

# Vietnam's Renovation—A Unique Growth Path

by David Dollar and Jennie Litvack

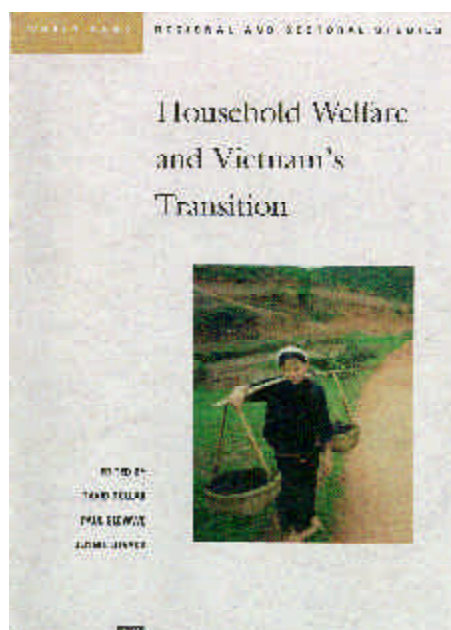
In the late 1990s Vietnam's economic status was very similar to that of other low-income countries, many of which have carried out macroeconomic policy reform supported by the IMF and the World Bank, but without Vietnam's spectacular results.

Vietnam's program of *doi moi* (renovation) began in the agricultural sector. Collectives were dismantled in 1988 and land was distributed among peasant households. Initially, the property rights to land were left vague. But in 1993 a new land law clarified that peasants had the right to use the land distributed to them for 20 years and that this right could be renewed. Further, peasants could sell or mortgage the right to use their land. Just as important as the reform of property rights was the reform of prices introduced in early 1989. Controlled prices for most goods and services were abolished. For several years the country was functioning with a system of dual pricing, in which most output (both agricultural and industrial) had to be sold to the state at official prices; the balance could be sold at market prices. The abolition of these controlled prices and the system of state procurement in 1989 strengthened the incentive to produce.

Reforms in agriculture were particularly important because it was the largest sector of the economy, accounting for 40 percent of GDP at market prices in 1989. But there were analogous reforms in other sectors as well. For years private production of goods and services had been tightly restricted. Official policy changed in the late 1980s to increasingly tolerate and even encourage the private sector. Price liberalization in 1989 gave major impetus to this trend. In 1989 overall GDP growth accelerated to 8 percent. There

was rapid growth in agriculture, services, and construction, all areas in which the private sector was able to respond quickly to strengthened incentives. On the other hand, industry, which remained largely under state control, showed negative growth for the year.

At the same time that the government was introducing these structural reforms, it was trying to cope with serious macro-



economic problems, including high inflation and the impending cutoff of Soviet aid. The fundamental problem was that the government and state enterprises were spending too much and this excess was being financed by Soviet aid and central bank credit. Strong measures to deal with this situation were introduced in 1989. Production and consumption subsidies were eliminated from the budget. At the same time, interest rates on loans to state firms were raised above the level of inflation (that is, to 9 percent a month in spring 1989, when inflation was about 7 percent a month).

In 1990–92 the government took additional steps to control the growth of credit and hence inflation. By 1991 credit was no longer used to finance the budget. Loans to state enterprises were also controlled more carefully and priced appropriately. This tightening of the budget constraint led to a major restructuring of the sector. Between 1988 and 1992 about 800,000 workers—one-third of the 1988 state-enterprise labor force—left the sector and the number of firms declined from 12,000 to 7,000. These policies gradually brought the expansion of credit under control. The restrained monetary policy succeeded in bringing inflation down to about 10 percent a year during 1993–95. The disinflation program required that discipline be imposed on state enterprises and on the budget.

Once stabilization was achieved, growth accelerated, averaging 9 percent for 1992–95. Because of this high growth and initial reforms of the tax system, government revenue increased rapidly after 1991, and the government was able to restore the investment and social expenditures that were cut during the austerity period. Thus government expenditures as a share of GDP were higher in 1994 than in 1989, at the beginning of the fiscal adjustment. Furthermore, because per capita GDP had increased substantially during this period, real per capita government expenditures were nearly twice as high in 1994 as in 1989.

Three aspects of Vietnam's reform strategy may help explain the country's outstanding results:

**1. Large agricultural and private sectors at the outset.** Stabilization is normally a shock to the economy because interest rates are raised, government sub-

sidies are cut, and devaluation makes imported inputs more expensive. Vietnam's stabilization had the predictable effect on the state sector of the economy, which showed negative growth in 1989. What distinguished Vietnam from most transition economies was that, alongside the state sector, the agricultural as well as the private service and manufacturing sectors were producing a total of about 60 percent of GDP and employing 85 percent of the labor force. These producers were receiving neither credit from the formal sector nor subsidies from the government. Thus, for them, 1989 was a year in which inflation fell and prices were liberalized, creating a good environment for expansion. The fact that interest rates were much higher and subsidies were lower did not matter to agricultural households and small private firms, since they were not getting any of the formal credit or budget subsidies to begin with.

**2. Thorough opening to international markets.** Opening itself to international markets included the unification of the country's multiple exchange rates in 1989. At the same time the official rate was devalued from 900 dong to the dollar to 5,000 dong to the dollar, the prevailing black market rate. The central bank has subsequently kept the official rate very close to the parallel rate. This bold devaluation in 1989 greatly strengthened incentives to export. At the same time administrative controls on exports and imports were relaxed. As a result exports have been a leading growth sector throughout the reform period, with real export growth averaging more than 25 percent a year. (For rice, oil, rubber, cashews, coffee, shoes, textiles, and tourism services.)

By 1995 imports plus exports relative to GNP had reached 79 percent in Vietnam, a high figure for a populous country. The comparable figure for Thailand—well known as an open economy—was 70 percent; Egypt, a large, closed economy,

had trade totaling 32 percent of GNP. Vietnam's export surge was important not only because it spurred production but because it financed the economy's growing import demand.

**3. Proper timing of reform-supporting foreign assistance.** Another key way in which Vietnam differed from other low-income reformers was that it did not have access to official finance. Soviet aid declined rapidly after 1988 and was not replaced by funding from other sources. The collapse of funding did not require any cutbacks in imports, however, because Vietnam's export growth was sufficient to ensure that imports could grow throughout this adjustment period. The current account deficit declined from more than 10 percent of GDP in 1988 to around zero in 1992.

Investment increased sharply between 1988 and 1992, while foreign aid was drying up. In response to stabilization, strengthened property rights, and a greater openness to foreign trade, domestic savings increased by 20 percent of GDP, from negative levels in the mid-1980s, to 16 percent of GDP in 1992. Foreign financial assistance was not offered to Vietnam until the country had an established track record of successful macroeconomic and trade reform. Financing from the World Bank and the IMF resumed in 1993. While the delay was largely political, it perhaps offers a useful lesson: too much financing in the early stages of reform may delay adjustment rather than support it. In Vietnam's case foreign aid came after good policies were in place.

**4. Quick benefit for a large number of households.** The underlying distribution of assets in Vietnam was quite equitable. Vietnam has very little capital stock, its main assets are land and human capital. The distribution of land among households is relatively equitable and basic education and literacy are widespread. The

vast majority of households were thus able to benefit quickly from market reforms and the opening of the economy to international trade.

Looking to the future, one important issue is whether the reform program will continue to generate robust growth. The state sector is still large and significant impediments to foreign trade and investment remain. It would be more difficult to promote private investment or to reduce protection of inefficient industries, if a large number of state-owned enterprises remained intact. Progress with structural reforms is thus one of the factors that will influence the country's growth. Divesting state enterprises, improving the environment for private investment, and lowering trade barriers are all structural reforms that will help sustain the growth of recent years. It will be easier for the government if it moves on all these policy fronts at once.

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# Vietnam: Economic Rethinking Amid Slowdown

**P**rime Minister Phan Van Khai told international donors during a one-day conference on June 15 that Vietnam was struggling to overcome its lack of competitiveness and efficiency in the face of the regional economic crisis. The weakness of the economy itself is the biggest bottleneck, the prime minister pointed out, adding, "growth during the first five months of the year had slowed to 6.8 percent (from 8.8 percent growth recorded in the same period last year). Vietnam's financial and monetary systems have many shortcomings, the government's management apparatus has not improved and is engaged in corrupt activities. Useful lessons must be drawn from the regional crisis. These include the need to create a level playing field and the encouragement of the entrepreneurial spirit and the promotion of competitive Vietnamese goods."

## Donors' Alert

The meeting in the central Vietnamese city of Hue was the first of its kind that brought together Vietnam-based representatives of the members of the Consultative Group on Vietnam, which meets annually to coordinate the international community's aid pledges. The major donors include the World Bank, the International Monetary Fund (IMF), the Asian Development Bank, the United Nations Development Program, Australia, France, Japan, and Sweden. The group's last meeting in Tokyo resulted in aid pledges of \$2.4 billion for 1998. The mid-year meeting reflected the donors' concern both over the pace of reform and over the impact of the regional economic crisis. They reiterated support for accelerated reforms in the financial sector, rationalization of state-owned enterprises, trade liberalization, and the reinvigoration of rural development. Rural development assumes both transferable land tenure

and the deregulation of economic activities in rural areas. Donors also acknowledged that Vietnam faces a dilemma over economic reform, particularly the social costs of embarking on initiatives such as restructuring state-owned firms.

Donors felt that fiscal transparency, specifically the publication of the state budget and other data, was critical to a continued high level of foreign assistance and important for Vietnamese citizens and the private sector. With technical assistance available from the IMF and the World Bank, donors expressed hope that the budget will be published before the next meeting, which will be held in Paris, December 7–8, 1998.

## Macro Worries

The impact of the East Asia crisis on the economy is reflected in the slower growth of industrial output, exports, as well as declining investment.

- **Industrial output** rose by 12.6 percent for the first six months of the year to \$5.55 billion, down from 13.6 percent in the same period last year, according to preliminary official statistics released on June 25. State-owned enterprises, which accounted for 47 percent of industrial output, saw a rise in production of just 9 percent. Foreign-invested enterprises accounted for 31 percent of industrial output and registered a 21.8 percent increase in output. (More than 80 percent of foreign-invested projects are done in collaboration with state-owned enterprises.)

- **Exports** grew by only 10 percent during the first six months, its lowest figure in many years, and less than half the 25 percent growth for all of last year, reflecting slower East Asian demand and a loss of price competitiveness owing to the relative strength of the dong. Consumer

goods exports—shoes and textiles and garments—have been worst hit, as demand from Japan and the Republic of Korea has fallen sharply. Imports grew by just 1.8 percent in the first five months of this year.

- **Foreign investment** has fallen 15.3 percent year-on-year in the first five months of 1998, and more and more foreign investors have scaled back or closed down altogether over frustration with rampant corruption, excessive bureaucracy, and opaque laws. For East Asian investors, who account for 64 percent of foreign direct investment inflows recorded to date, the cost of investing has increased as business transactions are increasingly conducted in U.S. dollars. EU and U.S. investors are also adopting a more cautious approach, despite the fact that this is a market of 75 million people, nearly 50 percent of whom are under the age of 25.

- Both domestic and foreign companies are **laying off workers** in growing numbers. Before the Asia crisis nearly 5 million people were jobless and the unemployment rate was estimated at 12.3 percent. It is estimated that up to 30 percent of state-owned enterprises (SOE) employees, or 600,000 people, are excess labor.

- **The agricultural sector** has been hit by drought and serious damage has been done to key crops. In the first five months of this year agriculture—which accounts for 28 percent of annual GDP—grew by just 2 percent, while annual agricultural growth rates over the past few years came to an average of 4.5 percent.

In mid-February the Central Bank of Vietnam lowered the interbank foreign currency rate by 5.3 percent to 11,800 dong to the dollar, but many foreign bankers

and economists say the dong is still overvalued. They predict increased pressure against the dong because of the considerable decline in new foreign investment, a slump in export growth, and general concern about the deterioration of the Vietnamese economy. The competitiveness of shoes and garments—Vietnam's chief manufacturing exports, which account for about 25 percent of export earnings—is especially vulnerable since the main competitors, Indonesia and Thailand, have seen their currencies depreciate between 50 and 70 percent. But Vietnam has been reluctant to undertake another major currency adjustment, it is concerned about the instability that a major devaluation might cause. Instead, it is offering new incentives to investing foreign companies and exporters. These include further tax reductions and lower land rents.

### **New Slogan: Equitize!**

In mid-June Communist Party General-Secretary Le Kha Phieu called on SOEs to press ahead with the government's program of partial "equitization" (privatization) of state-owned enterprises. Establishing vibrant, "equitized" companies is seen as a good way to create employment. Equitization is also regarded as necessary if plans to launch a stock market within one to two years are to be realized. As a first step the government plans to establish a Stock Exchange Centre, scheduled to be in place by September this year. The original program was launched in 1992, and its revitalization has taken on new momentum since Prime Minister Phan Van Khai came to office last year.

The government has indicated its intention to equitize 60 percent of the country's 6,000 SOEs. To date, 26 small, mostly local SOEs have been equitized and a further 200 have registered for partial privatization. Of these, around 100 firms are believed to be financially sound. There

are plans to equitize 150 firms by the end of the year, followed by a further 250 in 1999, and 600 in 2000. If any SOEs have been loss-makers for several years, bankruptcy proceedings are to take effect.

Strategic companies in such sectors as energy, telecommunications, and aviation, however, are excluded from the equitization process. Firms that are highly profitable, or the sale of which would involve large redundancies, will not be equitized either. Shares in equitized firms have hitherto been sold to companies' existing management and workforce. Outside investors are scrutinized closely to ensure their suitability. Foreign investors are currently limited to holding 30 percent of a company's equity. The pace of the equitization process is likely to be constrained by several other factors, including the following:

- Job losses have become increasingly politically sensitive. Firms are unlikely to receive government approval for laying off large numbers of workers.
- Due to concerns about rising layoffs and the loss of privileges that accrue to SOE managers, companies have been slow to volunteer for inclusion in the equitization process. Some firms are also concerned that evidence of mismanagement or corruption will come to light.
- Several banks are refusing to lend to newly equitized companies on the grounds that their profitability is not yet assured.
- SOEs enjoy relative autonomy in terms of day-to-day decisionmaking. Within each firm there is a complex set of relationships involving the controlling institution (usually a ministry or local government), the company director and the board of management, as well as the Communist Party and labor units. The various interests of these groups will have to be reconciled if equitization is to proceed.
- Before an enterprise can equitize, it must be audited and its assets valued, a process that has proven to be extremely complicated.

- Clear legislation is not yet in place, and the responsibilities of various arms of the administration are overlapping. Companies seeking to complete equitization procedures face inspections from a variety of different organizations.

### **Banks Need a Face Lift**

"Sound banking is critical for restoring Vietnam's rapid growth. The main tasks of banking sector reform are to develop a strong legal framework, strengthen banking supervision, improve credit quality, and improve the soundness of banking systems for economic growth—Le Duc Thuy, First deputy governor of the State Bank of Vietnam, pointed out during a June 29–30 international seminar in Vietnam, organized in collaboration with the World Bank to share international best practices in establishing sound banking systems.

Present problems include:

- Large amounts of capital are held outside the formal financial system in U.S. dollars and gold. The government has recently ordered exporters to sell surplus hard currency to banks. Nevertheless, individuals deposit money in banks usually on a short-term basis. In several high-profile banking scandals bankers have been found guilty of embezzling state assets.
- Due to deficiencies in the legislation on collateral and foreclosure and restrictions on the interest rates that banks can charge, lending entails significant risks for the banks. A good indicator is the high level of their indebtedness. The four state-owned commercial banks are estimated to have bad debts of some \$300 million. Questionable lending policies and property speculation—now banned under the new legislation—have resulted in the accumulation of debt by shareholding banks.
- Credit for small and medium-size businesses remains thin. Previously, these groups have been dependent on loans

from family members or private money-lenders who charge very high rates of interest.

Various initiatives are currently under way to strengthen the banking system. A number of local banks have broadened their loan portfolios to include private, small, and medium-size enterprises, and even small market traders. A program of bank mergers has been designed to strengthen the sector.

### The World Bank's New Strategy

The World Bank will announce later this year a shift in its Vietnam strategy away from big infrastructure projects and toward poverty eradication and rural development, Country Director Andrew Steer announced recently. World Bank economists are now working with the Vietnamese authorities on a Rural Development Strategy Report, which will be published in August and will serve as the basis for discussion by Vietnam's major donors during their forthcoming December meetings, where they will decide on their 1999 aid packages.

The new emphasis is in line with the World Bank's policies around the world and is also a response to conditions in Vietnam. At stake is the future of the country's peasants, who make up nearly 80 percent of Vietnam's population. Agricultural productivity has risen, but jobs off the farm are not being created fast enough, the World Bank believes.

The latest project of the Bank already reflects this new approach. A \$67 million IDA credit, approved on June 25, will help small farmers diversify their agricultural production into rubber, livestock, and crops in order to reduce rural poverty and maintain growth in rural incomes. A \$70 million annual rubber output would create 25,000 full-time jobs and increase farm income for some 100,000 families. For the next two years

the Bank is hoping to add 5 to 10 more local economists to its staff of 25 people and release another \$600 million in loans, in addition to the \$1.6 billion

concessional loan and grant assistance already pledged. Since 1994 the World Bank has disbursed about \$475 million to Vietnam.

## Milestones of Transition

**The European Bank for Reconstruction and Development (EBRD) forecasts 2.5 percent growth for Eastern Europe and the countries of the former Soviet Union in 1998.** The EBRD released its forecast at its annual meeting held May 11-12 in Kiev. GDP growth of 3.9 percent is seen for Eastern Europe and the Baltics this year. The Commonwealth of Independent States (CIS) region should have GDP growth of 1.5 percent. Of individual countries, Estonia should experience GDP growth of 5.5 percent (the 1997 estimate was 10 percent), Latvia 6.0 percent (6.5 percent in 1997), Lithuania 5.5 percent (5.7 percent in 1997) and Russia 1.5 percent (0.4 percent in 1997). The mounting current account deficits require fiscal policy measures. As a lesson from the Asian crisis financial sector reform is needed. Last year the EBRD provided \$2.6 billion in financing for 108 new projects. The EBRD presently has outstanding disbursements of more than \$5 billion, about \$1.5 billion more than in 1996. The largest debtors are Hungary, Poland, Romania, and Russia.

**Foreign direct investment (FDI) in transition economies was up a third in 1997.** A recent *Financial Times* survey found that FDI in transition economies rose from \$13 billion in 1996 to \$17 billion in 1997. The growth in FDI from 1996 was nearly 20 percent in Central and Eastern Europe and 54 percent in CIS countries. FDI to Russia in 1997 was \$3.9 billion (up 90 percent), Estonia \$131 million (up 18 percent), Latvia \$415 million (up 10 percent) and Lithuania \$327 million (up 115 percent).

**Leaders and laggards in the CIS economies.** Official data for the 11 CIS economies in the first quarter of the year show some successes, but most of the economies have still not shaken off their economic depression. (*CIS Goskomstat* bulletin, May 21). The Kyrgyz Republic and Georgia led the pack with reported GDP growth of 11 percent, followed by Azerbaijan with 8 percent. Armenia reported 6 percent growth, Belarus 13 percent, Tajikistan 1 percent, and Uzbekistan 3 percent growth rate. In the first quarter Moldova and Russia registered zero GDP growth, while Ukraine and Turkmenistan experienced a drop. Even though industrial output has stabilized in countries such as Kazakhstan and Moldova, agricultural output continues to fall there: meat output was 40-50 percent down from the 1997 level in those countries. This was also the case in Ukraine and Russia.

**EU Expands University Exchange to Central and Eastern Europe.** The European Union for the first time is extending its university exchange program, Erasmus, to five countries in Central and Eastern Europe. This year's budget is more than \$125 million. On May 25 the EU Commission approved the participation of 149 Central and Eastern European institutions of higher learning in the 1998/1999 academic year. More than 8,000 students and teachers from the Czech Republic, Hungary, Poland, Romania, and Slovakia will be spending study periods of up to one year at universities in EU countries. Their studies will cover languages, science, social studies, economics, and other areas. By the next academic year the Baltic republics

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