.4502	0.1269

with the values are -0.7943% and -0.7909% respectively. In addition, after the announcement days, the abnormal returns are mostly showed the negative values, except in day +1 and day -3. This suggests that the dividend payment value may not satisfy the market's expectation.

It also shows in the Table 1 that, the AAR on day 0 of dividend decrease announcement day is 0.194% , t-value is 0.7687 and CAAR is 1.225% . The significant abnormal returns show clearly on day +1, day+6 and day +8, with the values are $+0.7561\%$, -0.8780% and -0.6173% respectively. Regarding to CAAR values, it is interesting to find out that, both three cases of dividend increase, dividend decrease and dividend unchanged have positive figures in CAARs. In case

of dividend decrease and unchanged, this may suggest that because of information leakage in firms' under the research, the market has reacted the bad news before the announcement days, therefore, in the day of information is released, although the market has the negative action into the post-day announcement, but with the low decrease level compared to the high positive abnormal return before the announcement. As a result, the cumulative abnormal returns show the positive values. Also, it can be explained that emerging markets have been operated with less transparency, then it is not clear whether management use dividends intentionally as a signal or not. To some extent, managers can use the increase/unchanged of dividends to signal that

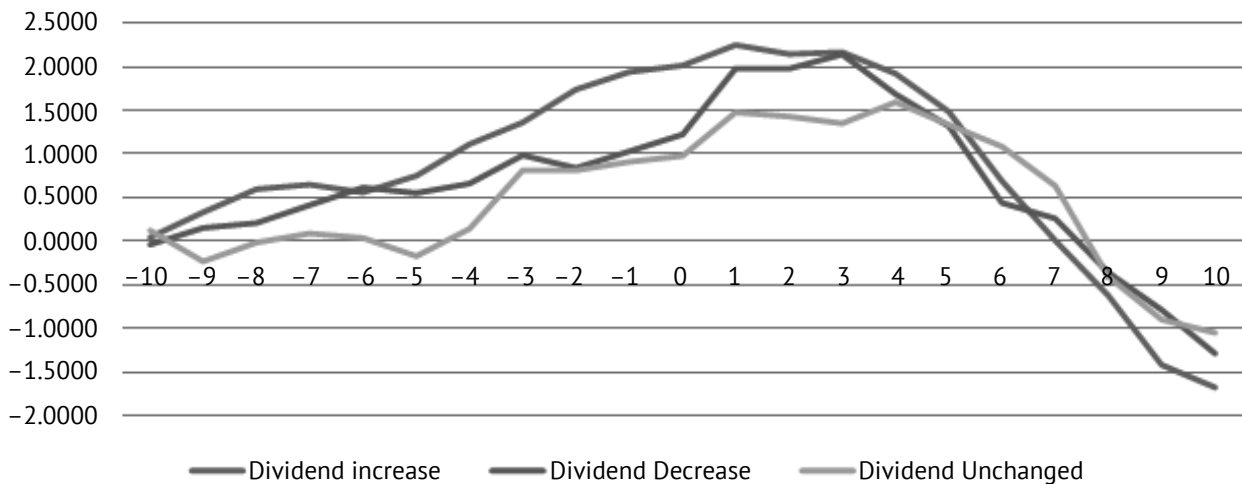


Figure 1. CAAR Surrounding the Announcements of Dividend Increase

(Dividend Decreases and Dividend Unchanged) (%)

the firm is undervalued, and because firms performing poorly cannot mimic the signaling due to their inability to sustain increased dividends, the signaling is credible. Thereby, investors are in doubt of any dividends announcements. In other ways, share price behaviors are mainly impacted by non-fundamental factors rather than fundamental factors such as dividends payout. It implies that dividend announcements do not really convey the important information to the public.

In the second step, we deeper examine the stock price behavior by combining information of dividend and earning changes. In specific, each group of Table 1 is subdivided into two further categories, including earning increase and earning decrease. The result consists of six groups that can be seen from Table 2.

The first group shows the market reactions when dividend increase news is tested with earning increase news as a whole. Importantly, positive average abnormal return is realized around 10 days of announcement date, but not remained over the 20 trading days. It can be understood that the early good news come out, the market reacts more positively. This is strongly evidenced with 0.13% and 0.24% of AAR on day 0 and 1 respectively, meanwhile insignificant AAR can be seen on the next 2 days and negative returns are realized around 10 trading days of announcement date with average AAR of -0.0291% .

It is also noted that the result of DI-EI group provides higher abnormal return than DI test-

ing alone. Figure 2 presents an offsetting effect whereby when good news from dividend corroborates with good news from earnings, it accumulates the overall positive effect during the period of ± 3 trading days around announcement date. However, the results of over next 3 trading days are not quite similar. To some extent, the reaction of Vietnam stock exchange is not quite different with the conclusion of Kane et al (1984) and Easton (1991), where earnings and dividends are found to have an interaction on share prices.

Group 2 mixed the case of good news from dividend announcement and bad news of earning report and thereby price behavior is recorded. As can be seen from Table 2, negative abnormal return is observed on the most of trading day but insignificant. Specially, positive abnormal returns only happened on day 0 and 1 with much lower numbers (0.05% and 0.001% respectively) than the results of DI-EI group. It is clear that the market performs less favourably to lower earnings report. On the other hand, bad news from earning news are strong enough to offset the positive effect of good dividend issues.

Observations of the CAARs plotted in Figure 3 demonstrate the same trend manner for the whole testing period. In specific, both dividend increase together with earning increase (CARR of DI-EI) and earning decrease (CARR of DI-ED) move in uptrend until the announcement day. After that clear downward movements are shown. This implies that the market is indifferent to both earning increase and earning

Table 2. Stock Market Reaction to Dividends and Earnings Announcements
(Dividend Increase – Earning Increase/Decrease (DI-EI; DI-ED))

Day	-10	-9	-8	-7	-6	-5	-4	-3	-2	-1	0	1	2	3	4	5	6	7	8	9	10	
1. DIVIDEND INCREASE																						
A. EARNING INCREASE																						
AAR	-0.05	0.10	0.16	-0.03	-0.08	0.02	0.19	0.22	0.15	0.10	0.13	0.24	0.00	0.00	-0.10	-0.13	-0.38	-0.35	-0.33	-0.35	-0.13	
t-Value	-0.51	0.56	1.56	-0.41	-6.54	0.12	1.19	6.42	0.68	0.94	2.29	55.41	0.02	0.18	-0.72	-0.43	-0.93	-1.07	-1.07	-0.79	-1.06	
CAAR	-0.05	0.06	0.22	0.18	0.11	0.13	0.32	0.54	0.69	0.79	0.92	1.16	1.16	1.16	1.06	0.93	0.55	0.20	-0.13	-0.48	-0.61	
B. EARNING DECREASE																						
AAR	-0.03	0.13	0.08	-0.05	-0.17	0.03	0.14	0.14	0.17	0.06	0.05	0.00	-0.11	-0.13	-0.14	-0.20	-0.36	-0.38	-0.25	-0.42	-0.17	
t-Value	-0.41	0.82	0.43	-0.49	-2.08	0.19	0.65	1.28	0.86	0.47	2.87	0.01	-11.16	-0.86	-1.25	-0.81	-0.85	-1.28	-0.67	-1.13	-1.98	
CAAR	-0.03	0.10	0.18	0.13	-0.04	-0.01	0.13	0.27	0.45	0.51	0.57	0.57	0.46	0.32	0.19	-0.01	-0.37	-0.76	-1.01	-1.43	-1.60	
II. DIVIDEND DECREASE																						
A. EARNING INCREASE																						
AAR	-0.25	-0.17	-0.32	-0.10	-0.42	-0.10	-0.21	0.07	0.05	0.50	0.19	0.09	-0.11	0.25	0.07	-0.11	0.07	0.04	0.06	0.06	0.06	-0.09
t-Value	-1.03	-0.64	-1.07	-1.31	-0.94	-0.35	-0.84	0.83	0.93	1.94	71.87	0.94	-3.01	3.56	1.81	-2.50	0.52	0.26	58.08	0.41	-1.69	
CAAR	-0.42	-0.16	0.00	0.32	0.42	0.85	0.94	1.15	1.08	1.03	0.53	0.34	0.24	0.35	0.10	0.03	0.14	0.07	0.03	-0.03	-0.09	
B. EARNING DECREASE																						
AAR	-0.07	0.08	-0.03	0.03	-0.02	-0.10	0.02	0.18	-0.09	0.06	0.12	0.26	-0.06	-0.06	-0.24	-0.16	-0.41	-0.13	-0.25	-0.24	-0.29	
t-Value	-1.98	0.74	-0.31	0.17	-0.10	-2.96	0.17	1.21	-1.48	0.45	1.45	0.53	-1.06	-0.28	-1.13	-0.78	-0.86	-2.83	-0.66	-1.26	-1.40	
CAAR	-0.07	0.01	-0.02	0.01	-0.01	-0.11	-0.09	0.09	0.00	0.06	0.17	0.44	0.37	0.31	0.07	-0.09	-0.50	-0.63	-0.88	-1.12	-1.41	
III. DIVIDEND UNCHANGED																						
A. EARNING INCREASE																						
AAR	-0.01	-0.43	0.27	-0.01	-0.12	-0.36	0.34	0.85	-0.07	0.09	0.26	0.74	0.06	-0.09	0.28	-0.08	-0.22	-0.47	-1.06	-0.40	-0.15	
t-Value	-0.09	-3.18	3.49	-0.11	-23.28	-12.59	2.44	3.49	-1.87	1.75	4.30	5.80	0.77	-2.97	2.78	-0.37	-1.58	-2.23	-2.08	-1.37	-2.20	
CAAR	-0.01	-0.45	-0.17	-0.19	-0.31	-0.66	-0.32	0.53	0.46	0.55	0.81	1.55	1.61	1.52	1.80	1.71	1.49	1.02	-0.04	-0.44	-0.60	
B. EARNING DECREASE																						
AAR	0.01	-0.19	0.05	-0.02	-0.15	-0.17	0.12	0.35	-0.01	0.01	0.05	0.13	-0.09	-0.18	0.11	-0.11	-0.09	-0.27	-0.46	-0.27	-0.12	
t-Value	0.08	-1.18	0.33	-0.16	-1.55	-4.40	0.61	1.10	-0.84	0.14	3.16	0.37	-2.26	-1.73	0.80	-0.70	-0.59	-1.47	-0.79	-1.22	-3.63	
CAAR	0.01	-0.18	-0.13	-0.15	-0.30	-0.47	-0.35	0.00	-0.01	0.00	0.05	0.18	0.10	-0.09	0.02	-0.08	-0.18	-0.44	-0.90	-1.17	-1.29	

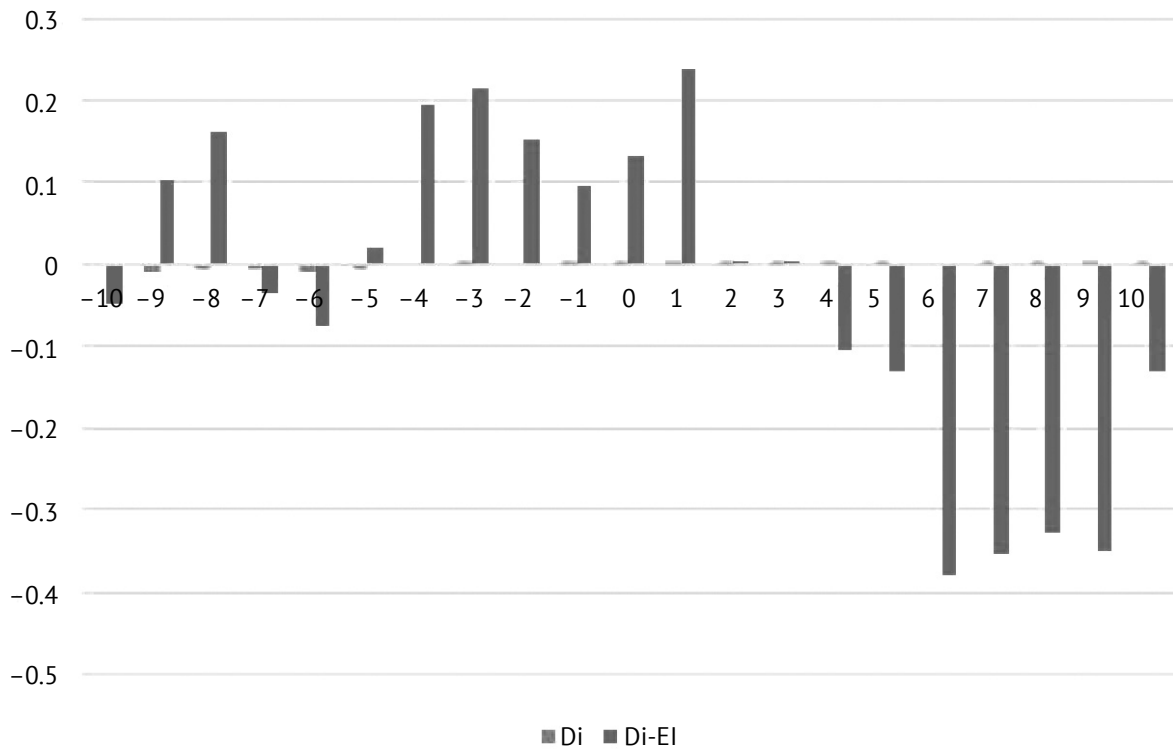


Figure 2. Average Abnormal return of DI and DI-EI group

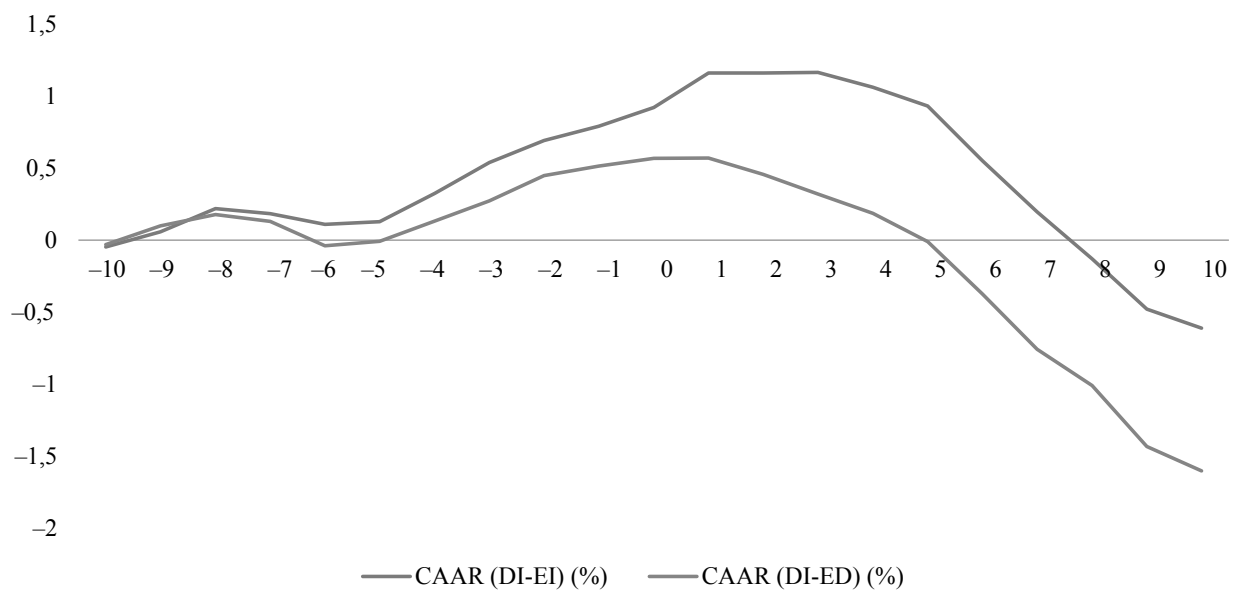


Figure 3. CAAR for Dividend Increase with Earnings Increase/Decrease Announcement

decrease news whenever the dividend increase news is announced to the public. Although, the slope of CAAR (DI-ED) curve is increasingly steeper than the CAAR (DI-EI) curve after announcement date. This proves that even earning results signal are not important news to the market but lower earnings results still received higher reactions.

Dividend Decrease – Earning Increase/Decrease (DD-EI; DD-ED)

Also from Table 2, we considered the combination of dividend decrease and earning increase as group 3 of DD-EI. The result shows a positive abnormal return of 0.33%, on average, over 20 trading days around news announcements. Compared with DI-ED group, the market participants

can earn higher positive abnormal return on announcement date of DD-EI. It means that when dividend decrease news is come up with earning increase, the stock market reacts quite positively. This contrast to the previous conclusion in the way good news from earning report play an important signal to the market. Specially, at the stage earlier, positive abnormal returns can be seen as the result of offsetting effect and much higher than the total sample of dividend decrease companies (See Figure 4). Thereby, although dividend payments are not as far as expected, the stock price is still uptrend due to good earning news.

In the case where both stock dividends and earnings per share decline, negative abnormal returns can be seen on most of the trading days surrounding announcement date. However, the market’s reactions are significant positively on day 0 and 1 with the relative same number of DI-EI group. Logically, both dividend and earnings decrease announcements should send a stock price down, but in reality the opposite happened. There are a number of reasons why the evidence documented for developed markets may not apply to emerging markets. Developed markets are highly sophisticated, closely regulated and considerable amount of resources is devoted to securities research and analyses as compared to emerging markets, which are characterized by a relatively large number of poorly informed and

unsophisticated investors, low liquidity levels, weak legal, regulatory and institutional framework, and operational bottlenecks (Osei 2002). The lack of understanding of the operations and mechanisms of the capital markets, and the poor state of communication to facilitate information flow also makes capital markets in Vietnam less efficient.

Besides, the phenomenon of positive AAR on and surrounding the DD-ED announcement day may be that, investors were uncertain or anticipated low earnings hence their confidence in the stock increase around the announcement days which caused the rise in the abnormal returns. The negative returns after the event day were recorded, confirms Dey and Radhakrishna (2008) study on earnings announcements where they found that individual investors do not only earn significant weak positive excess returns just after the announcements, but they also suffer significantly negative excess returns in the days after the announcement. Similarly, Cready and Gurun (2010) found that lower earnings results exhibit positive cumulative average abnormal returns (CAAR) and move market values higher. Hussin et al. (2010) from the study of market reaction to earnings announcements in the Malaysian stock exchange also found that earnings announcements affect the share prices with lower earnings leading to negative market reaction. However, these studies are silent on

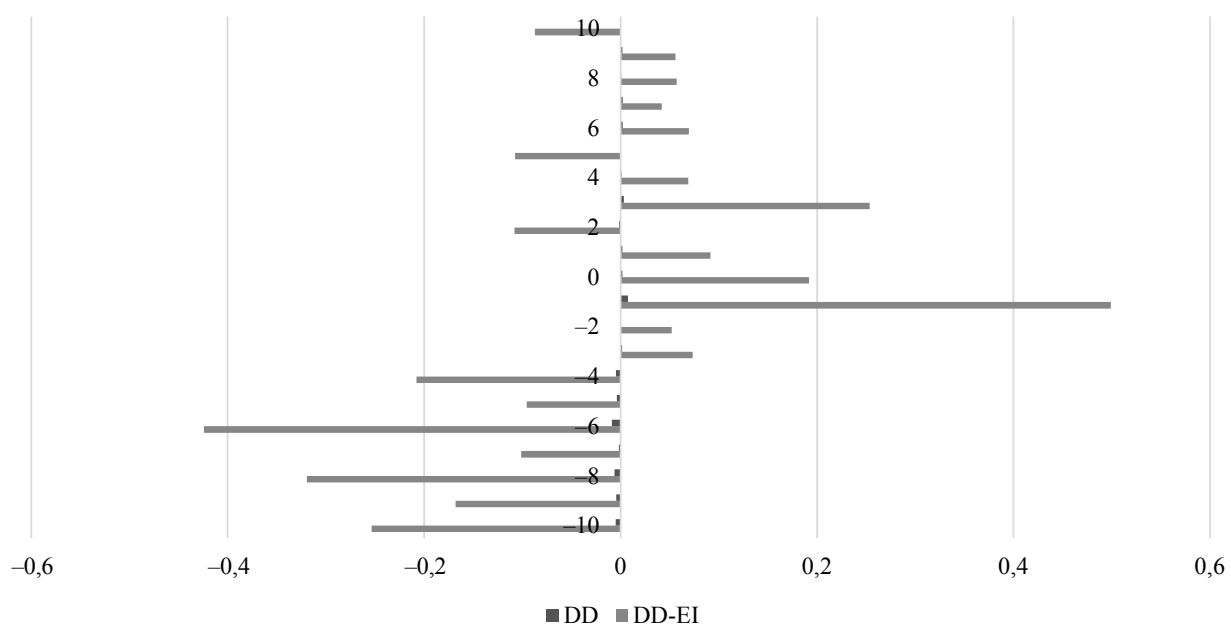


Figure 4. Average Abnormal return of DD and DD-EI group

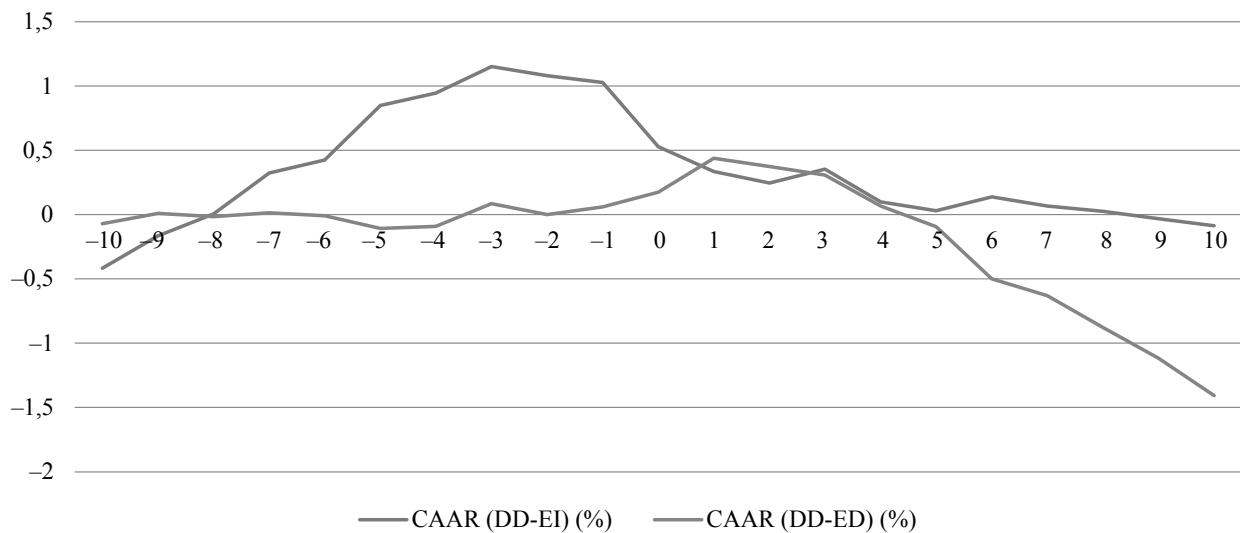


Figure 5. CARR of Dividend Decrease with Earnings Increase/Decrease Announcements

the state of the business cycle when the studies were conducted.

Figure 5 presents CAARs for both group of DD-EI and DD-ED. Until the announcement day, when dividend decrease news is accompanied by higher earning reports, the market reacts stronger positively to the announcement. After day 0, CAARs for both earnings increase and earnings decrease groups move in divergence with the earnings increase category which is moving upward, while the earnings decrease sample moves in the opposite trend. This follows the conclusion of Baharuddin (2010) that earnings results also provide an important signal to the uncertainty of the firm's future growth, where higher earnings results signal positive news to the market.

Dividend Unchanged – Earning Increase/Decrease (DU-EI; DU-ED)

To further clarify and draw conclusions on the effect of the earnings announcement on share prices, in Part III of Table 2, we subdivide the dividend unchanged category into earnings increase and earnings decrease groups. Both categories of earnings reveal a positive AAR on announcement day, and the CAARs are similar when the dividend unchanged group as a whole was tested until day -4. After that, negative and positive abnormal returns during the announcements period are not consistent for both events. In fact, earnings increase events support strongly for upward trend of CAAR within +/- 4 days

surrounding announcement day, meanwhile CAARs are maintained around 1% during the same period when negative earnings report is declared (See Figure 6). Bad earnings announcements, therefore, did not convey any important news to the companies. Clearly, we note that the market is quite different when the two signals move in different directions and when firms happen to pay the same dividends regardless of their differences in reported earnings figures.

Overall, in the first part of table 2, we conclude that earnings information does not affect investor interpretation on dividend information since the market reaction is indifferent when dividend announcements go in opposite directions and when companies pay similar dividend despite the changes in the reported earnings series for the year. In the second part, the results are quite opposite since earnings events, specially good reported earnings convey important information to stock price given dividend decrease. The last part provides the idea that the market will be uptrend even unchanged dividend payments. From those arguments, it is clear that both corporate earnings and dividend change announcements have significant effects on the stock price. However, changes in cash dividends do convey more useful information to the market beyond that provided by corresponding reported earnings for the year, consistent with previous studies by Aharony and Swary (1980), Isa and Subramaniam (1992), Dasilas et al. (2008), and Baharuddin et al (2010).

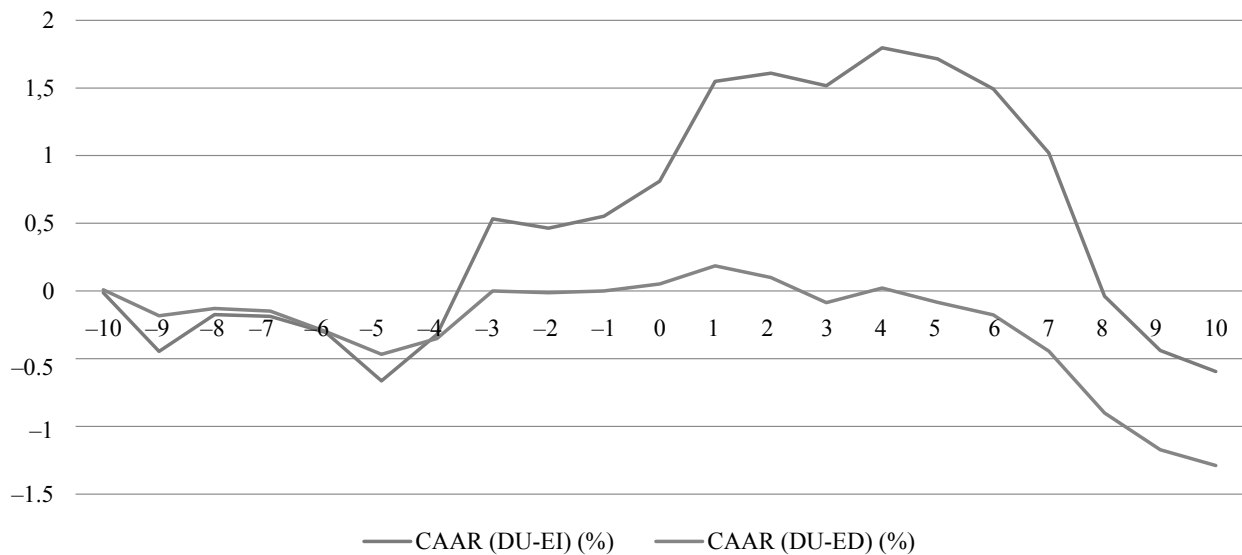


Figure 6. CARR of Dividend Unchanged with Earnings Increase/Decrease Announcements

Table 3. Summary of Results from Tests on Hypotheses

(with the event windows are (-1,+1), (-2,+2), (-3,+3), (-10,+10))

Hypothesis	Cumulative Average Abnormal Return (CAAR)				Results
	CAAR (-10,+10)	CAAR (-3,+3)	CAAR (-2,+2)	CAAR (-1,+1)	
H1: There is no significant difference between the Cumulative Average Abnormal Returns (CAAR) before and after dividends increase and earnings increase announcements.	x	x	x	✓	Marginal
H2: There is no significant difference between the Cumulative Average Abnormal Returns (CAAR) before and after dividends increase but earnings decrease announcements.	x	x	x	✓	Marginal
H3: There is no significant difference between the Cumulative Average Abnormal Returns (CAAR) before and after dividends decrease but earnings increase announcements.	x	x	x	✓	Marginal
H4: There is no significant difference between the Cumulative Average Abnormal Returns (CAAR) before and after dividends decrease and earnings decrease announcements.	x	x	x	x	Accept
H5: There is no significant difference between the Cumulative Average Abnormal Returns (CAAR) before and after dividends unchanged, earnings increase announcements.	x	x	x	✓	Marginal
H6: There is no significant difference between the Cumulative Average Abnormal Returns (CAAR) before and after dividends unchanged, earnings decrease announcements.	x	x	x	✓	Marginal

Note: Null hypotheses are rejected based on 5% level of significance.

Table 3 summarizes the overall results of our hypotheses with only one accept H4 at the 5% level of significance and marginally reject other hypothesis since there is at least one event window which is significant at the 5% level. Therefore, at a 95% confidence level, it could be concluded that regarding to price reaction to dividend and earnings announcements, Ho Chi Minh Stock Exchange has not fully achieved at its efficient level. There is still significant abnormal return within one month (20 trading days) surrounding the announcements date. In addition, the paper also expressed significant difference in CAARs between higher earnings news and lower earnings news when company reports a dividend decrease.

5. CONCLUSIONS

The study sought to investigate how Vietnam Stock Exchange reacts toward dividend and earning announcement and to test the semi-strong form level of the market efficiency. It is realized that there is no major correlation between the share prices and dividend announcement. It is also observed that there is insignificant reaction on the announcement day itself and also in the few days around it. Therefore, it is concluded that dividend announcement are not quickly and adequately reflected in stock prices and earnings announcements do not have any significant effects on share prices. Also whiles the results are inconsistent with the efficient markets hypothesis (EMH) which states that the price reaction to new information must be instantaneous and unbiased, the behavior of share prices is found to be inconsistent with the semis strong form of the efficient market hypothesis.

Additionally, from the market reactions to both dividend and earnings announcements, we conclude that both announcements have significant effects on the stock price. However, changes in cash dividends do convey more useful

information to the market. It is still witnessed significant difference in CAARs between higher earnings news and lower earnings news when company reports a dividend decrease.

As a sequel to the conclusions and based on the findings, the following recommendations are proposed:

First, it is essential to encourage listed companies release timely their financial statements. Accordingly, there are no opportunities for speculators earn abnormal returns surrounding dividend and earnings announcement date. By this way, it boosts liquidity and helps improve the informational efficiency of the stock market.

Second, the market should be made attractive to attract large institutional and foreign investors in order to improve liquidity of Vietnam stock exchange. In fact, institutional and international investors have greater security analysis capabilities; therefore, hooking them on board will help improve availability of quality and relevant financial information and the overall quality of the information environment in the market

Third, the stock market should also be encouraged to maintain modernized database of the various event dates in a way that make them easily accessible so as to aid in further event studies as opposed to the current way where a researcher has to search through so much information to extract the announcement dates.

Fourth, government should undertake policies to ensure macroeconomic stability since it is an important element that can boost investor confidence on the stock market and ensure firms to list on the market.

Last but not least, future research should consider a larger sample size and also broaden the scope of the research to cover more institutions as well. Also further studies should be conducted to establish the nature of the market reaction to good and bad news.

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Organizational aspects of the internal audit of Italian corporate groups

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Abstract. The objective of the paper is to explore some organizational aspects of the activity of Internal Audit (IA) in corporate groups. Having noted the limited literature on the subject, the authors intend to make a scientific contribution with the intention of reducing the existing gap in said literature, paying particular attention to the Italian context. In addition to expanding the knowledge of scholars and professionals in this sector, the content of the paper may be of support to the governing bodies of a corporate group, offering insights to better organize the function of IA and to ensure that activities are more efficient and effective for all entities of the group. Purpose. The Internal Audit's organizational aspects are particularly complex within corporate groups. The paper focuses on: a) the Internal Audit operating model that can be adopted: in-house solutions rather than outsourcing solutions; b) the organization structure adopted for manage the activities of the Internal Audit Function.

Design/methodology/approach. The research is based on a survey carried out on 56 groups listed on the Italian Stock Exchange and which operate in the industrial and financial sectors. Two case studies are presented: Finmeccanica and UniCredit. The individual case studies are concise, with an explanation of the main benefits and challenges inherent in each approach.

Findings. The main survey findings indicate that:

Each business group adopts the IA organizational model most appropriate to its needs.

Almost all of the groups adopt the in-house solutions, while the percentage of the groups that outsources the service is very low (10% just in the industrial sector).

In either sector, the delegation model is never used.

Finmeccanica adopts an original functional matrix structure for the IA to increase the effectiveness of interventions and the level of control and coordination of the Group's operating companies, and to improve the efficiency of operating costs.

UniCredit adopts the hybrid model: the IA function, structured as a Department, coordinates and monitors the Group's IA activities performed by the competent structures of the Group's entities ensuring control consistency and adequate attention to the different types of risk.

The case studies tell us that the corporate groups pay attention to develop and improve the organizational aspects of their own IA function. The goal is not just about keeping costs down but also maximizing the efficiency and effectiveness of IA operational model chosen.

Originality/value. The findings of this study are another element to help managers and governance bodies in their decision making process regarding organizational aspects of IA.

Keywords: Internal Audit Function, In-house Model, Outsourcing, Italian Groups.

Acknowledgments. The authors gratefully acknowledge the valuable feedback provided by all questionnaire respondents and Dr. Laura Palese (Postgraduate University of Salento) for the assistance in processing the data from the completed questionnaire.

Организационные аспекты внутреннего аудита в итальянских корпоративных группах

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Аннотация. Целью статьи является презентация анализа некоторых организационных аспектов внутреннего аудита в корпоративных группах. Отмечая недостаточность литературы по этой теме, авторы попытались внести свой вклад в существующий пробел в научных исследованиях, уделяя особое внимание условиям экономической деятельности корпоративных групп в Италии. В дополнение к расширению знаний студентов и профессионалов авторы статьи рассчитывают, что ее содержание поможет топ-менеджменту корпоративных групп в лучшей организации функционирования их внутреннего аудита, а также повысить эффективность и действенность работы их подразделений. В статье сосредоточено внимание на следующих аспектах внутреннего аудита: а) на применении оперативной модели внутреннего аудита, опирающегося в большой мере на внутренние ресурсы, чем на аутсорсинг; б) на организационных структурах, используемых в управлении деятельностью внутреннего аудита.

Ключевые слова: функция внутреннего аудита, модель “in-house”, аутсорсинг, итальянская корпоративная группа.

1. INTRODUCTION

The objective of this paper is to explore some organizational aspects of the activity of Internal Audit (IA) in corporate groups. Having noted the limited literature on the subject, we intend to make a scientific contribution with the intention of reducing the existing gap in said literature, paying particular attention to the Italian context.

In addition to expanding the knowledge of scholars and professionals in this sector, the content of the paper may be of support to the governing bodies of a corporate group, offering insights to better organize the function of IA and to ensure that activities are more efficient and effective for all entities of the group.

In view of the complexity and of the characteristics that distinguish corporate groups, it is

evident that the function of IA in an aggregate takes on an even more significant strategic role. In fact, it must define and manage the various auditing activities—operational auditing, financial auditing, compliance and fraud auditing and management auditing—inside a system of harmonic control that is useful for the whole aggregate.

Until now literature has found:

- different IA operating models, depending on whether the Internal Audit activities are entrusted to internal parties (IA in-house models) or external parties (IA outsourcing models);
- diverse organizational structures with which Internal Audit activities are managed.

Starting from these basic concepts which constitute the theoretical reference framework for these activities, we have chosen to investigate the aspects within corporate groups which, by nature, require the adoption of unique organizational models that are sometimes more advanced than those already used in individual companies. It is evident that the organizational problems related IA arise when the activity of IA is not outsourced. In this case, the organizational structures that can be defined differ essentially in whether the auditing activities are centralized or not within the parent company (centralized model, decentralized model) or whether all IA activities of all of the companies in a group are transferred to a company specifically set up inside the aggregate (consortium model).

From the literature review (Kolaska, 1983; Cullen & Perrewè, 1981; Anderson *et al.*, 2012) and some white papers drawn up by independent auditors (Ernst & Young, 2012) it emerged that the decisions related to the organizational aspects of IA activity in corporate groups reflect the aggregate businesses own complexity. Such choices, in fact, appear to be influenced by: the size of the group and the number of sectors in which holdings and subsidiaries operate; the geographical distribution of the participating entities; the nature and level of risk of the activities carried out; and, the amount of resources allocated to the functioning of IA.

Considering the Italian context, we formulated the following Research Questions (RQ):

RQ1) What is the predominant Internal Audit operating model used in Italian corporate groups?

RQ2) Which organizational structures are used by Italian groups to regulate the internal activities of the IA department/unit?

To answer the Research Questions an empirical survey was conducted from a sample of Italian listed companies operating in two specific sectors (banking and industrial). This sampling was carried out on the basis of a choice based on arguments that justify the theoretical relevance. This choice, in fact, is based on two assumptions:

a) In the Italian banking sector the activities of IA are affected by special legal provisions, which, even if they are of 2nd level, are often binding;

b) In the industrial sector the majority of groups are multi-businesses, and thus the activity of IA seems to be more complex and problematic.

To further investigate aspects related to RQ2 two cases have been proposed: Fimmeccanica, a group active in the industrial sector and UniCredit which operates in the credit sector.

Finmeccanica and Unicredit were chosen not only because they are the groups which, in 2013, invested more resources (human and financial) in the activity of IA, but also because they are the only corporate groups that have recently changed the organizational structure of their IA Departments adapting to the particular characteristics of each group.

The remainder of the paper is organized as follows. The next section presents the literature review analyzing the most important studies regarding internal auditing and, in particular, highlighting the pros and cons of different IA operating models (in-house, outsourcing) identified in the literature. In the third section, instead, the main organizational structures that can be adopted for carrying out the activities of IA Departments are shown. In section 4, the regulatory context related to Internal Audit relevant to the groups listed on the Italian Stock Exchange has been outlined. Section 5 presents the main findings of an exploratory study focused on the organizational aspects of the Internal Audit of the Italian corporate groups operating in two sectors: banking and industry. In the last section, some final considerations have been proposed.

2. REVIEW OF THE LITERATURE

Over the last decade, the studies on Internal Audit (IA) have increased exponentially. The study on the topic, as detected by Carcello *et al.* (2005a) and by Leung *et al.* (2011), is as a result of numerous financial scandals—i.e. Cirio, Enron, Montedison, Parmalat, Siemens, WorldCom—and, consequently, the global financial crises that followed.

In general, the confidence in the independence and in the reliability of audit firms involved in scandals and the trust in financial markets have failed (Ibrahim El-Sayed Ebaid, 2011).

However, in some studies, such as that of Lenz and Sarens (2012), it was intended to demonstrate the absence of a causal link between the activities of Internal Audit and the financial crisis, and between the solution of the crisis and the activities of Internal Audit.

A process was started which has brought significant changes to the philosophy, the intensity and the approach to be followed in the specification not only of the regulated markets but also of the aspects relating to both corporate governance and internal controls.

Italian companies, as those of the rest of the world, are experiencing an ever-changing regulatory environment, marked by the guidelines and recommendations of the European Union and the reform law enacted for the protection of savings (Law no. 262/05, the so called Savings Protection Act) and corporate law. However, it is important to point out that the evolution of the Internal Audit has also been influenced by other variables such as the increase in the size and complexity of the companies or the significant development of information systems (Allegrini *et al.* 2006; Hass *et al.*, 2006).

The IA has become an integral part of the management process, it is a supervision strategic tool that works closely with government and supervisory bodies and, simultaneously, it has become a tool for the improvement of other company's functions involved in various operational activities. The IA function is moving well beyond its traditional role of ensuring compliance. It is becoming increasingly involved in top level decision making, protecting the organization against risk, and improving control systems. The Internal Audit function has been defined, in the study by Stewart and Subrama-

niam (2010), as a key element for the functioning of the mechanisms of governance, are now entrusted with increasing responsibility. At this point, it is possible to highlight a paradox: while on one side, the conducting of such activities is prescribed to the companies, on the other side, the existence of an internal audit function is not mandatory for the companies.

Hence, the urge to explore, in general, the organizational aspects of the Internal Audit and, specifically, those within the corporate groups.

The correct collocation of Internal Auditing within the company organization and the concrete support granted to it by its management are the determining factors in its position and its value. The audit committees, therefore, should report directly to those who hold a higher position, whose authority is sufficient to ensure a proper consideration of the function.

Internal Auditing is defined as “*an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes*”. This definition, proposed by the International Institute of Internal Auditors (IIA), states the fundamental purpose, nature, and scope of internal auditing.

According to this definition, the audit committees is responsible for providing advice to senior management evaluations and recommendations concerning the activities examined in order to assess the appropriateness and feasibility of the strategic objectives established in relation to the internal and external conditions to the company.

IA has become the pivot around which the whole control system of the company relies on and being in close contact with government and supervisory bodies it becomes the tool to positively stimulate the strategic orientation of the company and, consequently, the continuous improvement of the corporate functions involved in the various operations. The IA performs, therefore, a large number of interventions: from those relating to accounting and finance (financial auditing), to ensure the regular preparation of financial statements and to prevent any fraud (Caplan & Kirschenheiter 2000, James, 2003) to

those of operations (operational auditing) designed to evaluate and monitor the operation of sub-business systems, ensuring compliance with the principle of efficient, effective and economical use of company resources (Reider, 1994).

These controls also include the assessment of the risks of legal sanctions, financial or reputational losses due to non-compliance with laws, internal and external regulations (compliance audits) (Ratliff *et al.*, 1994).

Finally, the IA carries out a consulting service for top management of the company (management audit) with the aim to improve the process of governance and control through the support in the design and implementation of the internal control system, of Risk Management system and those of the corporate governance system, as well as the elaboration of suggestions that promote the achievement of the interests of the company and of all the stakeholders.

In fact, as highlighted in the PwC's report (2013), Internal Audit should be in line with the expectations of corporate stakeholders to implement the necessary controls aimed at increasing business performance and, consequently, the strategic initiatives designed to preserve and increase business value.

In regard to the strategic importance attribute to the IA, a cultural leap by property and company management is required in order to not perceive such activities as a hindrance to the economic viability and development of the company or as a legal obligation.

On the contrary, the owners must become aware of the importance of the IA in improving governance process, in the activity of support to strategic planning. They have to consider the IA as a determining variable in the improvement of business results.

These principles have been demonstrated in the studies carried out by Cohen *et al.*, (2002) and Karagiorgos *et al.* (2010) which generally showed the increasing role that IA has in corporate governance. In particular, a number of empirical studies have been proposed relating to geographically wider contexts—as in the study of Paape *et al.* (2003) conducted at the European level—or to a national context such as the Italian case (Marchi & Allegrini, 2012; D'Erì & Regoliosi, 2014) or the Libyan one (Abdul-Nasser *et al.*, 2014).

Cohen & Hanno (2000) and Melville (2003), however, pointed out, respectively, the contribution that the IA can give to the Management control and Strategic management. While, in the study conducted by Allegrini & D'Onza (2003) the role of Internal Audit in the assessment of business risks have been enhanced. Studies have not overlooked the fact that there is a positive correlation between corporate performance and the activities of IA (Ernest & Young, 2012).

From what has been said, it is evident that the activity of IA requires increasingly specific skills and knowledge in order to provide the necessary advisory support to management to make the control models more adequate, efficient and effective in relation to both the risks and to business needs.

In this regard, the International Standards for the Professional Practice of Internal Auditing (IIA Standards) guide the activities of IA, so that this can be flexible and adaptable to the types of activities carried out by the company, by the size and by the complexity of the organization. It is evident, then, that companies must have specially qualified staff to carry out the activities of Internal Audit. However, the literature has found that the execution of such activities is often hindered by the under-sizing of resources—human and financial—and, in some cases, the limited availability of specific expertise on these issues justify an outsourcing solution.

The Internal Audit actively contributes to governance if it is able to guarantee an active and effective communication with administrative bodies and government (Leung *et al.*, 2011), without renouncing the principles of independence and objectivity which should characterize its choices and its activities as highlighted in the works of Christopher *et al.* (2009) and Dickins and O'Reiley (2009).

Even with regard to interactions with other business functions, the IA should not be seen as an inspection tool with the function to syndicate the work of individual employees or to find errors, but as an instrument at the service of all concerned, beneficial in operating with awareness and professionalism.

These features assist in the configuration of the IA staff as a specialist staff working in the service of the entire organization, and they emphasize the importance of placing the correct

function of IA within the corporate organization.

It is therefore obvious that a clear and constructive relationship between the Internal Audit Department and the Board is critical for the performance of control activities: support from top management, in fact, can foster collaboration functions which are subject to audit by allowing the completion of the assignment without interference and therefore working more effectively.

The achievement of this goal is also facilitated by the choice of an appropriate organizational structure of the IA Department.

It is evident that the organizational activities of the IA depend on the complexity and the high number of business sectors in which parent company and the subsidiaries operate. For the correct evaluation of the operational model and the determination of the optimal size of the Internal Audit Department, additional factors must be considered: the economic sector of the group, the size and complexity of the subsidiaries, the geographic distribution of the entities participating in the group, the distribution of powers and decisions, the level of risk of the business and the amount of resources assignable to the function (Kolaska, 1983, Cullen & Perrewè, 1981, Carcello *et al.*, 2005b, and Anderson *et al.*, 2012). Before conducting an analysis on the different operating models of Internal Audit Function, a premise is essential: in Italy there is not a law that imposes the carrying out of the Internal Audit activities within the company performed by its employees. One empirical study that addressed the specific factors associated with organizations' internal audit sourcing decisions is that of Wider & Selto (1990). In their study, they used the Transaction Cost Economics theory to explain the organization of IA. In 2007, the re-

sults of their study was replicated by Speklè *et al.* reinforcing the importance of the Transaction Cost Economics variables in explaining organizations' internal audit sourcing behaviour.

There are two types of sourcing arrangements for the internal audit function: each organization—as shown in Figure 1—may choose to undertake the IA:

- • in-house, the group maintains its own internal audit department;
- • in outsourcing, an internal audit service provider or an independent accounting firm conducts the internal audit function.

Both solutions provide different alternatives as shown below.

In-house organizational model

Allegrini & D'Onza (2003) assert that the activities of IA of a corporate group can be organized according to three different models.

In the first—centralized model—a single function of IA carries out its verification activities for all group companies. In the second—the so-called decentralized model—the IA function is present in the parent company and in each subsidiary. The third organizational model of IA—known as delegated or consortium model—provides for the creation, from scratch, of a company within the group with the exclusive purpose of providing auditing services for all group companies.

Therefore, while the centralized and the delegated model put the IA function within a single company (Parent company or one created from scratch), the decentralized model provides for the establishment of the IA function in each company of the group, or in those companies that are considered to be particularly strategic for the group.

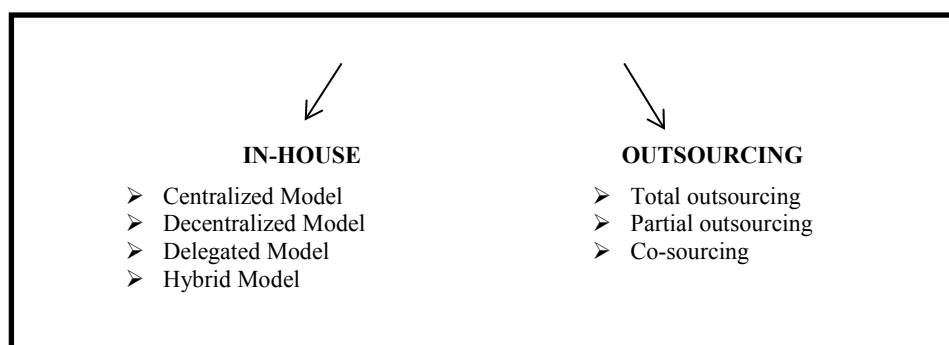


Figure 1. Two types of sourcing arrangements

It seems evident that the choice of a centralized model allows the IA function to obtain a complete overview of the group's activities and to report directly to senior management without intermediaries supporting coordination between decision-making and the achievement of economies of scale and learning. This organizational choice, therefore, is deemed to be convenient to those groups characterized by firms located in a given territory and whose subsidiaries have homogeneous activities.

In contrast, the decentralized model is used in groups that operate in complex and changing environments and that have subsidiaries distributed in different geographic areas.

As underlined by Child (1984) and Ratliff *et al.* (1998), the decentralized model allows you to have a greater knowledge of the risks, processes and legislation related to the areas that have to be checked, rather than the more timely intervention related to the high degree of decision-making autonomy of each IA function present in each company.

However, this model has two limits which must not be underestimated.

The first is found in the possibility of compromising the independence and objectivity of the IA function that could be conditioned by meddling from local management, damaging in this way, the independence of judgment required during the audits.

The second limit, however, is found in the possible difficulty in sharing the objectives among the subsidiaries; it is due, in part, to poor or no communication between the manager of each aggregate company and top management of the Parent company.

There is a fourth alternative for the organization of IA in corporate groups: the so-called "hybrid model" that combines the characteristics of the centralized model with those of the decentralized model.

In this case, the structure of IA, present in the Parent company, exercises direction and functional coordination of the Auditing structures of the subsidiaries, ensuring control consistency and adequate attention to the different types of risk.

This choice allows companies to take advantage of the centralized model—better coordination of activities within the groups and the use of common methodologies aimed at achieving

shared goals—and, at the same time, facilitates the work of the local IA team by using the knowledge of the organizational context in which it operates.

Outsourcing organizational model

As noted by Moeller (2004) and Spira & Page (2003), the outsourcing of IA is a practice dating back to 1980s. As in the in-house solution there are multiple alternatives also for the outsourced solution of the Internal Audit. As illustrated in the Position Paper of the Institute of Internal Auditors (2009), in fact, there are three forms of outsourcing:

Total outsourcing: the entire internal control activities are carried out by external parties and, usually, on an ongoing basis.

Partial outsourcing: only part of the activities of IA are provided by external parties.

Co-sourcing: the external resources jointly collaborate with internal staff to perform the activities of IA. The external auditors are entrusted with the services where special skills are needed, while the responsibility of IA and supervision of their work is assigned to the internal staff (Thomas and Parish, 1999).

However, regardless of the form of outsourcing that is used, the IIA suggests to always appoint an internal figure to be responsible for the activities of the Internal Audit.

As shown in the Position Paper "*Resourcing alternatives for the Internal Audit Function*" (IIA, 2005), the empirical results indicate that most of the Internal auditor agrees on the use of partial outsourcing, because the total outsourcing is particularly complex to manage.

The analytical study of Caplan and Kirschenheiter (2000) shows that the decision to outsource the IA is justified by the increased intensity of the stimulus that the professional external companies derive from performing such services. The effort of the co-sourced partner is primarily focused on compliance with legislation and risk identified in IT or accounting, finance.

But the adoption of outsourcing appears to be justified, also, from the greater flexibility in the cost structure and resource allocation. Carey *et al.* (2006) found that outsourcing makes it possible to replace the fixed costs of the staff with the variable cost of external consultants obtaining cost savings.

If conducted in a prudent way, outsourcing provides access to the best practices and then to a level of competence that can be expensive and impractical to maintain internally especially in the small corporate groups. In many cases, more extensive checks are required but, as demonstrated in the study of Aldbizer *et al.* (2003), the right expertise cannot always be found in the business group.

However, outsourcing has limitations. First, the external auditor does not have a deep and immediate knowledge of the business activities as those who work for the company and the objectives of the external auditor do not very often coincide with those of the company.

In regard to this, in order to avoid misunderstandings, the preparation of a detailed letter of appointment, and frequent communications between internal staff and those who are guardians of the Internal Audit assignment may be particularly useful.

Without these elements the following may occur, for example, that the external auditor carries out the Internal Audit Plan in a timely and professional manner, but does not adopt a proactive attitude aimed at improving governance, better risk assessment or process control.

Even though the internal audit function may be completely outsourced, responsibility for the overall efficiency and effectiveness of the internal audit function remains with the entity. It is therefore important for the entity to retain control of the internal audit strategic direction and to actively monitor the performance of the provider.

Where an outsourced delivery model is chosen, assigning a senior member of the entity's management team to oversee the delivery of internal audit services will assist in achieving close alignment between the entity's needs and the internal audit service provided.

In these cases, it is also useful to appoint a staff member as an in-house liaison officer for the provider. Such a person has specific responsibility for activities, such as monitoring the provider's performance. This latter role can be of great assistance to the provider as it can act as a reality check on internal audit findings and recommendations help the provider to understand particular organizational nuances and provide advice on sensitive matters.

The use of outsourcing is not without risks; to externalise the function, in fact, it careful attention is required in evaluating the following:

- Quality risk, related to technical and professional services provided by the supplier.
- Risk to reputation, if the outsourcer's error is reflected on the image and reliability of the group and how it is perceived by the market.

Legal risk, referred to the margins of uncertainty linked to the interpretation and enforcement of the contractual agreements as well as the confidentiality of certain information that, especially in certain sectors, such as the banking sector, is fundamental.

3. ORGANIZATIONAL STRUCTURES FOR IA DEPARTMENT ACTIVITY

The problem with defining organizational solutions for the activities of IA is that IA has particular characteristics compared to the other areas of the company. Behind the term IA, in fact, lie different activities—Financial Audit, Operational Audit, Management Audit, Compliance Audit, Fraud Audit, IT Audit—each of which has different elements with respect to: time horizons, degree of interdisciplinarity, supervision of activities, results and investments made. Overall, the IA is a highly professional labor intensive activity in which the intangible resources, such as technical knowledge, are paramount. Therefore, it is necessary to properly consider the differentiation, on an organizational level, of each sub-activity in IA: for example, the human resources necessary for Operational Auditing cannot be the same as those for Compliance or Fraud Auditing; and likewise, those used in Financial Auditing cannot be the same for IT Auditing.

It follows that the working organizational structure of IA in a company, and in particular, of more complex organizations such as corporate groups, must be able to coordinate and address the different professionalities with the aim of reaching precise pre-fixed internal audit objectives.

There are three main types of structural organization that can be adopted for the organization of the IA Department: functional structure, divisional structure and matrix structure.

Functional Structure

In a functional structure (Figure 2) the activities of the IA Department are grouped on the basis of

the criterion of specialized expertise with a further breakdown into sub-functions or organizational units whose characteristics are well defined.

The criterion of subdivision into sub-areas is the homogeneity of expertise, and therefore, the IA activities are structured on the basis of the technical knowledge to be used in order to carry out the different types of controls.

Within a functional structure, therefore, we can find, besides the position of Chief Audit Executive (CAE) who is the one responsible for the IA activity in his/her group, the following organizational units: Financial Audit, Operational Audit, Management Audit, Compliance Audit, and Fraud Audit. The sub-function of IT Audit is often found as a support element for all the other sub-activities.

The main advantage offered by functional structure consists in the economy of specialist resources: the aggregation of resources inside the functional organization allows for the optimization of the use of the same. Such a structure—although it facilitates the achievement of economies of scale and thus, a reduction in costs—is suitable for small groups, mono-businesses whose companies are in the same geographical context.

Divisional Structure

Divisional structure (Figure 3) was created with the aim of overcoming the limits of functional structure regarding organizations characterized by the complexity of their business and by the internal presence of various product lines or markets that are very different from one another. Therefore, such a structure may be adopted to organize the IA activities of large groups whose affiliates operate, for example, in different geographical contexts.

With divisional structure different IA units (or divisions) are created inside the group. Each director is granted vast decisional powers. The IA activities of the group are carried out with greater flexibility: the single divisions, being decentralized, have certain autonomy (decentralization of decision making from the top) and are characterized also by the fact that they have a greater capacity to adapt to the operational context in which they do business. The CAE of the division, therefore, in accordance with the IA plan of the group, can make decisions about matters specific to the context in which the company operates, thereby increasing the efficiency and effectiveness of his/her IA division.

Usually, for IA activity, groups adopt a structural division in geographical areas when they choose to divide the activities based on the geographical areas in which the organization is present.

Each division typically has a functional structure inside itself. It follows that the functions are duplicated from one division to the other. However, often, some functions of a general nature—such as IT Auditing—are centralized at a group level.

Divisional structure, on the contrary to functional structure, does not generate economies of scale often resulting in a duplication of specialized resources distributed in different divisions with an increase in costs.

Matrix Structure

The matrix structure (Figure 4) is a complex structure that combines the characteristics of functional structure with those of divisional structure. It comprises both dimensions: one typically functional and the other specifically tied, for example, to the business sectors of the companies in the group.

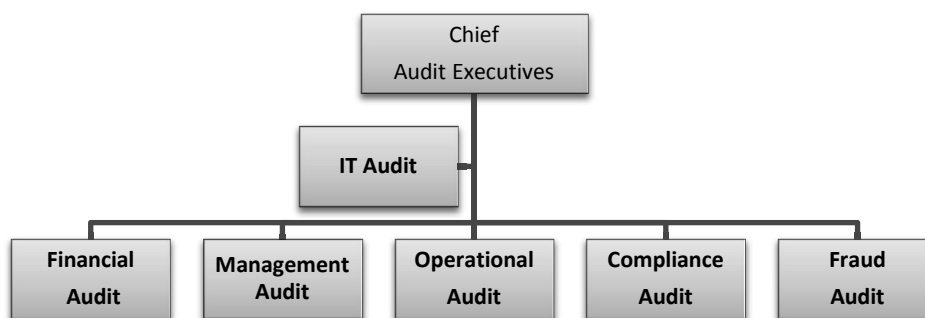


Figure 2. Functional structure

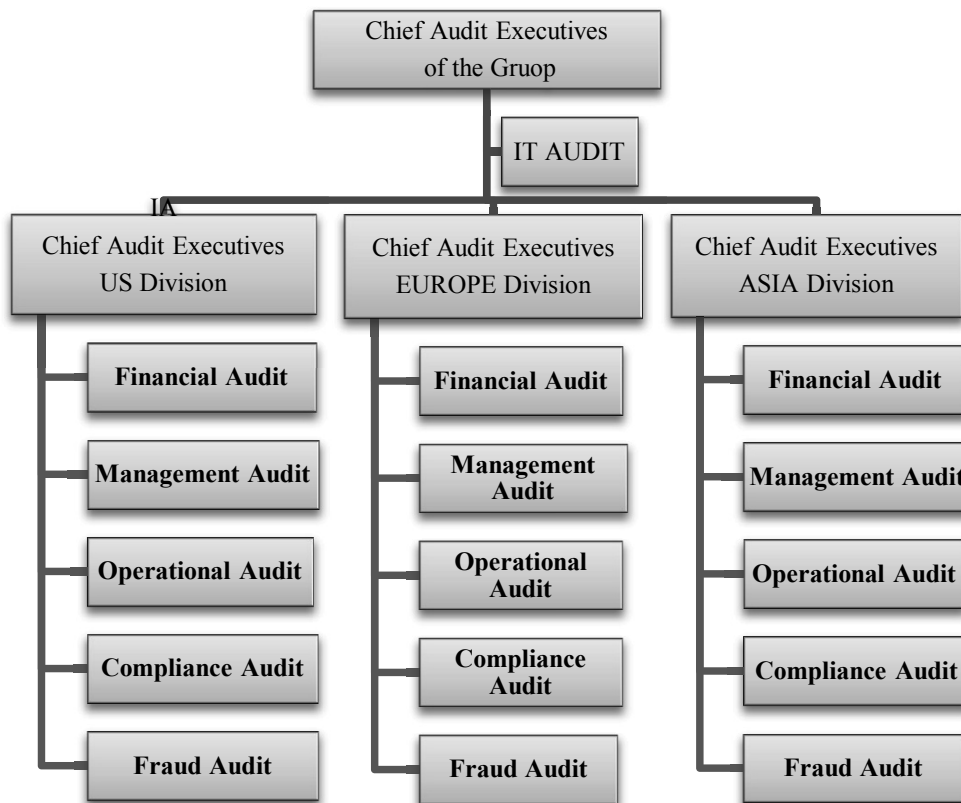


Figure 3. Divisional structure

The peculiarity of this structure is the allocation of different resources in the various sub-areas of the IA Department to the different product lines, projects or business activities of the companies in which the group operates.

Within these structures, therefore, resources are at the crossroads of two distinct lines of governance, one functional and one sector/project related. It is quite obvious that this structure can be adopted in those multi-business groups and companies that operate in an environment characterized by a high degree of instability and uncertainty.

For the use of professional resources this structure is very flexible: auditors, in fact, are employed as needed, to carry out the audits in one area or another.

The scheme can be read in two ways: horizontally, each line form groups of different inter-functional specializations (Financial Audit, Operational Audit, Management Audit, Compliance Audit, Fraud Audit, IT Audit) or vertically, each column represents, instead, a given sector/project offered by the group. At the point of intersection of the horizontal and the vertical lines, each sector/project gets the support and

professionalism of the Internal Audit specialist it needs.

Although the adoption of an organizational structure to carry out the activities of IA is a formal decision that has long-lasting consequences on its internal organization, we must not think of the structure as static and unchanging. In fact, it is possible to make changes to the organizational structure more than once for various factors, but especially due to two main reasons:

a) when the need to rationalize internal resources is driven mainly by the need to increase their efficiency. In this sense, for example, resources might be reduced due to an overlap of responsibility in two or more areas, creating new organizational units to conduct specific types of audits that, until a given moment, have proved to be critical since they had not been overseen properly;

b) when there is the need to adapt to changes in the activity of IA macro and micro environment in which the companies belonging to the group operate, by establishing, for example, new organizational units which are given the responsibility to oversee specific areas of internal audit.

From what has been stated, it is clear that senior management should periodically assess the adequacy of the IA organizational structure to determine if the same is suitable or not to fulfill the changing goals assigned to internal audit.

4. THE ITALIAN LEGISLATIVE BACKGROUND

In order to contextualize the results of the analysis, it is appropriate to recall, briefly, the Italian regulatory framework that regulates aspects relating to Internal Audit. It is worth pointing out that there are no legal provisions that expressly refer to the Internal Audit activities.

The only reference by law on the subject is found in Article 150 of the «Consolidated law on financial intermediation» (TUF) which provides that «The persons assigned to internal control functions shall also report to the board of auditors at their own initiative or at the request of one or more members of the board of auditors».

Further references and details can be found under the regulations at the second level, where membership is, however, no obligatory.

For example, the Corporate Governance Code set up by the Italian Stock Exchange, updated in July 2014, dedicates a specific article to the system of internal control and risk management that companies should adopt.

In Article 7, in fact, the general system of internal control is defined in an organic way, and the coordination of stakeholders involved in the actual processes is explained. In this context, the Internal

Audit function has become the entity dedicated to the monitoring and independent evaluation of the internal control system in support of the main protagonists in the system of corporate governance.

Internal auditors do not report to any operational area manager, but shall report on their activity to the CEO or to Internal Controls and Risk Committee.

On the other hand, it is desirable that they will enjoy the full support of the Board of Directors, in order to promote and spread a control culture into the company.

The Corporate Governance Code provides for the possibility of entrusting the function of IA, as a whole or by business segments, to outside entities which possess adequate professionalism and independence, to which the role of Internal Control Officer of the entity, who is in charge of overseeing the functioning of the internal control system, can be attributed.

However, the organizational decision to outsource the IA and the related reasons must be communicated to shareholders and the market in the “Corporate Governance and ownership structures” report drawn up in accordance with Article 123-bis TUF.

These regulations on the IA were already in existence for companies operating in the Italian banking and insurance sectors. The supervisory instructions for banks, issued by the Bank of Italy in 1999 emphasize the need that “the activities of internal audit in banks should be carried out by an independent entity (Internal Audit).

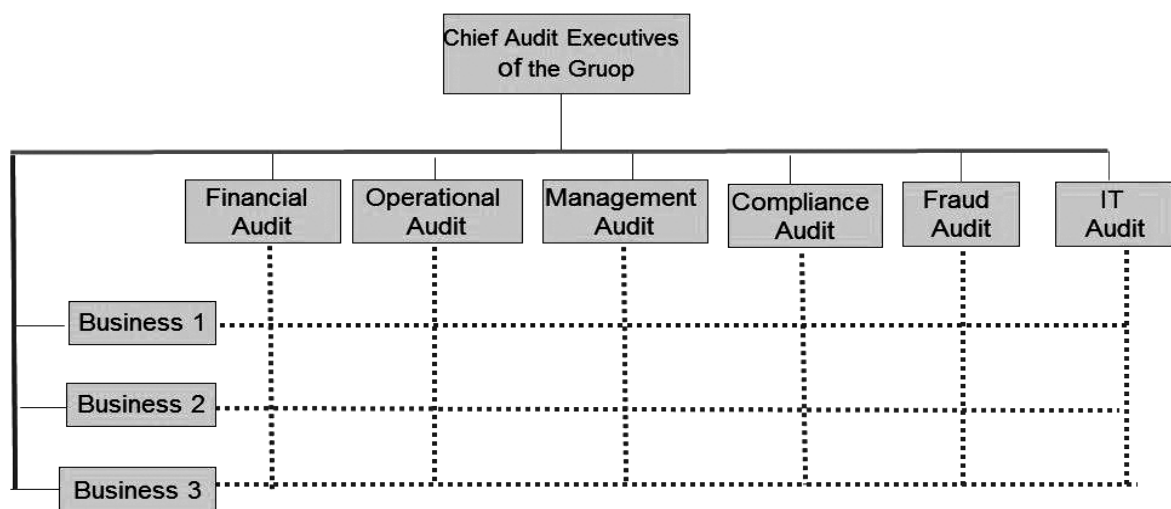


Figure 4. Corporate Governance and ownership structures

The institutions are being encouraged to review their internal audit function in the light of the latest guidance from the Basel Committee on Banking Supervision and to take appropriate action to address any identified material shortfalls or deficiencies. Indeed, the document “The internal audit function in banks” issued on 28 June 2012, updates and replaces the previous document “Internal audit in banks and the supervisor’s relationship with auditors” (2001). It is a guide for assessing the effectiveness of the internal audit function in banks and it is based on 20 principles and builds on the Committee’s Principles for Enhancing Corporate Governance which require banks to have an internal audit function with sufficient authority, stature, independence, resources and access to the board of directors.

This function—which should not depend on any head of operational areas—is aimed on one hand, to control, even with spot checks, the regularity of operations and risk trends; and on the other hand, to evaluate the effectiveness of the overall internal control system and to submit to the board of directors and senior management proposals to improve the risk management policies and their measurement tools.

Even for banks, the ability to outsource the function of IA is possible, even if—in principle—that option is not recommended in relation to the confidentiality of the information derived from the nature of the businesses activities.

However, as shown in notes drawn up following a consultation by the Italian banking system on the Basel document “Banks’ Internal Audit and Supervisors’ Relations with Internal and External Auditors”, it is believed that partial outsourcing may be feasible:

- In the case of orders requesting an impromptu audit of the bank’s activities that do not fall within the business areas that are of strategic importance for the bank;
- Or when they related to particularly specialist audit activities, that are not available within group, and if so, only at very high costs.

In the case of partial outsourcing, it would be appropriate to provide some connection between the IA staff and the outsourcer.

In principle, total outsourcing, is considered possible for the IA function when the bank is characterized by a reduced size of the company

and/or limited operational complexity of the group. In such cases, outsourcing has profiles of convenience both from an economic and organizational point of view. For small banks, in fact, the establishment of an internal function dedicated to IA is costly and, in some cases, it is not even possible for the different skills required.

In general, the decision to outsource the function of IA can be taken provided that the awarding of the task is formalized in an agreement in which objectives, methodology, frequency of checks and reports to be drawn up for the Top management inherent to checks carried out, are defined.

An internal audit outsourcing arrangement is a contract between the institution and an outsourcing vendor to provide internal audit services. On the one hand, outsourcing of internal audit activities, especially when it is done on a limited and targeted basis, can bring significant benefits to banks such as access to specialized expertise and knowledge for a special audit project otherwise not available within the organization. On the other hand, outsourcing may introduce risks to the bank, such as lost or reduced control of the outsourced internal audit activities. Those risks need to be managed and monitored; furthermore, the outsourcing may adversely affect the supervisory authority’s powers to gather information or to require changes in the way that the outsourced activity is carried out.

Regardless of whether internal audit activities are outsourced, the board of directors and senior management remain ultimately responsible for ensuring that the system of internal control and the internal audit are adequate and operate effectively.

Each bank should have a permanent internal audit function. In fulfilling its duties and responsibilities, the senior management should take all necessary measures so that the bank can continually rely on an adequate internal audit function appropriate to its size and to the nature of its operations. These measures include providing the appropriate resources and staffing to internal audit in order to achieve its objectives.

In larger banks, and in banks with complex operations, internal audit should normally be conducted by an internal audit department with

a full-time staff. In particular, the internal audit department should evaluate:

- The bank's compliance with policies and risk controls (both quantifiable and no quantifiable);
- The reliability (including integrity, accuracy and comprehensiveness) and timeliness of financial and management information;
- The continuity and reliability of the electronic information systems; and
- The functioning of the staff departments.

The internal audit department should give adequate consideration to the legal and regulatory provisions covering the bank's operations, including the policies, principles, rules and guidelines issued by the supervisory authority with regard to the manner in which banks are organized and managed.

If a bank has a significant branch abroad, the internal audit department should consider establishing a local office to ensure efficiency and continuity of its work.

As separate legal entities, banking or non-banking subsidiaries are responsible for their own internal control.

At these subsidiaries, the internal audit function may be performed by the internal audit department of the Parent company. When subsidiaries have their own internal audit departments, they should report to the Parent company's internal audit department. In this situation, the parent company should take all necessary measures, without prejudice to local legal or regulatory provisions and instructions, to ensure that its own internal audit department has unlimited access to all activities and entities of the subsidiaries and that it carries out on-site audits at sufficient intervals.

For branches abroad as well as for subsidiaries, the internal auditing principles should be established centrally by the parent bank without prejudice to local, legal and regulatory provisions and instructions. The parent bank's internal audit department should participate in recruiting and evaluating local internal auditors.

5. EMPIRICAL ANALYSIS

Design/methodology/approach

The Chief Audit Executives (CAEs) of 56 Italian Stock Exchange listed companies were surveyed

with a questionnaire that had been sent to them via e-mail. The questions were formulated considering the literature on the organizational aspects of an Internal Audit and also considering the Italian legislative background.

In its configuration, the questionnaire allows the making of a univariate descriptive analysis useful in observing the distribution of individually investigated variables.

Comparisons to overseas studies, where possible, have been drawn. Two case studies related to the IA operating model and their IA organizational structure were also presented: Finmeccanica (Centralized Model) and UniCredit (Hybrid Model).

The survey aims to verify:

- 1) dissemination of alternatives proposed in the literature for carrying out the activities of Internal Audit in the corporate groups (in-house solutions and outsourcing solutions);
- 2) the model adopted for the organization of the activities of Internal Audit.

To this end, some aspects, considered most influential in the choice of organization, were:

- System of corporate governance adopted by the aggregate;
- Resources (financial and human) allocated to IA;
- Information systems in support of IA.

Sampling and survey conduct

Data was collected through an electronic questionnaire (August-November 2014). The survey design was directed to formulate questions which could be easily answered by the Chief Audit Executive (CAE) and limit possible framing effects.

The questionnaire was sent to 56 corporate groups selected from the list of the Italian group that are listed in Borsa Valori (Borsa Valori web site, accessed on 01 August 2015) and that operate in two sectors: banking (n. 17) and industrial (n. 39), which constitutes our sample frame. From the questionnaires administered, n. 34 usable responses were received, a response rate of about 60.7 per cent.

Before sending the questionnaire, telephone calls were made to confirm whether companies had an internal audit department and who was the person to be contacted to complete the survey, usually the Chief Audit Executive. In some cases, a reminder was given after the established

date for the last sending of the compiled questionnaires.

The non-respondents were contacted in order to understand their motivations. The main reasons for not taking part in the study were: a) the internal audit staff did not have time to dedicate to the survey; b) the company was not interested in the project; c) the questionnaire was considered not applicable to its company; d) company's policy was contrary to the participation in statistical surveys. A total of 12.5% of non-respondents did not provide any feedback on their failure to answer.

Data analysis

Regarding the dissemination of alternatives proposed in the literature for carrying out the activities of Internal Audit in the corporate groups (in-house solutions and outsourcing solutions) the Figure 5 shown that almost all of the groups adopt the in-house solutions, while the percentage of the groups that outsources the service is very low (10% just in the industrial sector).

As shown in Figure 6 (IA Operating Model in Italian Corporate groups), the centralized model of IA prevails in both the banking sector (64.29%) and the industrial sector (83.33%).

The decentralized model is adopted only by 16.67% of the groups of the industrial sector.

The hybrid model is adopted by only 28.57% of the groups in the banking sector and it is justified by the geographical delocalization that characterizes the companies of the group; in these case, it is decided to use the IA centralized

model for Italian companies and the decentralized one for the foreign companies.

In either sector, the delegation model is never used.

The learning organizational model is adopted by only 7.14% of the groups of the banking sector.

In the banking groups that adopt the decentralized model, 75% have appointed an IA contact person in each company in the group. In the industrial sector, the contact person exists only in 33% of the groups.

The matrix organizational structure is adopted in 21% of the groups in the banking sector and in 15% of the groups operating in the industrial sector, who declare, among other things, to be multi-business.

The internal management costs are the main reason that prompted the groups to adopt a centralized model.

The groups which adopt the decentralized model, however, feel the need to have a greater flexibility in the structure of Internal Audit.

Instead, the decision to outsource the IA service is linked to the need to bridge the lack of specific skills, and as noted by some groups of the industrial sector, to the small size of the aggregate.

78.5% of the groups of the banking sector adopt the traditional system of corporate governance, while the other 21.5% that of the dual system.

However, in 85.7% of cases, the Chief Audit Executives report to the Board of Directors and

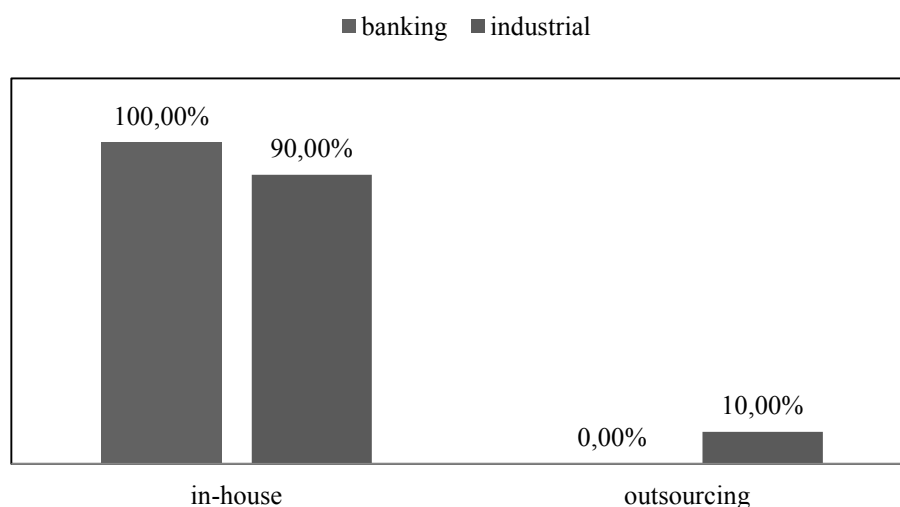


Figure 5. Adoption of the in-house solutions and outsourcing of services

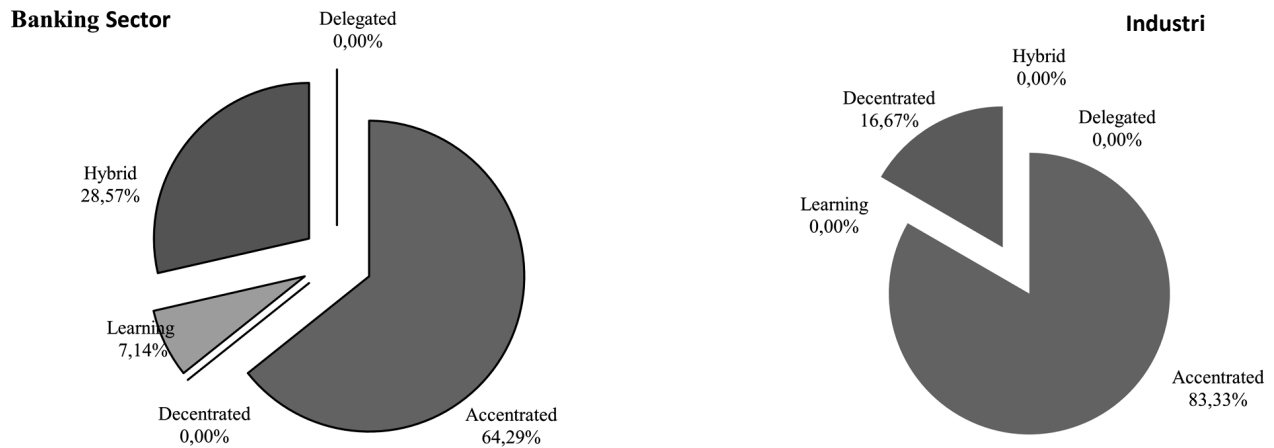


Figure 6. IA Operating Model in Italian Corporate groups

14.3% to the chairman of the Management Board and to the Chairman of the Supervisory Board.

64.8% of Chief Audit Executives fulfill, also, the functions of the Designated Internal Control Officer, while 57.1% of them are also members of the Supervisory Board which has the tasks of supervising the operation, effectiveness and compliance of the “Organizational, Management, and Control Model” adopted in accordance to the Legislative Decree n. 231/01.

100% of the groups of the industrial sector adopt the traditional system of corporate governance.

In 50% of cases, the Chief Audit Executives report to the Board of Directors and in 25% directly to the Chairman of Board of Directors, 15% to the Supervisory Board, and 5% reports to the Chairman of the Board of Directors, to the Supervisory Board and to the Designated Internal Control Officer.

50% of Chief Audit Executives fulfill the functions of the Designated Internal Control Officer, while 65% of them are also members of the Supervisory Board.

With regard to internal human resources employed for the Internal Audit activities, it is found that: in the banking sector, the number of employees ranges from a minimum of 19 to over 1,000 people.

In the industrial sector, however, in 50% of cases, only one person is employed for these activities; in 10% of cases, the number of the employees ranges from 20 to 70 people.

With reference to the financial resources dedicated to the Internal Audit function, it is noted that in the banking sector, 71% of the groups

allocate a budget of over € 100,000; 14% of the groups assign a budget of up to € 25,000 and 7% of the groups allocate a budget of between 25 and 50,000 euro. The remaining 8% of the groups did not answer the question.

In the three years (2012–14), 14% of the groups of the banking sector have maintained a constant budget for the Internal Audit, while 21% of the groups have increased its value. 57% of the groups have changed the budget in accordance with the needs of the entity; 8% of the groups did not answer the question.

In the industrial sector, however, the value of financial resources which groups devote to the Internal Audit function is diverse: 20% of the groups assign up to € 25,000; 15% of the group spend an amount of between 25,000 and € 50,000; 10% of the groups invest an amount between 50,000 and € 100,000; another 20% of the groups invest more than € 100,000. The remaining 35% of the groups of the industrial sector did not answer the question.

In the three years (2012–14), 55% of the groups of the industrial sector have maintained a constant budget for the Internal Audit; 10% of the groups have increased its value. 10% of the groups have changed the budget in accordance with the needs of the entity; 25% of the groups did not answer the question.

In the banking sector, 50% of the groups have a system of monitoring of costs related to the Internal Audit, while in the industrial sector, only 20% have it.

With reference to the presence of adequate information systems dedicated to the activity of Internal Audit, it is found that 97% of banking

groups are equipped with it, while in the industrial sector they are present in a smaller percentage (35%).

The main reasons why it is useful to have appropriate information systems are linked to: a) the creation of valid reports for the bodies of corporate governance; b) the traceability of the activities carried out by the staff employed for the Internal Audit; c) the general improvement of the quality of the information for the stakeholders.

Survey findings

There is no single model of internal audit: each organization adopts what is most appropriate to meet its needs in relation to the type of activity carried out by the different companies of the group, the size and complexity of the organization.

From the analysis of the data, however, it is possible to highlight some trends.

Regardless of the sector—banking or industrial—almost all of the groups have an internal function of Internal Audit which mainly operates through a centralized model.

The groups that outsource the service are a very low percentage contrary to what happens in other European countries such as Ireland (Ernest & Young, 2014) Netherlands (Spekle et al, 2007), or outside Europe, for example, Australia (Carey et al, 2006; Subramaniam et al., 2004), US (James, 2003; Ahlawat and Lowe, 2004; Dickins and O'Reilly, 2009), New Zealand (Van Peurse and Jiang, 2008) and South Africa (Barac and Motubatse, 2009).

In either sector, the delegated model is never adopted whereas, as noted in the study of Allegrini and D'Onza (2008), it is used in other groups (e.g. Fiat, Telecom and RCS) listed in Italian stock exchange but which operate in different sectors.

If the size of the entities, as detected in the paper carried out by Allegrini and D'Onza (2003), is one of the driving factors for determining the budget to be assigned to the Internal Audit Function, even the risk level inherent to the activities of the group can be considered a conditioning factor in the amount of resources (human and financial) to be allocated to the function of IA (Moulton, 2009).

With reference to the 2012–14 years, the financial budget for Internal Audit has remained

constant in both sectors. In contrast, a marked difference with reference to the staff employed in IA activities has been noted in the two sectors: while in the banking sector, the number of people employed in IA activities is variable, also in function of the greater use of the decentralized model, the industrial sector, usually, provides just one person. This finding should give pause, even considering that highlighted by Arena & Azzone (2009) with reference to the importance that external auditors attribute to the size of the IA team in the assessment of the quality of the Internal Audit.

The groups that organize the Internal Audit activities using a matrix structure are those who, while operating in several sectors, have identified common issues affecting the same structure of Internal Audit. However, there are groups that are mono-business and have subsidiaries located in Italy or abroad, which prefer to adopt a hybrid organizational solution rather than a centralized one for the organization of the Internal Audit activities.

With reference to these last two findings, the study continues with the analysis of two case studies related to the Finmeccanica group and the UniCredit group.

As shown in Figure 7, the two mentioned groups have been chosen in consideration of the human resources and financial budget they have assigned for the IA activities. They have resulted higher than the other groups of the sample. In particular, the Finmeccanica Group employs 70 staff and allocates financial resources of over €100,000, while the UniCredit Group employs 1,100 staff and allocates financial resources of over €100,000.

In regard to the organization of the IA function, while Finmeccanica adopts a centralized model, UniCredit uses a hybrid model.

Case # 1 The Finmeccanica Group

The Finmeccanica Group is one of the major Italian industrial groups. It is made up of about 200 companies directly or indirectly controlled by Finmeccanica SpA. Those companies operate in different sectors—Helicopters, Aeronautics, defense electronics and cyber-security, Defense systems, Space, Transport and other activities—and are among the top ten global players in the Aerospace, Defense and Security Sectors.

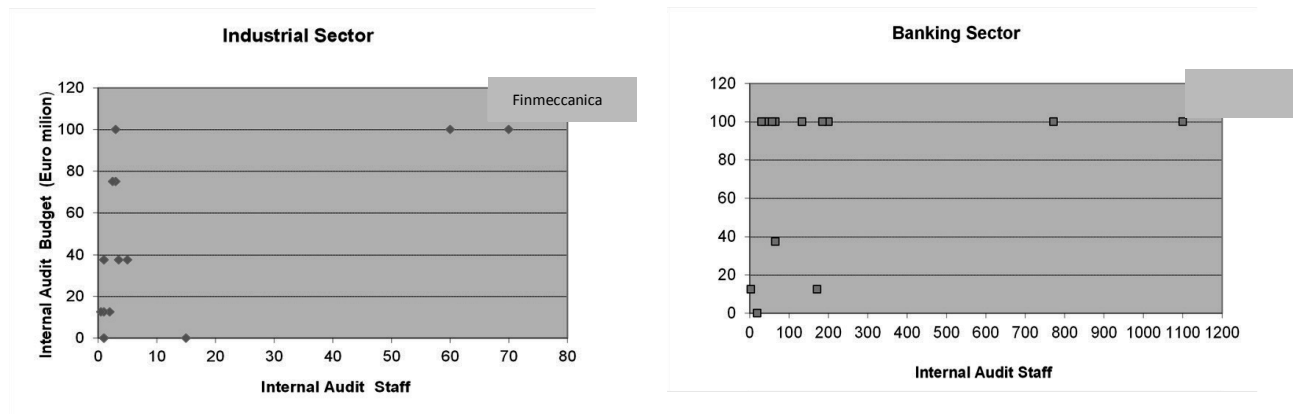


Figure 7. Human resources and financial budget assigned for the IA activities

Beginning from 2013, Finmeccanica has re-organized the Internal Audit Function of the Group, defining the centralization of the Group's Internal Audit activities with following aims:

- To increase the effectiveness of interventions and improve the efficiency of operating costs through a unitary audit structure;
- To increase the level of control and coordination of the Group's operating companies;
- to optimize the exchange of knowledge inside work groups, through a more transparent dialogue, cooperation of all those involved and sharing objectives with a core training unit;
- To improve the mix of skills through mechanisms of job rotation and career plans structured to allow for the acquisition of the importance of monitoring in management activities.

Through this structure, the allocation of business resources is clear at the corporate group level, the resources can be used at the right time, and the IA structure allows the company to fully manifest its potential.

The Group's new Internal Audit unit set up on 16 October 2013 reports to Finmeccanica SpA's board of directors and its functions are coordinated by the Chairman of the board of directors with the supervision of the risk and control committee in accordance with the provisions of the code of conduct for listed companies that Finmeccanica SpA has adopted.

The Group's Internal Audit unit is organized on a matrix model (Business Sectors/IA areas of activity).

To ensure the operational implementation of the matrix model, the person responsible of each business area reports its activities to the Head of the Group's Internal Audit and operates in con-

junction with functional referents for the different types of audits. To this end, the following organizational functions report their activities to the Head of the organizational unit "Group's Internal Audit":

- "Operational and Regulation Audit", with the responsibility of ensuring the preparation and monitoring of the Integrated Audit Plan, through the consolidation of the single contributions received from the other organizational units ("Commercial Audit, Fraud Audit e ICT Audit"), as well as directly supervising the implementation of interventions in the competent areas, ensuring also the coordination of the verification activities of the System of Internal Control and Risk Management, with specific reference to the Legislative Decree no. 231/2001 and L. 262/2005;
- "Project Management Office", responsible for planning and defining a correct balance in terms of qualitative and quantitative resource allocation taking into account the different sectors/types of intervention, in order to ensure the efficient and effective implementation of the Integrated Audit Plan as well as the constant alignment of the Group model to professional standards, national and international legislation; he is also responsible for managing and updating the Group Risk Library, in collaboration with other relevant corporate functions;
- "Management Audit", responsible for the implementation of audits required by Top Management and/or by the Boards of Directors and Surveillance Bodies not defined in the Audit Plan of Finmeccanica S.p.A or by the other Group Companies;
- "Commercial Audit", responsible in ensuring the implementation of the checks made in

relation to commercial aspects related to national and international standards, in coordination with the “Compliance” organizational unit (Legal and Compliance Corporate Affairs) and in collaboration with other relevant corporate departments;

- “Fraud Audit”, responsible for the implementation of the anti-fraud checks in connection with other competent business functions/units;

- “ICT Audit”, with the responsibility of implementing ICT tests, in order to prevent actions which may affect both the value and the functioning of asset/technological infrastructure of the Group, in collaboration with the organizational unit and ICT Security Officer of the Group.

Operational activities are governed by the Interrelation Operating Model. In regard to the aggregate planning of the verification activities to be carried out in each company of the group, the preparation and updating of the *Audit Plan* shall be drawn up taking into account the reports gathered during the risk-assessment activities and audit, the priorities expressed by Senior management (Finmeccanica S.p.A. and the other Group Companies), by the Audit and Risk Committee and by the Board of Statutory Auditors (Finmeccanica S.p.A. and the other Group Companies). It is established that the Board of Directors, the Audit and Risk Committee and the Board of Statutory Auditors of Finmeccanica S.p.A. are regularly informed by the Group Audit function on the progress of the Audit Plans and semi-annual monitoring of the Action Plan.

It is stated that the Statutory Auditors of all the companies of the group periodically inform the Board of Statutory Auditors of the Parent Company on the progress of the Action Plans mentioned above. The Interrelation Operating Model provides three types of audits:

1. *Ordinary Audits* that are provided in the aggregated Audit Plan; they involve a single company; the person responsible for its execution is the Sectorial Head of Internal Audit.

2. *Cross Audits* are carried out on several Group companies and are designed to: a) assess the degree and uniformity of implementation and adoption of Group directives and guidelines; b) analyze the ways in which activities/processes are managed within the Group.

3. *Special audits* are implemented on one or more companies and are required by the *ad hoc* bodies of Control and Supervision as well as by the senior management of each entity of the group; they are designed to conduct timely inspections of specific areas identified as particularly critical, for which Management Audit is responsible.

The Interrelation Operating Model regulates the flow of information (reporting), in relation to all three types of audit.

In March 2014, the Director in charge of the internal control and risk management system (SCIGR) of Finmeccanica Spa, prepared the document named “Guidelines for the internal control and risk management system”, which, compared with those prepared and approved during the 2013 financial year, led to a more precise definition of risks in the Group Library and a corresponding degree of coverage by means of the existing control mechanisms.

In this document, the Finmeccanica Group’s risks are identified and are classified as: *Compliance risks* (arising from the performance of ordinary business operations, which relate to the failure by the business activities to comply with the relevant contractual clauses, laws, regulations and rules); *Strategic risks* (affecting the degree of success of the Company’s strategies, the processes’ ability to achieve the objectives defined by Top Management and the Company’s image); *Operating risks* (concerning ordinary business operations, which affect the efficacy and efficiency of the various corporate areas or processes) and *Financial risks* (arising from the performance of ordinary business operations, which affect economic and financial figures within the management of accounting and reporting, taxation, cash and credit).

Case # 2 The UniCredit Group

The UniCredit Group is a leading global financial group with roots in 18 countries, with representative offices and 8,954 branches in 50 international markets.

As showed in Figure 6, the UniCredit Internal Audit function — structured as a Department — coordinates and monitors the Group’s Internal Audit activities performed by the competent structures of the various entities. It also performs third level control activities as well as on-site

inspections on the Parent Company and on the Group's Entities which outsource the internal audit activities to UniCredit ("in-service company").

In addition, the Department can conduct on-site visits on any Entity of the group, as a Group Internal Audit function. The IA Department also plays a role of steering, coordinating and monitoring the audit activities carried out by the Group's Entities Audit functions and continues updating the existing standards and policies in order to better support the audit process in the carrying out, reporting and monitoring phases, as well as the revision of the Group Audit Charter.

The Internal Audit Department of UniCredit verifies the compliance of the behavior of the companies belonging to the Group with the indications of the Parent company, besides the effectiveness of the internal auditing systems.

In the past, the activities of IA were carried out by a company specifically set up within the group, that is, by UniCredit Audit S.c.p.A., which, in 2013, was merged with the holding company. Top management decided to centralize and thus to provide for the managing of the IA within the parent company. The objectives that the management intended to pursue through the aforementioned modification were:

- To assign the task of coordinating and planning of IA activities on a group level to the management of IA, governing, in particular, the budget, the methodology, the IT tools and reporting;
- To delegate to the sub-functions of IA, located in each aggregate company the IA activities specific to each individual participating entity;
- To improve the overall effectiveness and efficiency of IA activities;
- To contain costs through the elimination of IA structures, which in the past overlapped.

The Internal Audit Department acts in compliance with the Audit Charter which defines its mission, responsibility, organizational structure, independency, tasks and powers. In particular, pursuant to the abovementioned Audit Charter, the Internal Audit is an independent function and is an integral part of the internal control system.

The Internal Audit Department, through an objective analysis of the circumstances identified during its control activities, and through the

assessment of the completeness and correctness of the design and functioning of key controls, aims at providing an independent assessment on the adequacy of the internal control system of the Company.

The Internal Audit can also provide consultancy services which aim at bringing added value and support to the Company assisting it in achieving its objectives, without compromising its independency.

The Internal Audit performs its activities in compliance with the Internal Audit Group Standards, which include the Ethic Code.

The Internal Audit Department reports, directly or through the Internal Controls & Risks Committee, to the Board of Directors and it is not assigned with any operational areas but reports hierarchically to the Board of Directors.

The Internal Audit function performs the following tasks:

- To develop a flexible annual audit plan through an adequate risk assessment, submitted to the Board of Directors for approval;
- To implement the annual audit plan—as approved—including the engagements or special projects requested by Management and/or by the Internal Controls & Risks Committee;
- To perform special investigations on operational events;
- To inform the corporate bodies, summarizing the results of the audits performed and the implementation status of the Management action plans.

In particular, in order to provide the corporate bodies and the Senior Management with an overall assessment of the internal controls system, the Head of the Internal Audit function arranges a quarterly report, called "Internal Audit Activities and Results (IAAR)". IAAR includes not only an assessment of the internal controls system, but also summary information on the activities performed, on the main risks which have arisen and on the implementation status of Management action plans.

Furthermore, the Internal Audit function forwards the Audit Reports rated *critical* directly to the Board of Statutory Auditors; in any case he can also send further Audit Reports which include significant deficiencies to the Internal Controls & Risks Committee and to the Board of Statutory Auditors.

With specific regard to the planning of activities, the Internal Audit function arranges:

- Group Audit Plans, based on the Risk Assessment results, in compliance with the Group Audit guidelines. Group Audit Plans also consider the requests made by Regulators and corporate bodies;
- the UniCredit Audit Plan as part of the Multi-year Audit Plan (5-year plan) based on the mandatory audits and risk assessment of the Audit Universe (“AU”) of UniCredit.

The Multi-year Audit Plan—revised annually based on risk assessment—enables an efficient and effective coverage of the AU in line with the risks of the Bank. The above mentioned Plans include IT auditing activities. As of March 1, 2013 UniCredit does not have total or partial outsourcing agreement of the Internal Audit function.

6. CONCLUSIONS

As the company is, by definition, a dynamic system that changes over time in relation to institutional, structural and environmental changes, even Internal Auditing has undergone, over the last decade, an important evolutionary process that has transformed IA from a mere tool of internal control—linked to the accounting and finance fields—to a real business function that invests in a set of sub-systems and enterprise resources dynamically and across the board.

With this study, we have intended to contribute to the scientific literature on the organizational aspects of Internal Audit, with particular reference to business groups. The proposed analysis, however, is not without its limitations: the small size of the sample, in fact, could affect the results. Consequently, it would be wrong to generalize based on the conclusions we have made.

However, it can be stated that there is not an exclusive model for organizing and managing Internal Audit: the administration can choose to have an internal IA (in-house), or it can entrust the same entirely to an outside provider (outsourcing), or it can consider the possibility of combining the two options (co-sourcing). The latter solution allows the organization to acquire specific competence from the outside (for example, of legal nature) that is not present inside the group, thereby allowing for the adequate functioning of IA activity.

The application and weighting of the individual criteria used for choose and assessment the appropriate IA operational model and the organizational structure of the IA Department will depend on the nature, scope, complexity, and risk profile of the institution. Whether in-house, outsourced, or somewhere in between, the internal audit department model should be based on the defining characteristics of the group as well as the specific applicability and potential benefits and challenges associated with each operating model.

Executive management and audit committees should periodically review their group’s risk profile and determine if their current internal audit model is optimal for parent company, subsidiaries entities and significant stakeholders. The many challenges internal audit departments face today, coupled with the administrative costs associated with maintaining an internal audit department, have caused many companies to re-evaluate their internal audit operating model.

Each company, therefore, as seen from the cases proposed, adopts the model that is most appropriate to meet its needs and to take advantage of the potential benefits that derive from it in terms of keeping costs low, increasing effectiveness of actions, acquisition of specific competencies that are lacking, or greater flexibility in carrying out audits.

This is true not only with reference to the business groups or firms of a medium or large size but also for smaller ones. These, like the others, should be equipped with an Internal Audit function that enables them to ensure not only the effectiveness of governance processes but also, to address the risks arising from the environmental complexity in which they are contextualized.

However from the analysis carried out in the Italian context, it was found that within the groups included in the sample and, especially, in those of the industrial sector, there is not a real function of IA, at the most, in terms of human resources, only a few units are assigned to perform this task. However, what emerged was the will not to outsource the function and to centralize the activities of IA in the parent company, especially in order to internally manage its costs.

The complexity and number of activities and sectors in which a business operates, the size of

the aggregate, human and financial resources allocated to IA activity and the geographical location of the companies belonging to the group, all make up the main variables that weigh on the organizational aspects of Internal Audit. In particular, these variables are decisive each time that the group must decide:

- Whether or not to externalize IA activity, having the choice between adopting an in-house model or an outsourcing model;
- Whether to centralize or decentralize in the holding the function of IA, if it should choose to adopt an in-house model
- Which organizational structure (functional, divisional or matrix) to adopt to manage IA activity in a corporate group.

The survey has shown how Italian corporate groups, in the banking and industrial sectors, have chosen to carry out internal audit in different ways. The used approaches aim to inform rather than judge, and the authors hope that the contents of the paper may encourage continuous improvement: some times, the benefits of one

organizational solution may represent issues and challenges for another. The importance of the internal audit function is growing and is creating more and more expectations: as highlighted by Chartered Institute of Internal Auditors (2015), *it would not be surprising if new models were to emerge in future.*

A research line for the future, which may be an interesting follow up, involves a bivariate or multivariate analysis for testing the relationships between pairs or groups of variables that affect both the choices of the organizational model of Internal Audit and the assigning of the budget that should be allocated to the function. Consistent with previous studies of the importance of internal audits, another research line for the future regards an empirical analysis to examine the effect of the internal audit on group performance. It would also be interesting to see whether or not the choice of in-house or outsourcing for IA activities has an impact on the overall performance of a corporate group.

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