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The Role of the State in Vietnam's Economic Transition

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Abstract
This paper discusses Vietnam's economic development for the three decades since the early 1980s, and the changing role that the state played in this process. The success of the first major liberalization step (Doi Moi) is attributed, in large part, to the microeconomic/structural reforms that occurred throughout the 1980s and to the confluence of economics and politics. This did not continue into the second half of the 1990s when reforms stalled. Since the Asian financial crisis in 1997/98, the pace of reforms has accelerated. This paper argues that, for the reforms to be effective, the state has to be viewed as performing a catalytic role whilst permitting the private sector to contribute directly to economic growth.

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“The Role of the State in Vietnam’s Economic Transition”

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This paper discusses Vietnam’s economic development for the three decades since the early 1980s, and the changing role that the state played in this process. The success of the first major liberalization step (*Doi Moi)* is attributed, in large part, to the microeconomic/structural reforms that occurred throughout the 1980s and to the confluence of economics and politics. This did not continue into the second half of the 1990s when reforms stalled. Since the Asian financial crisis in 1997/98, the pace of reforms has accelerated. This paper argues that, for the reforms to be effective, the state has to be viewed as performing a catalytic role whilst permitting the private sector to contribute directly to economic growth.

Classification codes: O1, P2. Key words: Vietnam, transitional economy, economic development.

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Introduction

The role of the state in national economies is changing everywhere, but nowhere more dramatically than in the transition economies. Vietnam is no exception. The essence of the set of reforms adopted under the banner of *doi moi* was a political decision to change the role of the state in the economy of Vietnam, to abandon central planning in favour of a "market-based, multi-sector economy with a socialist orientation."

While the state, or more precisely the political authorities, initiated many of the changes in the state-market relationship, some changes occurred spontaneously at the grassroots level and only later became validated by the political decision makers. Furthermore, the shift away from central planning did not occur abruptly with the adoption of *doi moi* at the Sixth Congress of the Communist Party in 1986, but rather occurred gradually as the state responded to widespread shortages of food and other commodities by loosening the tight controls of the central plan and allowing parallel markets to evolve. It is argued in Section I of this paper that the emergence of parallel markets in agriculture and industry in the early 1980s, by providing incentives to save and invest and by encouraging the monetization of the economy, contributed significantly to the success of the subsequent structural reforms and stabilization measures taken under *doi moi*.

The redefinition of the role of the state in the late 1980s brought about what has been labeled as "one of the more dramatic turnarounds in economic history" (Dollar and

Litvack 1994). However, while much has changed, some things remain the same. Allowing markets to develop and giving the right to private property have naturally encouraged the emergence of a private sector in Vietnam. The state recognizes that private economic activity and initiative are necessary for economic success, and yet there is great political ambivalence about the private sector. Many policy measures taken and not taken in the 1990s can be seen as attempts by the state to encourage and at the same time control (and thereby stifle) the private sector. In Section II, we discuss how this contradictory approach to the market economy and the private sector has distorted the structure of the economy, discouraged the emergence of a dynamic private corporate sector and frustrated the country's efforts to achieve sustained long-term growth.

What further redefinition of the role of the state in the economy is required for Vietnam to achieve its long-term development objectives? This question is addressed in Section III. It is argued that, as a catalyst for growth, the state should develop the legal/commercial infrastructure for a market economy. Furthermore there is a great need for the institution of market-friendly and efficiency-enhancing regulations in the financial sector, and the continuous effort to move towards indirect (rather than direct) controls over interest rates and credit. The state should enhance the institutional framework for Vietnam to participate more fully in the international trading system. It should continue to remove the discriminations against the domestic private sector, and encourage foreign participation in the provision of physical infrastructure services. In due course, the state should introduce industrial re-structuring and competition policy in the management of the state owned monopolies, while at the same time, set up an institutional framework for some form of social insurance. In this way, the state can play a positive role as partner to the private sector and as a catalyst to long-term sustainable growth.

I. Reforms in the 1980s, "doi moi", and the role of the state

Up until the introduction of a package of reforms in 1989, which combined macroeconomic stabilization with strong moves towards a market economy (the so-called *doi moi* or economic renovation), many of the reforms in the early 1980s were of a "stop-go" nature, reacting essentially to food and other shortages. In spite of the apparent lack of direction, however, it will be seen that these reforms did have a profound impact on the economy by shifting it away from central planning.

The Move away from Central Planning

In 1981, in response to falling food production and stagnation in industrial output, the state introduced the "contract system" in agriculture, and the "three-point-plan" in industries. The contract system marked the beginning of de-collectivization of agriculture by allocating individual plots of land to farmers and allowing them to make decisions regarding land management. Although most of the rice produced was required to be sold to the state at low prices, in practice, approximately 20% of the rice production was sold by farmers at substantially higher prices in the parallel markets. Thus, the contract system represented a tentative move towards private property rights and created incentives for farmers to work harder and to manage their allotted land more efficiently. Between 1981 and 1987, rice production grew at an annual rate of 4.2% (compared with 0.4% p.a. between 1976 and 1980). Furthermore, the use of materials (mainly fertilizers) grew at an annual rate of 3.3% during the period of the contract system, compared with a negative annual growth of –1.1% in the four years before 1981 under central planning (see Table 1 from Che, Kompas and Vousden 1999).

Table 1: Output and Inputs for Rice Production in Vietnam
Annual Growth Rates (%)

	Output	Labour	Land	Materials	Capital	TFP
1976-80	0.4	0.4	-0.8	-1.1	2.2	0.6
1981-87	4.2	0.3	-1.2	3.3	1.7	3.3
1988-94	6.1	1.3	-0.5	5.6	10.6	3.1

Source: Che (1997), Table 7.1.

On the industrial side, the three-point-plan meant that not only were state owned enterprises (SOEs) able to produce goods for the state using state-supplied inputs (plan A), they were also allowed to procure inputs outside the state plan and sell the output to the state (plan B), and furthermore they were permitted to procure inputs outside the state plan and sell the surplus output on the parallel market (plan C). Like the contract system in agriculture, plans B and C gave some degree of de-centralized decision-making to the individual production units in the management of inputs and outputs. Not only did these early reforms result in greater incentives to produce more efficiently, but they also gave rise to the dual price system and strengthened the parallel economy. As will be argued later, the development of parallel markets was important to the success both of macroeconomic stabilization in 1989 and of further liberalization and growth in agriculture in the 1990s.

Parallel Markets and the Failure of 1985 Reforms

In addition to improving allocative efficiency, the development of parallel markets (estimated at between one-third to two-thirds of total retail sales in the 1980s) contributed to macroeconomic stability, in particular by allowing Vietnam to avoid a large "monetary overhang" in the 1980s (Leung and Vo 1996). Monetary overhangs typically occur in centrally planned economies as a result of SOEs taking advantage of credit from state banks at zero (or near zero) interest rates and hoarding labour and other inputs from households in an effort to ensure the fulfillment of state plans. This implies injections of cash into the household sector. However, since there are usually few consumption or investment opportunities for households (in the absence of significant parallel markets), injections of cash exceed household expenditures, and households are forced to accumulate money holdings. The manifestation of this overhang of the money stock is the physical shortages observed in centrally planned economies, with prices regulated to avoid outbreaks (or to "repress') inflation.

The early reforms in agriculture and industry allowed Vietnam to move away from a strict centrally planned economy to a more modified version, and as Leung and Vo (1996) have argued, monetary overhang was virtually non-existent by 1985. Therefore, the confiscatory monetary policy in 1985 [1](making one "new" dong equal to ten "old" dongs), instead of eliminating the excess stock of money held by households, penalized the SOEs which had accumulated large stocks of dong assets

[1] Wealth held in dong assets was being confiscated because nominal prices were kept unchanged.

for purchasing inputs from the parallel markets. The subsequent “bail out” of the SOEs through budget subsidies and monetizing the budget deficits resulted in the hyperinflation episode of 1985-1988, and spelt the failure of the 1985 price-salary-money reform (see Table 2 from Leung and Vo 1996). The rampant inflation undermined financial wealth, the exchange rate, real wages, and the effectiveness of the public sector. It also undermined the contract system, and food production stagnated, contributing further to inflation.

Table 2: Budget (% Of GDP), Domestic Credits And Inflation (annual % change)

	84	85	86	87	88	89	90	91	92	93
Revenue	14.5	14.5	13.2	12.2	11.3	14.0	14.9	13.7	19.0	22.5
- SOE transfers	10.5	11.2	9.5	9.2	7.2	8.1	8.8	8.2	10.2	11.2
- Tax revenue	3.1	2.3	2.9	2.2	2.9	3.9	4.1	3.7	5.0	8.3
Curr. exp. (exc. int.)	13.5	18.0	12.9	12.7	14.0	15.6	14.9	11.5	14.0	18.8
- Wages & salaries	0.5	1.3	0.9	1.0	1.7	4.6	3.7	2.1	n.a	6.5
- Subsidies	5.2	4.7	2.9	4.9	5.3	0.0	0.0	0.0	n.a	0.2
Capital exp.	4.1	8.2	5.9	3.9	4.4	5.8	5.2	2.8	5.8	7.0
- Primary deficit	-3.1	-11.8	-5.7	-4.3	-7.0	-7.3	-5.2	-0.7	-0.8	-3.3
- Interest	0.2	0.2	0.2	0.1	0.2	0.2	0.8	0.9	0.9	1.3
Overall deficit	-3.3	-12.0	-5.8	-4.4	-7.2	-7.6	-5.9	-1.5	-1.7	-4.6
Financing	3.3	12.0	5.8	4.4	7.2[b]	7.6	5.9	1.5	1.7	4.6
- Foreign	2.3	4.9	2.2	1.4	2.4	1.5	3.1	1.0	2.4	2.7
- State bank	0.6	7.1	3.6	2.9	2.9	6.9	2.0	0.9	-2.0	1.8
- Gov. securities	0.3	0.0	0.0	0.1	0.1	-0.8	0.8	-0.4	1.3	1.8
Domestic credit	41	301	429	248	395	175	34	47	20	58.2
- Government (net)	n.a	n.a	n.a	321	736	370	26	4	-54	102.3
- SOE sector	n.a	n.a	n.a	221	355	111	43	78	36	24.7
- Other & private[c],	n.a	n.a	n.a	347	235	95	21	68	174	177.9
Inflation	65	92	487	301	308	35	68	68	18	5.2

a Preliminary estimation;
b arrears = 1.7;
c before 1992 most credits had gone to the cooperative sector.
Sources: For budget structure, World Bank (1994b, Table 5.1, p. 118 and 1992, Table 5.1, p. 141); for domestic credit and inflation, see Charts 2 and 3.
For 1993 data: WB report number 17031-VN "Vietnam Deepening Reform for Growth" - 1997

This experience clearly demonstrates that the earlier microeconomic reforms in agriculture and industry required the reinforcement of macroeconomic stabilization; specifically, there had to be a cessation of budget subsidies to SOEs in order to reduce budget deficits, and the reduced budget deficits had to be financed by means other than monetization. Like the tentative moves to private property rights in agriculture and de-centralized decision making in SOEs in the early 1980s, changing the macroeconomic relationships and stabilizing the macroeconomy are functions which only the state can perform, and in this case, this was done successfully under the package of *doi moi* reforms.[2]

The Success of Doi Moi

The success of *doi moi* has been well-documented in the literature (Dollar 1994, Lipworth and Spitaller 1993, and World Bank 1993), but less well- known are the favourable effects on macroeconomic stabilization of the structural changes set in train as a result of reforms during the 1980s before *doi moi* was launched.

Firstly, the ability to purchase goods and services on the parallel markets increased the transactions demand for money as incomes grew. This is reinforced by the fact that the ratio of money holdings to income was very low in Vietnam prior to 1989 (less than 10% for the M1/GDP ratio). The increase in transactions demand for money is evidenced by a very high and significant income elasticity of money demand estimated for the period 1978 to 1991 (Leung and Vo 1996). This means that,

[2] In addition to stringent budgetary and monetary policies, this package included the abolition of price controls, the unification of exchange rates resulting in a fivefold devaluation of the dong, the granting of full autonomy to SOEs in terms of their pricing, production and investment decisions while at the

for any given increase in domestic credit, the impact on inflation is likely to be less because of a more rapid growth in the demand for money.

Secondly, there is evidence to suggest that the positive real interest rates paid on dong deposits at Vietnamese banks as from 1989, as well as the confidence engendered by the *doi moi* package generally, had resulted in a movement away from holdings of dollar and gold into dong assets (a reversal of currency substitution, see Leung and Vo 1996). Indeed, there was a tripling of household savings between 1988 and 1989 (from 1.5% to 5.3% of GDP), and part of this would have been done at the expense of holding dollar and gold. Given the tight monetary policy at the time, the increased bank deposits would have been sterilized; that is, not spent or given as credit through the State Bank. Therefore, the structural shift towards increased demand for dong would have had a dampening effect on inflation.

Finally, the increase in bank credit in 1993 was directed mainly to rural households (World Bank 1994b). Given that an estimated 72% of the rural sector had previously taken loans from the informal sector, the credit expansion of 1993 could well have been offset by a fall in credit provided by the informal sector. Therefore, the net inflationary impact would have been reduced significantly as a result[3]. In short, the development of parallel markets and the availability of choices to households (including asset portfolio choices) made the task of macroeconomic stabilization easier for the government once the changes in the macroeconomic relationship

same time, severing the budget support for SOEs, the return to the family farm on the basis of long term leases, and the start of reforms in foreign trade and foreign direct investment.

[3] Using the black market prices for the years during which price controls were enforced, Vo (1997) found that the correlation coefficient between the change in domestic credit and the general retail price level fell from 0.884 for the period 1978-88 to 0.047 for the period 1989-95.

between the budget and the SOEs on the one hand, and between the budget and the central bank on the other, were accomplished.

Another success attributed to *doi moi* is the rapid growth of agricultural output. Rice production, in particular, grew at an annual rate of 6.1% between 1988 and 1994, turning Vietnam from a rice importer to the world's second largest exporter. Unlike the years under central planning (1976-80) and then under the contract system (1981-87), this period was characterized by very high rates of capital investment in farming (see Table 1 above). The granting of long term leases and the growing profits resulting from liberalization of internal and international trade in rice were seen as the main reasons for the high rate of capital accumulation (Che, Kompas and Vousden 1999). These were direct incentive effects resulting from the *doi moi* package of reforms.

In addition to these direct effects, there would have been the issue of the financing of physical capital accumulation in agriculture. Because of poorly functioning capital markets in Vietnam in the early 1990s, and the "lumpy" (or indivisible) nature of capital investments (McKinnon 1973), rural households would probably have had to save for a period of time before investments could be made. In spite of the period of hyperinflation in 1985-88, the emerging profits in the rural sector throughout the early part of the 1980s and more particularly since 1989 would have enabled such savings to take place. The expansion of bank credit to rural areas in 1993 (discussed above) would have also helped in the financing of capital expenditures. Therefore, both the supply of finance and the confidence to invest (through the granting of the long term leases) were present, and contributed to the success of *doi moi*.

Role of the State

These developments in Vietnam in the 1980s clearly show the key role played by the state in moving away from central planning. By reacting piecemeal to a series of crises and shortages, the state had, wittingly or unwittingly, allowed parallel markets to flourish. Once market forces had been unleashed and people's choices and economic horizons expanded, it was easier for the state to stabilize the macroeconomy in 1989, and to move further towards a market economy.

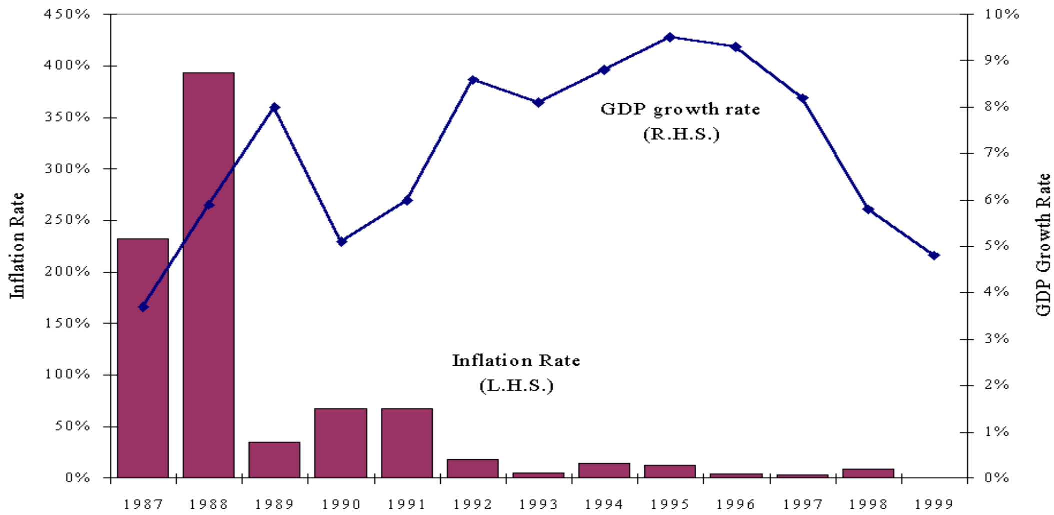
In other words, during the 1980s, there was a confluence between economic and political forces. Food shortages which represented a threat to political stability gave the impetus to move away from central planning. The resultant growth in parallel markets underlined the flaw in the confiscatory monetary policy of 1985 which necessitated a "bail out" of SOEs, resulting in greater economic and political instability from hyperinflation. This, together with the imminent collapse of the former Soviet Union, galvanized the government into fundamentally changing the macroeconomic relationships in pursuit of macroeconomic and political stability. The latter task was made easier because of the structural economic reforms carried out earlier in the decade. The interplay between economics and politics was mirrored by the interplay between microeconomic/structural reforms and macroeconomic stabilization, each reinforcing the other.

It will be argued in the next section that the fortuitous confluence between economics and politics was not sustained into the 1990s. In particular, the desire to protect the SOEs resulted in distortions that bias against a sustainable growth strategy based on export-oriented labour-intensive manufacturing. Furthermore, the 1997-98 financial and banking crisis of the East Asia has, in some quarters, encouraged the misguided view that administrative controls can be an effective answer to macroeconomic and political instability.

II. Growth under state control in the 1990s

The spectacular turnaround of the Vietnamese economy in the first half of the 1990s is now well known (see Graph 1). Between 1991 and 1997, real GDP grew at between 7% and 9% p.a.; inflation remained mostly in the single digits; exports grew at an average rate of around 30% p.a., and foreign direct investments flooded in at a rapid rate. However, even in the midst of this impressive performance, and prior to the outbreak of the East Asian financial crisis, certain structural problems associated principally with state controls began to emerge.

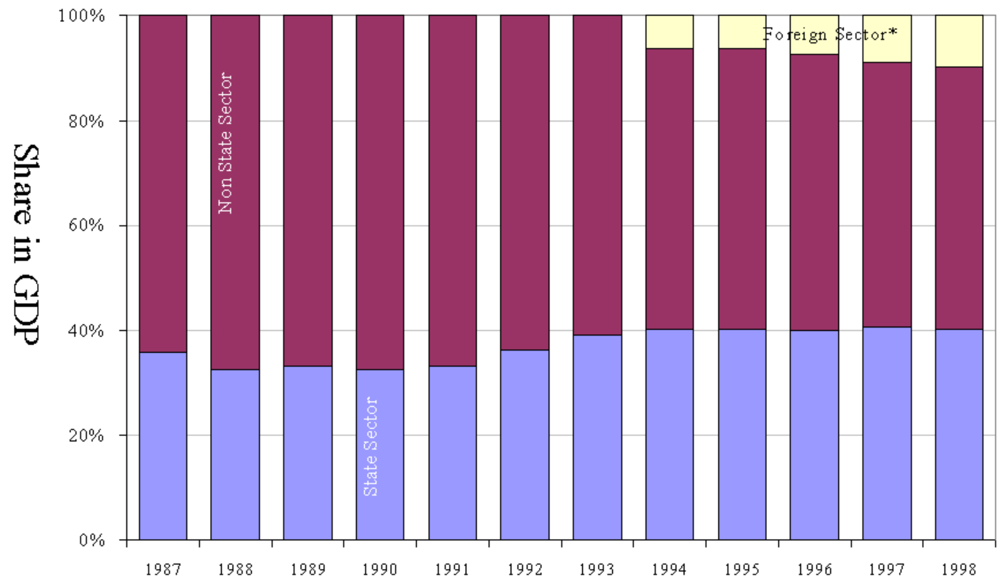
Graph 1: GDP Growth and Inflation in Vietnam: 1987-1999



Weaknesses in the Pattern of Growth

Firstly, an overwhelming majority (about 98%) of the foreign direct investment (FDI) inflows went into the state sector, chiefly in the form of joint ventures with the SOEs. This trend was so prominent that the state sector was actually expanding relative to the non-state sector during this period of rapid economic growth in Vietnam (Graph 2). However, the frustrations of foreign investors were already apparent by 1995 (see Kokko and Zejan 1996). By the end of 1996, FDI approvals, excluding the last minute approvals of two large real estate projects, had begun falling (Leung 1997).

Graph 2: GDP by Ownership



* separate data not available prior to 1994

Secondly, in spite of the high rates of growth in exports, Vietnam's export record between 1988 and 1997 in textiles and garments (the barometer for labour-intensive manufacturing exports in developing countries) was "...impressive but not outstanding in international perspective" (Hill 2000, p. 288). Even accepting that Vietnam was a latecomer in this activity, its per capita export of textiles and garments in 1996 was only about half that of China's ($US 16.7 compared with $US 31 in China; see Hill 2000). The lack of access to the US market on MFN terms was a serious barrier. Being a latecomer also meant that, like Bangladesh and Sri Lanka, and in contrast to China, Indonesia and Thailand, Vietnam had been a large net importer of textiles, reflecting the underdeveloped nature of the upstream textiles industry, largely state-owned. However, unlike all the other five countries, Vietnam's net trade ratio (defined as exports minus imports divided by total trade) for textiles and garments taken together was very close to zero, compared with net trade ratios in the range of 0.34 to 0.67 for the other countries (Hill 2000). Also, unlike the other countries, the proportion of state ownership was relatively high in textiles and garments, and this is reflected generally throughout the manufacturing sector in Vietnam. All these factors point to structural problems on the supply side of the industry.

Thirdly, by 1997, Vietnam's domestic financial sector was still largely under-developed. 75% of total assets of the financial sector was controlled by four large state-owned commercial banks. Even though this is fairly common amongst developing countries, and reflects the fact that banks generally are more efficient in handling the problems of information asymmetry and adverse selection so prevalent in information-intensive industries such as finance (Mishkin 1996, also see Section III below), the relatively low deposit/GDP ratio and the high currency/deposit ratio suggest that there was (and still is) significant distrust amongst the public regarding financial institutions[4]. Furthermore, over half of the assets of the state-owned banks were in the form of loans to SOEs (admittedly down from 90% in 1990 to 55% by 1997, see Leung and Doanh 1998). This, together with the Law on Credit Institutions enacted in 1997 providing for preferential bank credit for SOEs, cooperatives, and remote areas, means that the commercial viability of Vietnamese banks and other financial institutions was being seriously undermined, and the financial sector made vulnerable to the fortunes of the SOEs.

The SOE problem

State-owned enterprises in Vietnam dominate the industrial sector. In the economy as a whole, SOEs and their foreign joint-venture partners account for about 50 percent of

GDP, and in the manufacturing sector their share of value-added is about 75 percent. Their claim on the nation's savings is even greater than their relative contribution to GDP, with about 80 percent of all investment outlays accounted for by the SOEs and their joint-venture partners. As providers of employment, however, their contribution is small, absorbing only 10 percent of the labor force. Thus, the private sector, which consists mostly of household farms and businesses, absorbs 90 percent of the labour force, but is allocated only 20 percent of the nation's capital resources.

The dominance of SOEs in the industrial sector is a serious matter because SOEs in Vietnam, like their counterparts in most other countries, are notoriously inefficient. The manifestation of their inefficiency is a lack of profitability. A 1997 survey by the Ministry of Finance found that 60 percent of SOEs, accounting for 45 percent of employment in the State sector, were unprofitable. Since the operating losses of SOEs have to be financed either out of the government budget or through loans from the banking system, the SOE problem spreads throughout the entire economy, either by creating macroeconomic instability or by crowding more worthy borrowers out of credit markets. When SOEs cannot service or repay their debt, the entire financial system may be put in jeopardy.

The extent to which the SOE problem threatens the banking system is indicated in Table 3, which reveals the extent to which SOEs dominate both domestic and foreign currency credit. The problem of crowding out was exacerbated during the 1998 economic downturn, when SOEs increased their borrowing from the banking system to finance inventory accumulation and financial losses. At the end of 1999, SOE debt

[4] In 1996, the deposit/GDP ratio was 16% compared with 50% in China and 43% in th Philippines. The

stood at 199 trillion dong (US$14.2 billion), a significant proportion of which the SOEs are unable to service or repay. According to the State Bank of Vietnam, 14.5 percent of outstanding bank loans (135 trillion dong or US$9.3 billion) are non-performing, though some experts suggest the figure could be as high as 30 percent of outstanding loans if international accounting standards were applied (World Bank, 20/3/2000).

Table 3: State Enterprises Borrowing from the Banking System: 1995-98

	1995	1996	1997	1998
Credit to SOEs/Credit to the Economy	56	52	49	52
SOCB Credit to SOEs/Total SOCB Credit	62	57	55	57
SOCB Foreign Currency SOE Loans/Total	91	93	90	91

Source: IMF Staff Country Report No. 99/55, statistical appendix.

The SOE problem—their dominance of the industrial sector and their general inefficiency—lies at the heart of development challenge facing Vietnam. More investment must go to enterprises that earn higher returns and as a result generate more growth per dollar saved and invested. More investment must go to those sectors that have the capacity to create productive employment for the millions unemployed and underemployed workers. More investment must go to those sectors that have the capability of competing in world markets and earning the foreign exchange needed to keep the growth engine running. Finally, more investment must go to those enterprises that are potentially profitable and capable of paying the taxes that are necessary to finance government spending on social and economic infrastructure.

currency/deposit ratio, on the other hand, was 54% in Vietnam, compared with 16% in China, and lower figures in other ASEAN countries, (see World Bank 1997c).

Discrimination against the Private Sector

Many of the structural problems facing Vietnam are related to the allocation of land use rights in favour of SOEs at the expense of the domestic private sector. FDI flows and flows of bank credit went to the state sector partly because the SOEs were (and still are) the only institutions provided with clear land use rights over urban land which could be used as collateral in joint venture projects and in securing bank loans. Private sector firms seeking credit have had to go to the informal sector where interest rates are typically several percentage points higher than in the formal sector.

Added to this is the administration of the trade regime and the allocation of export quotas in particular, in favour of the SOEs (for details on trade regime and policy, see CIE 1998). For example, in the textiles and garments industry, upto 80% of the export quotas were allocated to SOEs who usually were not able to fulfill the allocations and therefore sold the unused portions on the market to the private sector at a fee equivalent to about 5% of the value of the quotas (Hill 2000).

All this adds significantly to the uncertainty and cost of doing business in Vietnam, with the result that, in spite of private companies in Vietnam having quadrupled in numbers since 1992, about 80% of the new companies are in the form of household enterprises, and most of these are enagaged in trade and commerce rather than in manufacturing (Riedel 2000). The “missing ingredient” is the small to medium sized firms engaging in labour intensive manufacturing and exporting (Riedel 1999)

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Vietnam’s lack of an adequate legal/commercial infrastructure providing the confidence to invest in manufacturing is seen to be a key factor behind its failure to take advantage of its considerable potential in labour intensive exports. Underlying this lack of infrastructure is an unwillingness on the part of the bureaucracy to remove controls over, or to “unshackle”, exporters and others in the domestic private sector. The imposition of the many trade licenses, and the intense bureaucratic opposition to the initial removal of 84 different licenses, is another example of the deep-seated distrust on the part of the state for legitimate private sector activities (CIEM briefing March 2000). The excessive reliance on bureaucratic discretion, together with low salaries in the public sector, forms the basis for corruption, with negative impact on the institutional credibility of the country from the viewpoint of investors, and hence on growth (WDR 1997). According to surveys of business perception of corruption undertaken by Transparency International, Vietnam ranks 79 out of a total of 99 countries surveyed. It is placed lower (that is, considered more corrupt) than Malaysia (33), Philippines (54), China (59), Thailand (69), and India (73), but is considered less corrupt than Pakistan (88) and Indonesia (97).

In the short term, there appears to be a conflict between Vietnam’s economic objectives for rapid growth and employment creation on the one hand, and its political desire to control private sector activities on the other.

“Wrong” Lessons Learnt from Financial Crises

The belief in administrative controls was unfortunately boosted by Vietnam’s being shielded substantially from the immediate turmoil of the Asian financial crisis through extensive controls over international trade, investment and finance. Even before the Asian crisis erupted in July 1997, Vietnam had its version of a “mini” financial crisis (for a detailed analysis, see Leung and Doanh 1998). The combination of a tight monetary policy and a pegged exchange rate regime in 1996 had opened up differentials between domestic and foreign interest rates, and set up incentives for enterprises to borrow unhedged in foreign currencies. The opportunity to do so amidst extensive capital controls came in the form of trade credits guaranteed by Vietnamese state-owned banks for foreign purchases by Vietnamese SOEs. This amounted to SOEs borrowing foreign currencies short term guaranteed by state-owned banks, and the amount of such borrowings grew rapidly. In the event, some SOEs used their funds to fuel a real estate bubble while some others used the imported inputs in products where the markets had declined. By early 1997, an estimated 40% of the guaranteed letters of credit (equivalent to 3% of GDP) became bad debts. Following the State Bank rescue which significantly reduced Vietnam’s international reserves and credit rating, substantial controls were imposed on guaranteed letters of credit. Unfortunately, instead of recognizing the vulnerability of the banking sector and the dangers of the pegged exchange rate supported by extensive capital controls, the lesson learnt from this episode was Vietnam’s need to rely on the successful implementation of controls to fend off the emerging financial crisis. Furthermore, by dealing with the foreign exchange shortage (crisis) through rationing, many of the most worthy claimants of foreign exchange (private small medium enterprises) were crowded out of the market. Foreign exchange rationing may have been an important reason for the fall off in exports since without imported materials and capital, many firms could not expand exports.

Reduction of Poverty through Growth

Low inflation rapid growth in the 1990s has brought significant reduction in poverty in Vietnam. In a study comparing the two Vietnam Living Standards Surveys taken in 1992-93 and then in 1997-98, it was found that poverty, as defined by the percentage of population with less than 2100 calories of food consumption per day, fell from 53% in 1992-93 to about 26% in 1997-98 (see Liu 2000). Improvements have been most marked in the urban areas where poverty has fallen from about 32% of the population to a little over 10% in the course of five years. In the rural areas, however, about 30% of the population are still living below the poverty line, albeit a fall from 58 % in 1992-93. This development has meant that Vietnam now compares favorably with developing countries such as India, Pakistan and Bangladesh, but lags behind quite substantially in terms of the poverty index compared with China (Liu 2000, Table 7).

China’s apparent success in reducing rural poverty lies significantly in the fact that people in the countryside have been able to get non-farm employment through the process of rural industrialization, in part via the setting up of township village enterprises (TVEs) (Luong and Unger 1998). However, it has been argued that the TVEs were a sub-optimal (albeit temporarily successful) response to the opportunities and constraints that existed in China at the time, and that the same opportunities and constraints are not currently present in Vietnam (Huang 1999). For instance, China’s TVEs took advantage of the gap left by its heavy industry-oriented state-owned enterprises in the supply of consumption goods to the domestic market. In Vietnam, this gap in consumption goods is already filled by urban enterprises as well as by imports. Furthermore, there does not appear to be quite the same degree of political constraints on private ownership in rural Vietnam today as there was in China in the early 1980s. Export-oriented industrialization *a la* Taiwan rather than rural industrialization *a la* China remains the 'first best" strategy for Vietnam.

III. The State as Catalyst for Growth in the 21st Century

"Second generation reforms may be seen as the set of measures to enable a country to attain, in a sustained way, high-quality growth. Such growth will enable the economy to function more efficiently in – and to derive greater welfare from – the globalized economy…"(Camdessus 1999).

A necessary condition for the implementation of second generation reforms is the development of effective institutions (both formal and informal). This is especially relevant for Vietnam in its efforts to maximize the benefits of international integration in finance and trade, and at the same time, to minimize the potential instability associated particularly with international capital flows. A sound and robust domestic financial sector is an undeniable pre-requisite for joining the international financial markets, and the state has a very clear responsibility in setting the appropriate institutional framework in this regard.

Institutional Framework for a Well-functioning Domestic Financial Sector

The very nature of finance involves transfers of funds (from lenders to borrowers) at one point in time, with expectations of repayments (with interest and/or dividend) at subsequent points in time. Laws enforcing contracts and property rights are clearly fundamental to the effective functioning of a financial sector.

Furthermore, because borrowers can be expected to have better information about their own situations and prospects than lenders (the asymmetric information problem), lenders have to gather sufficient information about borrowers to ensure that borrowers with unacceptably high default risks would be excluded. That is, to guard against "adverse selection". Also, once the loans are made, further monitoring is needed to guard against reckless behaviour on the part of borrowers which could lead to default on repayment (the "moral hazard" problem). Finance is, therefore, a highly information-intensive industry. This information is valuable not only to ensure repayment of loans, but more importantly, to maximize the efficiency of investments, promoting economic growth. A well-functioning financial sector is, therefore, essential to economic development, quite apart from being a pre-requisite for maintaining macroeconomic stability once the economy opens to international financial markets.

The information-intensive nature of finance helps explain the relatively underdeveloped state of this sector in transitional economies such as Vietnam. If information on borrowers was not readily available and/or unreliable (in other words, "opaque"), then financial transactions could be expected to take place in the informal sector amongst families and friends where personal knowledge could be expected to fill the gap. At the other extreme, if information on borrowers was readily available in a standardized format, then stock markets and other securities markets could be expected to develop (White 1999). In the intermediate range where information is semi-opaque, financial intermediaries such as banks would be expected to play a strong role since these are institutions that have the comparative advantage in the gathering of financial information on borrowers (Mishkin 1996). This is consistent with the observation that banks usually dominate financial sectors in developing countries. In the case of Vietnam, the dominance of the state owned commercial banks (75% of total financial sector assets) is attributable more to their connections with SOEs than to availability of information or public confidence in the banking sector. Indeed, the very low degree of financial deepening as well as the prevalence of dollar holdings in Vietnam indicates that the degree of information opaqueness is well below the intermediate range. Therefore, one important role for the state in developing financial markets is to promote regulations relating to information. This would include laws relating to the regular issuance, on the part of publicly traded companies, of financial information on a standardized basis using internationally accepted accounting and auditing practices. The institution of government bodies such as the securities and exchange commission and of professional bodies such as the institute of chartered accountants and auditors would greatly facilitate this process. The accreditation of five local firms as auditors in Vietnam is a step in this direction, although their credibility would be enhanced if some of the accredited auditors include foreign firms with international reputation and experience. In the absence of underlying institutions (both the formal laws and the government and professional bodies) giving credibility and transparency to the financial performance of Vietnamese firms, the stock market will fail to function properly.

The information asymmetry problem in finance also means that depositors' interests vis-à-vis banks need to be safeguarded as the confidential nature of commercial banks' dealings with their customers means that it is very difficult, if not impossible, for depositors to monitor the activities of their banks (Mishkin 1996). This provides the basis for the plethora of prudential regulations of financial intermediaries, including minimum capital requirements, restrictions on certain activities, honesty and competence on the part of the owners and senior management of banks, market value accounting, and so on. These regulations normally entail a government prudential supervisory body (be it the central bank or a separate body) that is responsible for carrying out the supervision of financial intermediaries. Prudential regulations also encompass the corporate governance of financial intermediaries. In the case of Vietnam, the establishment in 1999 of the National Development Support Fund to provide directed lending to state-targeted projects is a step in the right direction. However, the setting up of State Bank loans to re-capitalize the commercial banks, and the establishment of an Asset Management Corporation to manage the non-performing loans and to remove them from the balance sheet of those banks are still under consideration.

Nevertheless, greater flexibility in the management of loan interest rates has been introduced. This should constitute a positive step towards promoting competition in the financial sector. With greater depth in the government bond market, the State Bank will, in due course, be able to move from conducting monetary policy through credit ceilings on banks to the use of open market operations, thereby further utilizing market forces rather than direct controls.

Because of the importance of finance to the growth of small to medium sized enterprises engaged in labour-intensive manufacturing (Riedel 1999), the success of the Vietnamese government in developing market-friendly and efficiency-enhancing regulations, while at the same time removing direct controls over interest rates and credit allocation, can be truly catalytic. On the other hand, the state owned commercial banks with their stocks of non-performing loans could be a "fiscal time bomb" (Flatters 2000), and failure on the part of the government to re-structure the banking sector could result in a serious threat to macroeconomic and political stability. Whilst enacting laws and building other less formal institutions take time and human capital, the "post crisis" on-going efforts by many East Asian countries in the area of financial sector reform provide plenty of learning opportunities. In this regard, Vietnam's membership of ASEAN is invaluable, in addition to the benefits of opening the country to international trading opportunities. The joining of ASEAN is, of course, another example of the catalytic role of the state.

Controls over International Capital Flows

The importance of market-friendly, efficiency-enhancing regulations applies equally to the *external* financial sector. The potential instability of short term capital flows is well-demonstrated by the East Asian financial crisis. However, attempts to control these short term flows should focus on taxing inflows (such as forced lodgment of a certain proportion of short term inflows with the central bank at zero rates of interest) rather than directly controlling outflows. Not only are such controls more effective in discouraging short term flows, they also allow the recipient country to benefit from whatever short term flows that do occur.

Currently, Vietnam's foreign exchange regulations appear to be more focused on controlling imports and promoting certain industries than on managing the instability of short term capital flows (Flatters 2000). The present regulations also help support a pegged exchange rate which, from time to time, is in danger of being over-valued, with negative consequences for manufacturing exports, feeding back to balance of payments difficulties, and more import controls via exchange regulations, in a downward spiral. Furthermore, the complexity and opaqueness of Vietnam's foreign exchange regulations discourage long term capital flows and distort the efficient use of the capital that do enter (McCarty 1999). They also encourage domestic savings in the form of US dollar holdings outside the banking system, and hence prevent such savings from being channeled into domestic investment and growth (see Leung and Duc 1999). An overhaul of Vietnam's foreign exchange regulations would free up significant domestic and foreign capital for effective investment. This is another area where appropriate regulations could be developed which would enhance growth and help manage macroeconomic instability at the same time.

Institutional Framework for Taking Advantage of International Trading Opportunities

Much has been written about ways to improve Vietnam's current trading regime (see CIE 1998, Warner 2000). Briefly, these include relaxation of administrative controls over international trade and associated quantitative restrictions, rationalization of customs duties and their interactions with domestic taxes, improvement in the administration of customs, reduction in direct impediments to exports, and the institution of coordinating bodies within the government to provide advice on trade, industrial and agricultural policies. In addition to these, Vietnam's membership of international bodies such as the ASEAN, APEC, and potentially of the WTO would help consolidate reforms at the domestic level. Furthermore, the recent ratification of the bilateral trade agreement with the US should give a boost to labour-intensive manufacturing exports the tariff on which will drop from 40% to 4%. In return, this agreement, amongst other things, requires Vietnam to open some of its most protected sectors such as banking, insurance, and telecommunications to 100% US owned firms within the next seven years. The implementation of this provision will require Vietnam to develop its courts and judiciary system in order to handle appeals from domestic and foreign firms against administrative decisions of the government. Therefore, with the signing of the US bilateral trade agreement, Vietnam has effectively committed itself to an overhaul of its judiciary system. If successful, this will mean that laws governing commerce (for example, Enterprise Law and Bankruptcy Law) will be given real meaning as breaches of the law will be brought to the courts and punished under the law.

Effective Partnership with the Private Sector in the Provision of Infrastructure Services[5]

According to the government estimates, a minimum annual investment of US$ 3 billion, or 12 percent of GDP, is required in the coming years to meet Vietnam's needs for physical infrastructure. There are four potential sources of funding: (1) the government budget, (2) self-financing by the state-owned infrastructure enterprises, funded mainly by credit from the state-owned banks, (3) overseas development assistance (ODA), and (4) private (mainly foreign) investment.

[5] This sub-section is mainly taken from Riedel (2000).

Based on current estimates, the government budget can, at best, be expected to contribute only about one-fourth of the total financial requirement for infrastructure investment, or three percent of GDP. In the coming years, according to the World Bank, ODA flows to Vietnam are unlikely to be more than about 2 percent of GDP annually, even if disbursements are accelerated (Vietnam-CG meeting, 1999). This leaves an infrastructure financial gap of about 6 to 7 percent of GDP, or about US$ 2 billion to be met through self-financing by infrastructure SOEs and from private sources.

SOEs are likely to receive lower, rather than higher, levels of bank credit for infrastructure investment, given that the state-owned banks are in financial difficulty (mainly due to SOE debt) and are undergoing restructuring (see Section II above). Contribution from the private sector in infrastructure finance is therefore essential. For this to occur, changes to the existing policy and institutional framework are needed.

The government of Vietnam has taken measures to encourage private participation in infrastructure, including various decrees to permit and encourage BOT projects. However, serious impediments remain, including price controls that make infrastructure projects unprofitable, the lack of a proper legal framework, excessive bureaucracy and prolonged negotiations, a weak regulatory regime, and the lack of a transparent bidding process (Vietnam-CG meeting, 1999, p.45). Removing these obstacles and tapping the potential of private investment in infrastructure is of utmost importance given the existing financing gap in infrastructure investment. In addition, foreign participation in infrastructure can contribute significantly to raising the efficiency of infrastructure providers by introducing competition and gaining access to new technologies and management practices. This is closely linked to issues of SOE reforms and competition policy.

SOE Reforms and Monopoly Regulations

The National Assembly of Vietnam has approved plans to deal with the SOE problem by diversifying ownership through equitization and divestiture and raising the efficiency of retained SOEs by restructuring and downsizing. So far, more than 700 SOEs have been equitized since 1999. Over the next five years, the government's plan is to reduce the number of SOEs further from the current number of 5,280 to 2,000 enterprises by the year 2005, which according to the NERC Vice Chairman, Pham Viet Muon, will be "mainly working in the public welfare sector and the State monopoly branches, maintaining a a leading role in the national economy" (Saigon Economic Times, 25/5/2000).

The impact of equitization on the economy has so far been relatively minor, since only the smaller SOEs, the majority capitalized at less than 10 billion dong (US$700,000) have been selected for equitization. The impact of equitization on the performance of the firms themselves has not been thoroughly analyzed. The only available evidence is an IFC study of the first 14 equitizations, which reported that company performance improved after equitization, but attributed the result to the strong initial position of these companies rather than to equitization per se. In the press, it is frequently reported that turnover and profits of equitized companies have increased and that the shares of equitized companies trade in the unofficial market at a 25 to 30 percent premium, but this is hardly solid evidence of the success of equitization.

Indeed, there are reasonable grounds for concern about the efficacy of equitization as a means of raising the efficiency of SOEs. One of the most serious limitations of the equitization program in Vietnam is the statutory restrictions that are imposed on equity share holding, which serve to limit the ownership share of outside investors. As Table 4 shows, the majority ownership of most equitized SOEs is held by the State and the employees of the enterprises. This is a matter of concern because evidence from China and elsewhere is that little is gained in terms of improved efficiency and profitability when the majority-owners of equitized enterprises are insiders.

Table 4: Ownership of Equitized SOEs

	Number of SOEs under equitization	Majority owned by outside investors (%)	Majority owned by employees (%)	Majority owned by the State (%)
Ministries	43	33	40	27
Corporations	22	19	43	38
Provinces	159	9	63	28

Source: World Bank, Preparing for Take-off? Consultative Group Meeting for Vietnam, December 1999, p.38.

Perhaps even more important than equitization, which is focused on the smaller SOEs, is the program of restructuring and downsizing larger SOEs. A monitoring system is being planned to keep tabs on bank borrowing and budgetary support for the larger, highly-indebted SOEs, and they are to be made subject to credit ceilings to ensure that they implement restructuring. Of course, any program of SOE reform would be incomplete if it did not address the problems of the State's General Corporation, especially in the traded-goods sectors, which are going to come under increasing pressure from both domestic and foreign competitors as Vietnam fulfills its obligations under the AFTA and the Vietnam-US bilateral trade agreement.

In the non-traded goods sectors, the large corporations bring significant monopoly power into strategic sectors of the economy such as energy, aviation, telecommunication and transport. Without an adequate competition policy, the costs flowing to the traded goods sector are high, thereby compounding the problems of the SOEs in this sector as they face international competition as a result of Vietnam's fulfilling its obligations under the US-BTA and AFTA.

In August 1995, the drafting of anti-monopoly legislation was formally placed on the legal reform agenda. But regulating monopolies is a complex task that involves a balance between preventing the abuse of monopoly powers and stifling incentives to invest and reduce costs. It would be preferable to promote competition through industrial re-structuring, and to regulate only those segments that are rendered natural monopolies by virtue of technology.

Industrial re-structuring and the introduction of competition policy are further "second generation" reform measures that would strengthen an economy and prepare it for taking full advantage of international integration. They would also facilitate private sector participation in the provision of infrastructure services (see sub-section above). However, given the relatively weak capability of Vietnam's public sector currently, priority should be given to the re-structuring of finance and trade, and the removal of discriminatory measures against the domestic private sector. Industrial re-structuring and competition policy should, however, be on the agenda of debate over SOE reforms so that the focus can be shifted away from the short term concerns about the financial state of the loss making SOEs to the much broader and potentially more serious impact of government owned monopolies on the entire economy.

Institutional Framework for Social Insurance

The transition to a market economy where decisions regarding production, consumption and investment are made at an individual and firm level implies that risks have become more idiosyncratic (individual-specific). A market economy means that individuals are freed from the traditional ties of families, kinship, and/or work units and communes, to pursue his/her talents to the best of his/her abilities. This underpins the dynamism and growth potential of a market economy. The downside is that the individual is subject to greater income variability, and is less able to tap into traditional sources of income support (Rodrik 1999). Without adequate social insurance, this could lead to social strife and chaos, with significantly negative impact on growth.

In most industrialized western countries after the Great Depression and the Second World War, the welfare state emerged as an institutional solution to the problem of social insurance (Rodrik 1999). This has been found to be costly, both in terms of the fiscal drain and of the impact on effort, and these countries have been in the process of trying to wind back the welfare state arrangements.

In Japan until recent years, employment practices such as life-long employment, and protection of domestic industries can be viewed as a form of social insurance in order to ensure social cohesion and stability (Rodrik 1999). This too has been found to be highly costly in terms of economic growth.

Indeed, central planning itself can be viewed as an institution of social insurance, and history has shown that this is perhaps the costliest system of all.

Therefore, the search for an adequate and least cost solution to social insurance is occurring worldwide. At Vietnam's current stage of economic development, and as a society with very strong family ties, the state could perhaps combine elements of traditional family and kinship support with selected welfare programs of the industrialized western economies. A detailed discussion of the options for Vietnam is beyond the scope of this paper. Suffice to say that the continuous development of an institutional framework for least cost social insurance within the context of a market economy remains one of the biggest challenges for governments in the 21st century.

Conclusions

This paper documents the changing role of the state as Vietnam moved away from central planning in the 1980s towards developments of markets and greater integration with the world economy. It argues that initial structural/microeconomic reforms in agriculture and industry in the early 1980s reinforced macroeconomic stabilization at the end of the decade such that political and economic forces converged to bring about the success of *Doi Moi*. However, the concern about instability associated with private sector activity and the desire to control it throughout the latter part of the 1990s have meant that Vietnam has not been able to take full advantage of the opportunities offered by international integration in trade and finance. On the other hand, low inflation and rapid growth have brought significant benefits, including substantial reduction in poverty. Continuation of growth through export of labour intensive manufactures is both an economic and political imperative.

To do this, the role of the state has to be re-defined away from that of "controller" of the private sector to that of a "partner" working with the private sector to promote growth. Laying the legal/commercial foundation for finance and trade, whilst removing the discrimination against the domestic private sector, is the first priority in this regard. The successful implementation of the Enterprise Law is an indication that this process could be already underway. Attention then needs to be re-focused away from equitization of loss making SOEs towards a more comprehensive plan for industrial re-structuring and the introduction of competition policy so that Vietnam's domestic economy can be made more internationally competitive. At the same time, a framework for social insurance appropriate to Vietnam's situation needs to be instituted.

Once it is understood and accepted that the state has a catalytic role in promoting growth together with the private sector, then there is the further task of improving the capacity of the state so that it can continue to pursue market-friendly and efficiency-enhancing regulations, interacting positively with the private sector to promote sustained growth.

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