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Economic Policy for Vietnam in a Period of Economic Turbulence

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Introduction

Vietnam has a decade or more of economic reform experience, and most of it has been good.[1] GDP growth has been healthy, even after taking the 1998-2000 slowdown into account. Real output doubled from 1990-2000 and real output per capita grew by two-thirds. Poverty has been greatly reduced, health and education are broadly improving, and regional economic growth has been widely if not evenly spread. Most remarkably, exports have shot up seven times in US$ (1991-2000), showing that Vietnam is quite capable of competing in tough foreign markets. The energetic response of private firm creation in the wake of the Enterprise Law shows that many Vietnamese want to run their own companies, and create jobs and output at the same time. A naïve observer would remark, "well done - do more" and go on to the next issue.

But the issue is more complicated than that. The world economy Vietnam now faces is not the benign global boom it enjoyed for much of the 1990's. Parts of Asia in 1998, and Japan for much of the last decade, had already faced actual contractions in output or very slow growth. Now, however, there is the prospect of a pronounced slowdown in growth in most major regions of the world, in both developed and developing nations. China and perhaps India with their large internal markets and low export/GDP ratios are exceptions to this general trend, but there are few others. How bad is the outlook, and should a poor outlook for global economic growth suggest a different growth strategy for Vietnam?

[1] While original *Doi Moi* reforms began in the later 1980's, many of the key changes -such as the reduction in inflation rates and certain price reforms - only took place in or after 1991. The Enterprise Law only took place in January of 2000. For the private sector, this was a decisive reform.

The Changed Global Outlook

The first question is how bad is the outlook for the global economy? For the OECD[2] nations, an October 2001 revision to their forecasts shows how much lower expected real GDP growth now is:

GDP Forecasts as of May and October

Country	2001 (May)	2001 (Oct.)	2002 (Oct.)
US	1.7%	1.1%	1.3%
Japan	1.0%	-0.7%	-0.8%
Germany	2.2%	0.7%	1.0%
UK	2.5%	1.9%	1.6%
France	2.6%	1.9%	1.6%
OECD 30	**2.0%**	**1.0%**	**1.2%**

Source: Organization for Economic Cooperation and Development; cited in Financial Times, 10/19/2001, p.1

The May estimate of 2002 growth for all OECD members had been 2.8%, but this is now only 1.2%. While some of the slowdown can be attributed to the terrorist attacks and their impact on air travel, tourism, and even general consumer spending, it would be wrong to attribute the change only to those causes. There had been too much investment in several sectors, and in the US both companies and consumers had taken on too much debt. Economists had underestimated the difficulties these mistakes would cause, not only in the US but also in other economies. The events of 9/11 gave a further push to an already fragile situation, and allowed many forecasters to revise their past forecasts with less embarrassment. For example, Morgan Stanley (an investment bank) changed its prediction for 2002 GDP growth in Latin America from 3.3% to 0.7% after Sept. 11th while non-Japan Asian growth fell from 5.8% to 4.5%. Most forecasters now expect any global recovery only to occur later in 2002 and even this is uncertain. The table below gives some October 2001 estimates of GDP growth in 2001, forecasts for 2002, and also actual GDP growth for 2000 and average annual GDP growth from1990-99.

	2000	2001	2002	1990-99
China	8.0%	7.5%	7.3%	10.7%
Hong Kong	10.5%	-.2%	2.3%	6.9%
India	5.2%	5.2%	5.8%	6.0%
Indonesia	4.8%	2.9%	3.4%	4.7%
Malaysia	8.3%	0.0%	2.5%	7.3%
Philippines	4.0%	2.5%	2.9%	3.2%
Singapore	9.9%	-1.4%	2.2%	8.0%
South Korea	8.8%	1.8%	3.2%	5.7%

[2] The OECD, or Organization for Economic Cooperation and Development, is a group of 30 mainly rich nations from North America and Europe, with Japan, South Korea, Australia, and New Zealand also among its members. The Secretariat in Paris makes twice-yearly economic forecasts.

Taiwan	6.0%	-2.1%	2.3%	6.5%
Thailand	4.4%	1.6%	2.7%	4.7%

Source: The Economist, October 20, 2001. They collected data from various forecasters for 2001 and 2002. The 2000 data are taken from the Asian Development Bank web site, and 1990-99 from the World Bank's 2001 World Development Indicators. (Table 4.1) except for Taiwan. That comes from the Taiwan Statistical Data Book 2000. It should be noted that many analysts believe official Chinese GDP data are overstated by at least 2% a year.

It should be kept in mind that the 2002 forecasts are tentative, but they show that most nations are expecting sharply lower growth in 2002 compared to the 1990's, though higher than 2001. Much will depend on the ability of the OECD nations to recover from the recession. If this comes in mid-2002 as expected, growth should also pick up in many other nations. If not, a longer period of slow growth is likely.

At times like this, it is best to inquire what has changed and what has stayed the same. A good deal of the gains in production in the last decade came from increasing global economic integration. As more and more output was traded, firms, consumers and nations reaped benefits from economies of scale, learning-by-doing, and the ability to spread research costs over more units of output. A decreasing share of spending went to military uses, which are not directly productive. (The US share of military spending in GDP had fallen below 3% compared to over 6% in the 1980's.) If the rise in terrorism reverses these trends, then long-term growth prospects will be reduced. More money will be spent guarding airports, refineries, electrical power plants and lines, pipelines, fuel storage depots, dams, etc. There will be delays as more containers and trucks are searched. Resources will be diverted to counter-terrorism, concerns with biological threats, etc.

These shifting priorities will not only slow the economies of the rich nations. The poor nations will also feel the impact, both directly and indirectly. The direct impact will be felt because they too have many "soft" targets and will have to take some defensive steps. The indirect impact will come because a slower rate of economic growth in the rich countries means a slower growth of demand for the exports of the poor nations. Not surprisingly, everyone can be poorer if new threats cause resources to be switched from productive to non-productive but necessary defensive uses. (Even though the costs of extra guards are counted as part of GDP, they may not even bring back the previous level of security, much less otherwise increase welfare. So welfare and growth are reduced.)

In summary, there are two differences from the 1990's. First, the entire world is likely to enter a recession or period of pronounced slow growth. It is uncertain how long this will last, but most estimates see a pickup coming sometime in 2002. Most recessions last only a year or so, and if peak employment is used as a marker of the start of the recession, the pickup in the US should come in the middle of 2002. The second difference is that longer-term growth rates may be slower than before due to higher costs. It is unclear what the magnitude of this factor will be, but $100 billion in higher costs of surveillance, police, etc. would be 1% of US GDP. If this were taken from investment rather than consumption, then growth would slow by as much as 1/5th of 1%, or from 3% to 2.8%. This is a definite cost, but not so much as to change the fundamental outlook. Indeed, as better technology is used to improve inspections, it is reasonable to think that many of these costs would decline over time.

Past Winners and Losers

There is another way to approach this question. Let us look back at past shocks to the world economy and see how differently run economies responded to them. The oil shocks of 1973-75 and 1979-81 are examples of periods of world recession and turbulence. What types of economies managed to adjust fairly smoothly, and what kind of economy had a rough time paying for oil and finding ways to service its debt?

Basically, the world breaks down into economies that are oriented internally for self-sufficiency, and those that emphasize exports, especially of manufactures.[3] (The oil-based economies are a third type. They benefited from the oil price rises and are not reviewed here, since their "shock" was positive.) The typical economy that was oriented towards import-substitution (IS) had high tariffs and other trade barriers, often with an overvalued exchange rate and controlled interest rates. This allowed domestic industry to be high-cost, and uncompetitive with few world-class producers who exported, and a bias against primary exports. Since inputs for exports were expensive, not many manufactured exports or other exports were profitable.[4] When oil prices rose and a world recession ensued, the IS nations found that their raw material export prices fell or rose only modestly, while oil import prices were several times higher. Unable to export manufactures to supplement declining or inadequate raw material exports, they had to squeeze imports of intermediate and capital goods. This led to a slower rate of growth. In some cases (e.g. Brazil), the immediate response was to borrow more. This allowed fast growth to continue until about 1980, when the debt burden became too heavy, and then growth slowed for a considerable time - really one to two decades. In short, the IS countries "painted themselves in a corner" from which it was difficult to exit. They lacked the ability to respond competitively during a period of weak global growth.

Import Substitution	*Real GDP Growth*			*Export/GDP Ratio*		
	1960-70	1970-80	1980-90	1970	1980	1990
Bangladesh	3.6%	3.3%	4.3%	.05	.06	.08
Brazil	5.4%	8.7%	2.7%	.07	.10	.07
Argentina	4.2%	2.5%	-0.7%	.11	.05	.10

[3] There are some very poor economies with only primary exports and little manufacturing, but these are not of immediate relevance or interest.

[4] The manufactured exports in 1970 of all of Latin America to the OECD nations were $1.3 billion, while Hong Kong alone had manufactured exports to these rich nations of $1.9 billion! Latin America followed IS policies, while Hong Kong was an open port. Even in 1990, Latin America less Mexico (excluded due to border processing deals with the US) had manufactured exports of $22.2 billion while Hong Kong's level was $24.3 billion. Latin American population (less Mexico) was **sixty** times that of Hong Kong. Similar figures for 1990 come from India ($9.2 billion in manufactured exports) vs. Thailand ($10.5 billion), even though India had more exports than Thailand in 1970 and fifteen times as many people. Policy counts!

Export Oriented

S. Korea	8.6%	10.3%	9.4%	.14	.34	.31
Taiwan	9.6%	9.7%	8.2%	.30	.53	.45
Thailand	8.2%	7.7%	7.6%	.15	.24	.37

The export-oriented countries started with a fairly high export/GDP ratio, and it grew to reach much higher levels. They also had most of the growth in exports come from manufactures. Thailand, for example, started with only 25% manufactures in 1978, but twenty years later the share of manufactures had risen to nearly three-quarters. So, these fast-growing nations used growing manufactured exports as a leading sector. (Other nations, such as Malaysia and - after 1980 - Indonesia did the same but they also benefited from high oil prices.) In contrast, the IS nations never managed to reach high levels of exports/GDP. The fluctuating levels export ratios are due to fluctuating prices of major exports, such as coffee for Brazil. For Bangladesh, there were few exports except for quota-textiles, and these grew faster than GDP, but not so much as to push growth much.

The interesting point here is that the more "exposed" nations were actually able to grow better and get more stability because of the skills learned while exporting. Their low tariffs, at least on goods to be used for exports, and other business-friendly policies allowed firms to develop technical and marketing skills. When prices changed and rich economies slowed, they were more nimble than their import-substituting competitors. It appears from this cursory examination - which could be extended - that by trying to wall oneself off from the fluctuations in the global economy, the cure is worse than the disease. A number of studies have found this to be true for large samples of nations. One famous study by Sachs and Warner[5] found open economies grew by nearly 5% a year while closed economies grew by less than 1% a year. This is a huge and astonishing difference, even if it is correct to argue as some critics have, that openness is a necessary but not sufficient condition for sustained economic growth.

Vietnam is Now an Open Economy With Special Characteristics

Vietnam, of course, has had a spectacularly successful experience in increasing its exports. All exports in 2001 are 50% of GDP - higher than the exporting nations discussed in the table! Even excluding oil, exports/GDP will approach 40% of GDP. While manufactured exports are still a relatively small proportion of total exports, they have been growing faster than other segments. However, recent experience suggests that further fast growth in textiles and footwear exports will be difficult. To widen the types of manufactured exports will require a deeper kind of competitiveness. Vietnam will need firms that understand foreign markets, make better use of technology, and have fast decision cycles so that fleeting opportunities are seized rather than dropped due to sluggishness.

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[5] Jeffrey Sachs and Andrew Warner, "Economic Reform and the Process of Global Integration", *Brookings Papers on Economic Activity*, 1995.

A large part of the current Vietnamese investment strategy is to develop “heavy” industry. There are plans for two oil refineries, two urea plants, a steel industry, millions of tons more capacity of cement plants, and many more similar investments. These investments will cost many billions of dollars. They are mostly aimed at import substitution. They seem to require fairly high tariffs in order to break even. It is not clear to what extent these tariffs will conflict with existing trade commitments under the ASEAN Free Trade Agreement, the Bilateral Trade Agreement, or the forthcoming agreements under the WTO. If they do conflict, then Vietnamese exporters will face retaliation in sectors of Vietnam’s trading partners, and the retaliation is typically imposed on the most competitive exports. These are the ones with the highest growth potential and, often, the greatest employment growth. A decision to favor high-cost local production is ***necessarily*** also a decision to discriminate against competitive exports. (It is not comforting that other nations, including the US, are also protecting domestic steel production by imposing “anti-dumping duties” on low-priced imports. It has been estimated that for every steel job saved, consumers in the US will pay $500,000 in higher prices of steel!)

This disconnect between trade and industrial policy will be resolved in one or more of three ways:

1. The high cost industries will remain high-cost and need tariffs or subsidies.
2. The high cost industries will shut down.
3. The high cost industries will be able to lower their costs and compete.

It is possible that all three of these outcomes will occur, even with one product. For example, while a few sugar factories are already competitive at world prices, many others will be able to operate only at the high domestic prices, and some will have to shut down even with those high prices. The policy of charging poor Vietnamese consumers double the world price so that foreign buyers can purchase subsidized sugar exports from high-cost producers in Vietnam is especially curious. Why would any government want to “tax” (by high prices) its own citizens to benefit foreigners? Of course, any Vietnamese exporter needing sugar is automatically at a disadvantage with this policy. Pineapple exports in cans with sugar syrup are unlikely if sugar is so expensive! The decision to produce a million tons of sugar was not meant to hurt pineapple farmers, but that is its impact.

The recent increase in imports of Chinese motorcycles is another indication of the distance between protected production and competitive costs. Locally assembled Hondas had cost over $2000 when the Chinese motorbikes began to come in. With a cost of only about $600, they quickly gained a large market share. Honda has cut its prices, but upgrade kits using Honda parts for the Chinese bikes (costing $100-$200) allow the quality difference to diminish and Honda will remain under tremendous pressure. This scenario will be repeatedly replayed unless Vietnam develops policies to encourage low-cost producers.

The full implication of China joining the WTO and successfully attracting foreign investment needs to be understood. Their high savings rate, sizable pools of both skilled and unskilled low-cost labor, and large domestic markets make them a formidable competitor in many of the goods that Vietnam (or ASEAN) might normally expect to produce. Rather than focus on whether or not a company is state-owned or private, or based in the north or south, it is more strategically correct to think in terms of ANY successful Vietnamese company being crucial for effective competition against China. Reducing the disparity in treatment between private and state firms is not just fair - it is a required condition for successful industrialization, and thus for successful development.. Without successful industrialization, the ability of the economy to generate anywhere near enough jobs for the millions of young Vietnamese who have some secondary school education and are unwilling to work in agriculture will be utterly inadequate. That would lead to many social problems that are best avoided.

Fortunately, there is real hope that Vietnam can find a way to live with its huge neighbor and still find a rapid growth path. There are several reasons.

1. Unlike Vietnam, whose state sector is small (2 million or only 5% of all labor) in terms of employment, China has a large state sector and fears growing social unrest. While it is pushing for more efficient and fewer state enterprises, it will slow down this process when social tensions rise beyond some point. Indeed, it was doing this in October when its Supreme Court virtually ordered a halt in bankruptcies of larger state owned firms. China's need to be cautious gives Vietnam an opening, if it is nimble. China had over 85 million SOE workers in 1999 (down from 112 million in 1996), which was over 40% of all urban workers, and needs to worry about layoffs. Vietnam has plans to use foreign aid to compensate retiring workers in state-owned enterprises, and so could reach a competitive level with minimal social friction. It can and should move faster than China, opening up new opportunities.
2. Many multinational companies are reluctant to "put all their eggs in one basket." That is, they want to diversify their production among several different nations. Thus, for Nike, no more than 30% of sales will come from one nation. This gives Vietnam a chance to be nearly as important as China in a number of important exports, if it can also become a low-cost and high-quality producer.
3. When China grows, the income of its people also grows. They buy more of many things that Vietnam can sell: rubber, coffee, tea, seafood, and other foods and raw materials. If these are processed efficiently, their huge demand can give a lift to many agro-industries in Vietnam. China, after all, typically imports about as much as it exports. There is no reason given its location and ability to find out about markets in China why Vietnam should not become a beneficiary of a prosperous China, just as Mexico has managed to benefit from US growth in the 1990's.
4. The huge response to the Enterprise Law suggests that there is a tremendous energy and interest in owning and running businesses all over Vietnam. If the financial system and other changes allowed the best of these businesses to grow rapidly, then there is every reason to expect that local firms would be able to compete.

5. Vietnam is still small, especially in terms of its manufactured exports. Small players can grow more easily in sluggish conditions. The newly open US market could attract a number of investors and help support rapid export growth. Instability in other ASEAN societies could also make Vietnam a more desirable investment destination, though there are clearly other negative effects from that turmoil.

In many other respects, Vietnam is well situated to benefit from relatively open flows of goods and capital. It has a well-educated work force, renown for its ability to work hard and learn quickly. It is close not just to China, but also Taiwan, and other Asian economies that are good markets or likely to "spin off" labor intensive export activities that could easily fit with Vietnam's economic potential. It has achieved macroeconomic stability, a competitive exchange rate, and an improving legal climate. If the world economic weather forecast is cloudy and stormy, at least Vietnam is in a good relative position.

Vietnam Needs Rapid and Labor-Intensive Growth

However, it is one thing to start a race from a good position and another thing to win the race. The importance of good policy is arguably more important in a weak global economy than a good one, when many mistakes are forgiven or erased by a general upward trend. Indeed, it now appears that Vietnam is facing both a tougher internal as well as external environment. Data from the Ministry of Labor showed a surprising *drop* in the level of workers in agriculture from 1996 to 2000.[6] Those counted as being in farming fell from 24.4 million to 22.7 million, suggesting job losses in that sector of 400,000 workers a year. New entrants to the work force are at least another 1 million a year, and any displaced workers from state enterprises would add even more job seekers. These data are not shocking, for most of the younger workers have at least some secondary education. With the share of agriculture in the work force over 60%, but its share in output less than 25%, the gap between non-farm and farm (or urban and rural) incomes is high and growing.[7] It is to be expected that as older workers retire, many more of the younger ones will want to earn higher incomes and benefit from other amenities of urban life. But that also means that literally millions of jobs need to be found at a time when state enterprises are likely to be shedding workers along with agriculture. The paramount task of the Vietnamese government is to create conditions for generating new jobs. These jobs need to be productive and sustainable, not simply make-work activities supported by the budget.

With the SOE sector providing only 5% of jobs and likely to shrink, there is no question of the government being able to provide jobs directly. They will have to come from the private sector, both domestic and foreign. The foreign sector with 300,000 workers in 2000 would do very well to double its workforce over the next five years. The formal

[6] Status of Labour-Employment in Vietnam 2000, Ministry of Labour, Hanoi, 2001
[7] In 1994, urban per capita monthly income was 360,000 dong and rural income was 141,000. By 1999, urban incomes had risen to 832,000 and rural to only 225,000. The gap had risen from 119 to 830 thousand dong! Figures on Social Development in the "Doi Moi" Period in Vietnam, GSO, p. 377

private sector had one million workers in 2000 and 20% employment growth (very optimistic!) would add 300,000 jobs a year to 2005. This leaves the 8.6 million in informal and household sector jobs in 2000 and that sector will have to absorb the rest. (Very few will migrate abroad.) But we know that productive job growth in the informal sector largely mirrors the overall rate of economic growth. Vietnam needs 8 to 9% growth just to keep opportunities growing nearly as fast as likely entering workers in that sector. The table below gives illustrative calculations of what negative job growth in agriculture and zero job growth in the state sector imply in terms of the other sectors.

	2000	2005	Annual % Growth
Labor Force (millions)	38.6	43.6	2.5%
Employment (millions)	36.2	41.2	2.6%
Of which:			
Agriculture	22.7	20.7	-1.8%
State Sector	3.6	3.6	0.0%
Foreign	0.3	0.7	18.5%
Formal Private	1.0	2.5	20.0%
Informal/Household	8.6	13.7	9.8%

Notes: Figures for 2000 are actual data. Projections for agriculture are based on 1996-2000 trends. The state foreign, and formal private sector jobs are from assumptions. The informal/household sector is calculated as a residual. The employment projection assumes a constant number of unemployed.

This table is alarming. It suggests that even if the formal private sectors, foreign and domestic, do incredibly well, it will still be very hard to manage adequate job growth in the next five to ten years. If the growth in informal sector jobs is thought to be unrealistically high, it is not clear where the adjustment would come from. Will fewer people switch out of agriculture than in recent years, given the growing income gap and rising educational levels? Will the state sector become a net source of jobs, and in a significant way, given the planned conversion or closure of many existing state firms? (Indeed, the 20% annual growth in private domestic employment reflects some gains from converted state enterprises.) Or will the number of jobless grow faster than projected?

The conclusion of this brief analysis is that Vietnam needs GDP growth as rapid in this decade as it achieved in the last one, but with more employment intensity in the non-farm sectors, because agriculture is no longer contributing to job growth, as it did prior to 1996. The goals of poverty alleviation, reasonable equality in job opportunities, and avoidance of social evils all turn on the ability of the state to create appropriate conditions for both informal and formal sector private firms.

Constraints to Stabilizing Growth

Consider that the rate of GDP growth needs to be rapid and the employment intensity of that growth needs to be higher. Now seek out those investments and policies that will support fast, labor-intensive growth. Conversely, identify those activities that frustrate or diminish those goals. Into which box do most of the import-substituting investments fit? They cost many billions of dollars, generate few continuing jobs, and raise the costs of inputs above those of imports for labor-intensive exporters. They generate little or negative value added at world prices, meaning they are both anti-growth and anti-employment. Such investments have strong political and bureaucratic constituencies, but are not good for the economy! Unless they can operate without subsidies or protection, they simply favor an inefficient industry by imposing costs on other sectors.

Another part of the answer lies in the financial system. The financial system in a market economy is like the heart in a person. Money is the blood, and a healthy financial system takes in money (savings) and pumps it out to where it is needed. The financial system in Vietnam is not healthy. Institutions that have a great deal of trouble lending to private businesses dominate the banking system. For historical and other reasons, they even deposit hundreds of millions of dollars in low-yielding foreign bank accounts rather than lend it out within Vietnam! (The Bank for Agriculture and Rural Development does have a record of making successful short-term loans to farmers.) There is virtually no private bond market, only very limited leasing activity, and an extremely modest stock market. In short, private firms rely either on their own resources or on borrowing from friends, family, and private sources. This makes their growth slower than it otherwise would be, and restricts their ability to make larger or longer-term investments.

The most obvious way to reduce the blockage would be to allow a greater role for foreign banks in Vietnam than is now the case. Foreign banks taking in and lending local deposits would bring in credibility, capital, capacity, and discipline. Their global portfolios are big enough that they could take on exposure that Vietnamese banks would find risky. They would demand – and thus help develop – accounting and managerial practices that would help Vietnamese borrowers to become more efficient. Yet the acceptance of private foreign banks is scheduled to take about one decade after the BTA is ratified, though minority stakes will be possible in 2002. The state-owned commercial banks argue that they need time to become more efficient. The question to be asked is how quickly can they become efficient? And, can the economy wait as long as it will take them? Bank reform without "new blood" has been found to be very difficult in other Asian economies, and it is likely that Vietnam is not so different. The longer it takes to begin using savings efficiently, the slower the private sector will grow.

Improving the performance of the banking system is not the only desirable financial reform. Life insurance companies[8], commercial bond markets, leasing firms, and vibrant stock markets are all part of a well-functioning financial system. Yet, except for the Development Assistance Fund – a bureaucratic creation that absorbs large amounts of aid and other funds – and lends largely to government projects, there has been only modest progress in other sectors. Life insurance sales have grown rapidly, but it is not clear where they will be able to invest productively unless other reforms are made.

[8] A.I.G., the American International Group, has operated in China for many years and helped to develop a better life insurance sector, and also upgraded analytical skills in investing in Chinese companies. Similar benefits could occur in Vietnam if conditions allowed long-term investments in competitive firms.

The pace of reform with state-owned enterprises has been slow in 2001 and also the last five years. While the numbers of "converted" state firms now mount to the hundreds, they are all small. Perhaps 2% of state capital has been "equitized" since 1995. So long as this reform goes slowly, there will be resistance to bank reform, great difficulty in creating a "level playing field", and a large lobby group devoted more to political negotiation to maintain advantages than to study ways to compete in the global economy. The high cost of telephone service, often noted now for several years, has been lowered only a little. Even using low cost calling services, Vietnam's costs are more than triple Indonesia's, four times China's and six times Malaysia's costs for calls to or from the US. This is part of the hidden cost of an effective state enterprise monopoly when the state enterprise does not perform as well as similar companies in neighboring countries. [See Box on next page.]

Provincial Differences – What Are the Main Reasons?

The policy of Vietnam is now at a point where local governments are *allowed* to attract both private domestic and foreign investment. But those unfamiliar or unwilling to do so often resort to older mechanisms to spur growth. Public investment is often used to create unneeded infrastructure in provinces where the quality of regulation is such that few care to invest there. Many are familiar with the path breaking policies of Binh Duong, but repeating them here may be worthwhile.

When it was still Song Be province, the local leadership knew it was one of the poorest provinces. It was far from Hanoi and unlikely to attract much state investment. So, it went to people with money and *asked* them to invest in the province. They did not specify what to invest in, or "call" for specific projects. They simply assured potential investors that they would be welcome. When problems arose, people got together to solve them with a minimum of red tape. For example, there was a problem with land. You needed land to have a business and you needed to have a business to get land. So, they made it easy to rent land, or buy use rights to it, so that businesses could find the space and buildings they needed. Banks were unwilling to make loans unless there was collateral. So, they decided that 70% of the value of a new capital good could count as collateral. This considerably reduced the amount of pre-existing "outside" collateral that was needed. Applications for licenses required few signatures and decisions were made quickly. New workers had to migrate into the province, given the success in attracting new businesses. The province created a voluntary labor exchange where newcomers could register and employers could find workers. The provincial leadership also worked to invest in needed roads, power, water supply and new industrial parks – not so much anticipating massive future growth as responding to clear evidence of demand. With a population of only 740,000, the province licensed over $2.4 billion of FDI and they had realized investment of over 1 trillion dong in 2000 for private domestic investments, and licensed seven times as much in 2001.

Telephone and Internet Service in Vietnam

It is widely accepted that the quality, cost, and availability of telecommunications and Internet service is becoming as important as roads and ports were in previous centuries. Although the "dot com bubble" has burst, there is still a steady, rapid growth in the use of these services to arrange for bidding and communication for trade. High-level Vietnamese and foreign investors have stressed the importance of making these services available at a reasonable cost. What is the current situation and prospects for the future?

The Vietnamese telephone company deserves high marks for rapidly expanding the number of telephone lines in recent years. It recently passed 5 lines per 100 families, or 4 million fixed and mobile phones, compared to only 1 million as recently as 1996. It takes from $800 to $1000 to put in place a fixed line with all the switching equipment and lines, but mobile connections can be much cheaper. (A recent news item said that a fixed wireless device provided regular-speed Internet and voice connections at $250 per subscriber, even in remote villages. It is not clear, though, if that includes the central station cost.) The number of Internet subscribers has been growing rapidly, and hit 150,000 in mid-2001, or 2 subscribers per 1000 people. The cost of Internet dial-up connections in off-peak hours was slashed to just D100 per minute. They also have been gradually cutting telephone rates, though international charges are still well above those of neighboring countries. There is a medium-term goal to charge comparable rates, though it is not clear when that will be reached. About 90% of 9000 communes now have telephone connections, and all should be covered by 2003. The goal is for doubling to tripling the lines per 100 people by 2010. For a nation that is still poor, this is very respectable – better than Indonesia, but far short of China's progress. (China has added 80 million mobile phones since 1996! On a similar per-capita basis, Vietnam would have had to add 5 million mobile phones, but it has less than half as many in total. Similarly, China has 20 million Internet users, or 15 per 1000.)

There are some problems. One is that there is excess employment in the VNPT, and slow deregulation will mean slow reductions in high costs of operation and probably charges as well. Current plans are to allow 25% private telephone ownership by 2005 and 50% by 2010. How fast will conditions improve at this pace of change? The other problem has to do with the speed of the Internet. Fire walls are software programs that check the Internet material being used, keeping out undesirable content. There are different levels of filters, and some take longer to check than others or restrict even acceptable output. A very conservative approach tends to slow down the transmission of information, rendering hardware upgrades, such as better switches and bigger information pipes, useless. That is one reason the Internet in Vietnam is often very slow, though low switching capacity has also been an issue. Full commercial use of the Internet will require higher effective speeds. In summary, there has been real progress but the competition is moving faster and a greater sense of urgency is needed. Real competition could be introduced more effectively, as it has been already in the case of Internet service providers.

Industrial employment in Binh Duong rose by over 45 thousand (1997-2000) to 127 thousand. Exports exceeded $550 million in 2000, and were 85% manufactured goods. (That is equal to 10% of Vietnam's manufactured exports with less than 1% of the national labor force!) Clearly, the province has done a superior job of attracting investment and creating jobs, output and exports. Why? There are different explanations. Some say it is simply because it is close to HCMC, though it was also close in 1990 when it was one of the poorest provinces in the nation. Nor does closeness explain why private domestic investment per capita in Binh Duong in 2001 was ten times more than in Dong Nai, which is even closer to HCMC. In Tay Ninh province, right next-door, total FDI amounted to only 8% of Binh Duong's, though its population is one-third higher. Clearly, location is not the only explanation. Or, more precisely, location may be necessary but is not nearly a sufficient explanation for their success. Could more provinces also succeed?

Clearly, there has to be a combination of a good location and truly welcoming policies from the local administration, not just a few top officials. One of the Binh Duong officials noted that everyone agreed that new private businesses were needed, and so everyone worked together. It was not just a case of announcing business-friendly policies and then having them undone by lower level officials. Another aspect of the Binh Duong success in attracting FDI is that almost all of it is export oriented. Some other provinces have a large FDI total, but behind the big numbers are only a few big projects, often for cement, sugar, or just one or two big investments that are more politically pressured than economically sensible. Even provinces that have a large port, good road connections to other places, and a central location fail to attract much efficiency-oriented investment of any kind. This is not a good sign for the province, or for the nation. National success cannot come from just a few provinces attracting lots of investment. However, this does not mean that steps should be taken to force or subsidize investment to other places, or to penalize the places that have been successful. Building on successes and learning lessons is a better path. There is no reason why Vietnam cannot become more like Guangdong province (with fewer people than Vietnam), which gets over $10 billion in actual foreign investment inflow each year, compared to only $1-2 billion for Vietnam. If places in the Red River Delta outside of Hanoi, or in and around Danang were able to attract more efficiency-oriented FDI, the ability of Vietnam to create jobs and sustain growth would be much greater.[9] It is likely that policy and regulation are more important in these areas than infrastructure, which needs improvement but is probably not the most binding constraint.

How could a province improve its reputation among investors and thus its performance in attracting really profitable and efficient, not just protected, industries? The best way is to find out what problems investors are facing and then to solve them in a fair and speedy manner. This requires a good line of communication. One investor in Hai Duong mentioned that provincial officials visited his home to invite investment, rather than being difficult and hard-to-meet as in a neighboring province. He decided to invest there.

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[9] Danang has licensed about $360 million in FDI, or less than one-sixth as much as Binh Duong, and has about the same population. From 1997-2001, the licensed investment was less than $100 million, or less than 10% of Binh Duong's in the same period. Clearly, the difference is not due to the Asian Crisis.

In general, if there were local business associations that met regularly with government officials, and were dedicated to solving problems, the reputation of a successful process would be worth a great deal. Investors talk to each other, and know how easy or difficult the investment environment is in a particular place. You get a good reputation by being good more than by advertising or getting positive news coverage in a local newspaper or magazine. This applies to attracting investment, but does not ensure that the firm succeeds.

In fact, nothing can ensure that every firm will thrive. Part of a market system is that better-run firms grow and others shrink or even go out of business. However, both the national and local governments can create conditions so that well-run firms have fewer problems and more success. For example, credit is widely cited as a constraint, especially long-term credit. There are good reasons for this. Accounting and loan analysis skills are poor. There has been no central credit registry, and taking property pledged as collateral can be complex and uncertain. The borrowers often want to borrow in dollars, even when their earnings are in local currency. This can lead to problems if the exchange rate changes against them, as was the case in Thailand and Indonesia. Notice, however, that a lack of savings is not the primary constraint. Hundreds of millions of dollars, or more, are deposited offshore in foreign banks by Vietnamese banks. An improvement in the legal system, or a change in regulations that allows some fraction of a capital good to count as collateral are examples of appropriate government policy. Subsidizing credit or directing loans are inappropriate ways, because they weaken a commercial credit system. (The Development Assistance Fund is really a different way to spend public money more than it is a credit system. Thus, it is best discussed as part of public spending than credit.) The job of the government is to create conditions so that good bankers want to make more loans to good credit risks. If more loans are available, it is likely that accounting will also improve.

Another major constraint for many firms has been a lack of marketing knowledge. This includes not knowing the exact designs, quality standards, or necessary scale and timing as well as the obvious problems of linking up with a buyer. This is a problem that governments cannot solve directly, but by supporting industry groups that collectively hire expertise they may be able to reduce the problems caused by this factor. In Taiwan, the government put a very low export tax on manufactured exports and gave the proceeds to CETRA (the China External Trade Association), an industry association. The association commissioned surveys of markets or technology and helped the small and medium sized firms in Taiwan to overcome their lack of sophisticated marketing departments. Each CETRA chapter was based in a major city or region – it did not cover all of Taiwan. This made it easier for the businessmen to meet and oversee the association.

Other changes are also needed, especially in taxation. If Vietnam is going to integrate with the region, it should be sensitive to what regional taxes are and not fall too far outside the range that its neighbors have. The income tax on Vietnamese, for example, is 50% over D 15 million a month and there is also a surcharge that raises the effective tax rate to about 60%. The rate of personal income taxation in most of ASEAN at similar income levels is about 30%.[10] It makes no sense to tax highly qualified Vietnamese so heavily when others do not. The tax revenues from a high tax rate are very low, but the incentives created are for hiring of foreigners, immigration of skilled Vietnamese[11], and avoidance of Vietnam for high-skill activities. Recent changes are in the right direction but too little to solve the problem. Even a revenue maximizing tax rate would be much lower. It makes no sense to go higher than that! It also makes sense to make the corporate and personal tax rates equal or very similar, so that there is no advantage to shifting income between them.

Another example of a misguided tax is the value added tax on domestic supplies sold to exporters. Since imports do not pay a VAT if they are used in exports, this virtually destroys the ability of Vietnamese firms to become local suppliers. But local suppliers lower costs and help encourage the rapid buildup of export clusters. Here again, the revenue gained is trivial, but the cost of lost activity is huge.

By combining an efficient and responsive provincial administration with national policies that help remove obstacles to emerging firms, it is likely that Vietnam will be able to reap the full rewards from its Enterprise Law. In two years, the numbers of formal domestic private firms have doubled. That is a wonderful start, but only a start. These firms need to grow and become important enough that they make a dent in the big job picture. Because the formal private sector, foreign and domestic, starts with fewer than 1.5 million workers, it will take several years of rapid growth for it to grow to significant size. Because the immediate future is likely to have a recession prone global economy and possibly major troubles in Japan over the next few years, domestic policy will have to be as good as possible to offset these influences. With luck, a dynamic Chinese economy, a lift from the BTA, and an ability to attract FDI will provide the needed impetus for further rapid growth.

Some Scenarios of Future Growth

This section asks what the future will be like. Obviously, no one really knows. However, these exercises can still play a useful role. They can identify what is within the control of the Vietnamese government and what must be taken as "exogenous" or outside of any control – rather like the weather. If flooding were of concern, the investment in weather forecasting, river monitoring, dike repair and construction, and emergency evacuation would all be within the control of the government. The rain would not be. Asking what a rainfall of so many centimeters would imply in terms of flooding is not a useless exercise, even if nobody knows exactly what the rainfall will be. Just asking the question can lead to investments that reduce the impact or severity of the floods. It is in that spirit that this section is written.

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[10] China's maximum personal tax rate is 45%, but personal income taxes provided only 4% of all taxes, or well under ½ of 1% of GDP, in 1999. In Vietnam, personal income taxes accounted for 2.2% of revenue. Thailand, with personal income tax rate of 38% over $108,000 a year gets 2% of GDP and 13% of all taxes from that tax. Clearly, reducing a tax rate can sometimes reduce avoidance and evasion and raise revenues.

[11] "Vietnam Loses Grip Over Young Talent", in Labor, November 6, 2001, p. 3. The article starts, "Vietnam has so far failed to provide favorable educational and working environments for talented people, who prefer to opt for better opportunities abroad."

What is under the control of the government? The tax and spending system, the regulation of the financial system and public monopolies, trade and industrial policies, the legal system, and the exchange rate are all important variables that the government can control or influence. The rate of world or regional GDP growth is clearly like the weather.

In terms of the global economy, consider two scenarios. One is a resumption of fairly brisk growth in international trade and global GDP. The rich nations GDP would grow at 2.5% to 3% a year and developing nations at double that. Trade would grow at 6-7% a year in current dollars. This would all start sometime in 2002. The other alternative is a much slower decade, with world trade growing only 4-5% a year, rich country GDP at 1.5% to 2%, and developing countries growing only 4% a year. Such a scenario is consistent with a sluggish US and Japanese recovery, increased trade barriers driven by fears about terrorism, and generally increasing trade barriers. If the European nations lag in reforming their pension and labor systems, that would retard their growth. The deadweight loss of spending on security, or of damages from terrorism, could also act to depress growth in the second scenario. Even worse (or better) scenarios can be imagined, but these are probably reasonable alternatives reflecting moderately good and bad outcomes.
In terms of Vietnamese policy, we can similarly assume relatively good or bad policies. But what are they? The major variables are:

1. The pace of reform in the financial system.
2. The emphasis on protected vs. export-oriented industrialization.
3. The regulatory climate for the private sector, down to the provincial level.
4. The pace of SOE reform.
5. The productivity of public investment.

To be clear, the more the financial system can gather savings, allocate them to efficient firms with a variety of maturities and financing forms (bonds, stocks, bank loans, leases, etc.), and attract international portfolio investments as needed, the faster Vietnam will be able to develop a modern economy with opportunities and equality.[12]

To the extent that Vietnam avoids investing in high-cost industries that will either need protection or subsidies, it will not oppose its industrialization strategy to its trade strategy. This restraint will release funds and also reduce costs for other industries that will use less capital per job, provide more growth, and be sustainable over time.

[12] Although bank deposits have grown, broad money (M2) was only 50% of GDP in December 2000, including both dong and dollar deposits. This is half to a third of similar ratios in China and ASEAN. As other financial sectors such as bonds and stocks are even smaller in relative terms, the ability of the financial sector to support growth is limited by both its ability to select borrowers and its current supply of funds. However, if profitable investment opportunities existed and could be serviced, it is likely that money could be found.

To the extent that the provinces in Vietnam follow up on the intent of the Enterprise Law and make it easy for private firms, foreign and domestic, to do business, the faster economic activity will spread from a few places in and around HCMC to many places throughout the country. All provinces would benefit from continued improvements in national policies, such as lower telephone charges and income tax rates, faster Internet connections, and improvements in the legal system.

To the extent that state enterprises either have to compete with imports or other local firms, or are equitized and treated without special favors, the prices of goods and services will become more like those in Vietnam's neighbors. This will help export-oriented firms, reduce pressures on banks to make "policy" loans, and create a more level playing field. This "level field" is needed to compete with China, not for ideological reasons.

Perhaps one of the hardest steps is to reduce the extent to which public investments are treated as political decisions, and to transfer more authority to those that are more likely to choose appropriate investments with high rates of economic return. Again, thinking of the national interest is likely to lead to faster growth than treating each province as a separate unit that deserves public money even if it is not going to be used very well. Empty harbors, or lightly used roads and bridges are a sign of failure and misallocation.

Given these choices, there will also be a two-way division of domestic policy into "good" and "bad". Some aspects of current policy are broadly correct, but the pace of reform is too slow, and other policies are slowing both growth and equity. In this context, a "good" internal policy is one that tends to accelerate growth with equity, while a "bad" policy mix does the opposite. With two external and two internal scenarios, there are four possible outcomes.

External Environment →	**Good**	**Bad**
Internal Policies:		
Good	1	2
Bad	3	4

Scenario 1: The pickup in global trade comes in the middle of 2002, and Vietnam is poised to take full advantage of it. The BTA helps raise FDI inflows to $3 billion a year, attracted by the reduced red tape and business friendly investment environment. The boom in private investment continues, as banks, bonds, and leasing companies all add to the options of successful domestic firms. They begin to develop supplier networks with exporters, and develop better access to marketing and technical information. Investment is 35% to 40% of GDP and growth is 10% a year. Poverty drops rapidly, and the

government is occupied managing the increased investment in infrastructure required by the rapidly growing economy. Exports continue to grow at 12% to 16% a year, now driven by manufactured exports, including agro-exports. Off-farm incomes grow rapidly too, as both industrial and service jobs are created to absorb those leaving agriculture and state enterprises.

Scenario 2: The global recession ends later in 2002, but the recovery lacks conviction and a long period of sub-par growth begins, affecting both developing and developed nations. Vietnam gets some benefit from its reforms and the BTA, but chronic global overcapacity slows FDI and export growth. Still, FDI inflows (not just licensed but actual) rise to \$2-\$2.5 billion a year, and investment/GDP averages 30-35% a year. This is enough to support growth of about 8% a year and export growth of 10% to 12% a year. Because several other ASEAN economies suffer from slow exports and shaky banking systems, the financial reforms in Vietnam attract portfolio investment that benefits a growing bond and stock market. Although GDP growth is only a little higher than in 2000-2001, it is more labor-intensive and job growth is sufficient to absorb most new entrants and those leaving farming and state enterprises, though at somewhat lower incomes than in the first scenario.

Scenario 3: Vietnam seems to be of two minds in this scenario. The growing global economy creates many export opportunities, but red tape, slow financial reform, and heavy protection for selected heavy industries act as a break on such growth. A few provinces manage to overcome these problems, but many do not. China's rapid growth pressures many domestic industries, and politically understandable but inefficient public investments waste much of the aid, which begins to dwindle. The result is 6% annual GDP growth, 7-8% annual export growth, and a fairly capital-intensive pattern of industrial growth. There is no disaster, but a steadily growing number of urban poor are clearly living on the margin. There are growing disparities among and within regions, raising social tensions. Crime and drug abuse rise as idle but educated youths find little outlet for their energies.

Scenario 4: The slowly growing world economy gives rise to a sense that global integration is, if not a mistake, at least a strategy that has as many dangers as opportunities. There is more emphasis on saving even inefficient state enterprises, resisting change in the financial system, and generally an attempt to avoid having the private sector play too large a role in the urban economy. Potential investors sense this attitude, but continue to invest in Vietnam at a modest rate in infrastructure, oil, and some manufacturing. Exports grow slowly, only 6% a year, while GDP growth is only 4-5%. There is a marked outflow of well-educated Vietnamese to jobs in other countries, as there is a growing sense that the boom of the 1990's will not soon be repeated. Growing unemployment leads to noticeably rising crime levels, slum areas, and a generally sullen attitude.

These scenarios are one person's best estimates of an uncertain future. If they seem unlikely or inaccurate, others are invited to create their own scenarios. The only requirements for such new scenarios are that they be as realistic as possible, internally consistent, and plausible. For example, it would be hard to believe that aggressive financial reform and better regulation of private firms would be combined with steps to keep inefficient state enterprises operating. These would be contradictory, as the private sector would grow rapidly even as the interest groups wanting them to be at a disadvantage were also strengthened. Such a combination of policies is contradictory, and would likely change either one part or another over time. Nor could very rapid export growth be sustained for long in a sluggish global economy, even if Vietnam's initial starting point is modest.

If some version of these scenarios is accepted, then the question becomes how to organize economic policy to achieve the goals of the government and Party. If the goals themselves involve "trade-offs" or are not entirely consistent, then priorities will have to be established. The important point is that the impact of a policy mix should be understood and support what is wanted. If it fails to do this, then confusion and waste will result.

Annex: Catching Up with Its Neighbors?

Consider where two of the scenarios would place Vietnam compared to Thailand over the next two decades. Thailand had GDP per capita of $2000 in 1999, while Vietnam's per capita GDP was nearly $400. Let us assume that Thailand were to grow at 4.5% a year during the current decade and 4% a year from 2009-2019. Since its population growth is likely to average only 1% and 0.8% a year in each decade, its per capita growth rate would be 3.5% in the first decade and 3.2% in the second. Its GDP p.c. would rise to $2820 in 2009 and $3870 in 2019.

Let us consider just two possible growth rates for Vietnam. In scenario 1, the growth rate is estimated to be 10% a year. In scenario 3, it is 6%. My estimates for population growth for Vietnam are 1.6% in the first decade and 1.4% in the second. In scenario 3, the annual per capita growth of GDP is 4.4% in 1999-2009 and 4.6% from 2009 to 2019. Vietnam's GDP per capita (in real terms) in scenario 3 rises to $660 in 2009 and $990 in 2019. In scenario 1, its GDP per capita rises to $910 in 2009 and $2060 in 2019. The results are shown in a table, below:

Projected Levels and Differences in GDP per Capita, 1999-2019

For Thailand and Vietnam's Scenario 3

	GDP per capita in 1999$		*Difference in GDP p.c.*	
Date	Thailand	Vietnam (3)	Thailand-Vietnam(3)	Vietnam/Thailand
1999	$2000	$400	$1600	0.20
2009	$2820	$660	$2160	0.23
2019	$3870	$990	$2880	0.26

Compare the results with scenario 1:

	Thailand	Vietnam(1)	Thailand-Vietnam(1)	Vietnam/Thailand
1999	$2000	$ 400	$1600	0.20
2009	$2820	$ 910	$1910	0.32
2019	$3870	$2060	$1810	0.53

The result in scenario 3 is that the absolute distance between Thailand and Vietnam grows sharply over twenty years and *Vietnam fails to reach 50% of Thailand's **1999** level of income by 2019!* In sharp contrast, scenario 1 has Vietnam by 2019 starting to shrink the absolute gap, and surpassing Thailand's 1999 level of GDP per capita. Only scenario 1 can really be said to be "catching up" in any reasonable time period. Income per capita in scenario 1 is **double** that of scenario 3 by 2019. Scenario 3 would seem like stagnation in comparison and would also make it easier for other nations to attract skilled Vietnamese. It could be said to fail making Vietnam "industrial and modern" within a generation. This is in spite of Thailand's modest growth and relatively low output of scientists and engineers. If the same calculation is made in GDP valued at purchasing power parity, the results are very similar. Good policy creates much better outcomes.

The same sort of exercise could be applied to China. China's recent GDP per capita is about $800 and it is widely expected that annual GDP growth will be sustained at about 7-8%. If population growth falls from its recent 1% a year to 0.8% and then 0.6% in this and the next decade, then China's per capita GDP would rise to $1480 in 2009 and $2750 in 2019. This can be compared to Vietnam's two possible outcomes:

Year	China	Vietnam(1)	Vietnam(3)	V(1)/China	V(3)/China
1999	$ 800	$400	$400	0.50	0.50
2009	$1480	$910	$660	0.60	0.45
2019	$2750	$2060	$990	0.75	0.36

Here again, it is a matter of catching up with China vs. falling ever further behind in a relative as well as absolute sense. If Vietnam wants to become a modern and industrial nation, it will have to do those things that make it one, and to do them as well or better than its neighbors. That is a tough but not impossible task.