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FEAR OF FLYING: WHY IS SUSTAINING REFORM SO HARD IN VIETNAM?

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Background

It has been twenty years since the *Doi Moi* reforms were launched in Vietnam and the economy has been transformed in that time. The well-known turnaround in agriculture – from hyperinflation and food shortages to price stability, higher rural incomes, and top-tier global rice exporter – has often been told. On top of this have come successes in coffee, rubber, seafood and fish, and many other agricultural products. “Going private” in agriculture was an astonishing success that reduced poverty more than anything else in the first decade of reform. Poverty declined from about $\frac{3}{4}$ to under $\frac{1}{4}$ in two decades, in spite of the collapse of the Soviet Union, the major aid giver and trading partner of Vietnam.

Then there was the striking decision made in 2000 to allow easy registration instead of licensing of most formal private business. The result was over 120,000 new firms, millions of jobs and billions of dollars of investment capital mobilized. In terms of gross industrial output, the share of the domestic private sector has risen from $\frac{1}{4}$ in 2000 to $\frac{1}{3}$ in the first quarter of 2006, taking more or less equal shares from both the state sector and foreign sectors. The state’s share in industrial output growth is now only 15-20%, in spite of taking higher levels of capital and educated workers than the private sector. Here again, relying on the private sector has paid off incredibly well, helping to extend the reductions in poverty and accelerate GDP growth from an already healthy level.

There has also been an open door policy to most forms of foreign investment, and after an initially slow period after the Asian Crisis, it appears that foreign interest in Vietnam is growing strongly. Part of this might be due to increasing tensions between Japan and Taiwan (two major investors) and China. Increasing reluctance to put all their FDI eggs in the China basket has helped Vietnam, but improving policies, infrastructure, and productive and fast-learning literate labor have also contributed. Certainly, the interest of Intel and Microsoft comes not only from cheap labor! Approved licenses for new investment and higher allowed reinvestments in existing projects exceeded \$5 billion in 2005, and realized FDI should be \$3 to \$4 billion in 2006. Inflows in 2000 were under \$1 billion. This is a high level of FDI, higher even than China’s on a per capita basis.

The growth in exports is another indicator of success. Exporting requires efficiency – one is competing against the lowest cost suppliers in the world. From \$2.1 billion in 1991, exports grew to over \$32 billion in 2005. This is a compounded growth rate of 21% a year over fourteen years. Moreover, there were many products that exceeded \$500 million in export value – crude oil, coal, garments, footwear, seafood, rice, coffee, rubber, electronics and furniture. Vietnam is proving its competitive ability in agricultural raw materials, minerals, labor-intensive goods, and even some higher value-added goods. It is significant that export growth continues even into 2006 at a rapid rate (25%), and entry into the WTO should help maintain future progress.

Indeed, given the declines in poverty, growth in real GDP, exports, and industrial output, improvements in education and health, and obvious signs of prosperity in the cities, some might simply give Vietnam a grade of “A” and be done with it. Those familiar with the author’s habit of analysis will not be surprised to find this is not his conclusion. Not only

in spite of but because of the very successes outlined above, it seems to be difficult for Vietnam to move decisively in the direction that its past remarkable successes clearly indicate. Vietnam's leadership is not stuck, but it is torn. Parts of it fear that giving ground too quickly on state owned production would be dangerous politically, even if sound economically.¹ Because so much of the legitimacy of the government and Party is built not only on the resistance struggles, but also on more recent and very positive social and economic accomplishments, this position might be hard to understand. The paper will analyze it from a foreign economist's perspective. Its conclusions may inform future discussion concerning the right mix of policies going forward.

The First Decade

Vietnam tried to graft central planning on top of a poor, rural economy after the 1975 unification of the country. In the north, the ending of war and familiarity with collective agriculture allowed for little progress – a 22% rise in food output from 1974 to 1986, which was slower than population growth. This approach also worked poorly in the south, where the drive to collectivization was passively resisted. However, increasing cultivated area for annual crops by 30% via irrigation investments and introducing improved varieties helped boost 1986 rice output by 39% over 1975.² Even so, there were food shortages and hyperinflation. (The latter was a monetary phenomenon, but it could not have helped to improve the allocation of resources.) Output of paddy in all of Vietnam rose from 11.8 million tons in 1976 to 15.1 million in 1987, a 28% increase. But since population grew 27% in the period, there was virtually no improvement in per capita rice availability. It was not impressive for a country recovering from war.

After the *Doi Moi* reforms, food output rose to 25 million tons by 1995, a 65% jump over 1987, or about 40% per capita. This jump, along with a loosening up of labor movement, helped to push poverty rates down sharply. Poverty rates described as “well above 70%” in the mid 1980's³ fell to 58% in 1993 and 38% in 1997-8 – a probable halving in 12 years.⁴ Output of real GDP rose in a similar manner, with growth of 7-8% a year in the 1987-96 period. Estimates of real output growth in the earlier 1980's are unreliable due to many factors, but electricity output rose 56% from 1980 to 1986, 73% from 1986 to 1992 and 115% from 1992 to 1998. Taken together with the progress in agriculture, there is every reason to believe that real output also saw a 50-100% faster rate of growth under *Doi Moi*. Indeed, it was not just that output grew faster – it was also more attuned to the market. If exports are any indication of ability to respond to market opportunities and tastes, then the progress is nothing short of astonishing. In 1986, exports were about \$500 million, or less than ½ of imports of \$1.1 billion. By 1997, exports of \$9.2 billion were equal to 80% of the \$11.6 billion in imports. This 18-fold jump in exports created a huge opportunity to buy both capital goods and consumer goods. Because of aid,

¹ Some others think that state-led heavy industry is needed – both politically and economically.

² Rice output in the South had grown 45% from 1965 to 1975 in spite of the war. See Appendix to The Rice Economy of Asia, Beth Rose, 1985 Resources for the Future, p. 156

³ This comes from p. 35 of Doi Moi and Human Development in Vietnam, 2001, National Centre for Social Sciences and Humanities, Hanoi, 2001. Poverty estimates in the 1980's are educated guesses.

⁴ The 1993 and 1997 poverty estimates come from the Vietnam Living Standards Surveys, supported by the UNDP and the World Bank. They are generally regarded as reliable.

remittances and FDI the trade deficit was easily financed. Inflation remained low and the exchange rate depreciated at a controlled rate that reflected a desire to maintain competitiveness.

The social indicators also improved during this decade. Enrollments in primary and middle schools, already high for a low-income country, grew more or less in line with student-age populations, but the enrollments at secondary and tertiary levels showed sharp gains. Secondary students actually dropped from 911 thousand in 1986/87 to 564 thousand in 1992/93 as subsidies were cut back, but then jumped to 1390 thousand in 1997/98. (The population of 15-17 year olds rose 17% from 1986 to 1997, but secondary enrollments rose 53 %.) The collapse of the subsidized education system was overcome by increased spending from private sources, and also from public sources after an initial period of austerity. In tertiary education, the students dropped from 126 thousand in 1986 to 107 thousand in 1991 but then rose to an astonishing 663 thousand by 1997! While quality issues remained a concern, the raw numbers showed impressive gains.

The health data also show gains from an already impressive level. The under-five mortality rate was estimated at 82 per 1000 in 1979-83, falling to 69 in 1984-88 and 55 in 1989-93. (These estimates are based on Intercensal demographic surveys from the GAO – different sources show different estimates.) By 1997, the rate had fallen to 40 per 1000, similar to the 38 of Thailand with more than triple Vietnam's per-capita income. Improvements in nutrition and an ability to buy medicines, along with an aggressive vaccination program helped to bring life expectancy up to levels typically associated with middle-income countries. By 1997, men had a life expectancy of 66 years and women of 71, again virtually identical to Thailand's level, close to that of China and actually better than that of Brazil.

However, the very successes of the economy and the society gave rise to a perverse caution and even reaction within the leadership. Highly dubious and low-return government investment projects were initiated. (The north-south power line was rushed through, reportedly against the advice of technical specialists. It delayed the development of adequate thermal generating capacity and contributed to uncertain power supplies.) Import-substituting industrialization, often in forced combinations of foreign investors and state enterprises, created bad feelings and high costs. There was glacial reform in privatizing (or even equitizing⁵) state enterprises⁶ and the financial system. The regulatory system was heavily stacked against formal private sector businesses of any but the smallest sizes. One World Bank study found most of the reform in Vietnam up to 1996 came before 1991 – that is, before significant aid flows!⁷ As aid increased, the share of the state in total investment actually increased. By 1997, the state sector accounted for over 47% of gross industrial output, while households had 14% and mixed

⁵ Because of aversion to “private” firms of any size, the solution to inefficient state enterprises was to turn them into joint-stock companies with state entities owning a controlling share. This is called “equitization.”

⁶ The often-quoted reference to “thousands” of SOEs being privatized in the early 1990's is misleading. They were mostly small. Local enterprises outside of the central planning system, accounting for little employment, capital or output. The resources were easily redeployed locally as the economy grew.

⁷ Assessing Aid, What Works and What Doesn't, World Bank, Oxford, 1998, p. 107.

and foreign-connected output (including oil) covered another 36%. Formal (larger) private and collective industrial output accounted for all of 3% of total industrial output!⁸

It was almost as if there was an ideological preference for inefficient investment and policy. This preference was indulged in good economic times but was adjusted when economic hard times or disaster threatened. This approach was not likely to produce the fastest poverty reductions or the most equitable outcomes, but it did create a kind of political equilibrium within the various elite groups. While the increase in oil, aid and over-enthusiastic FDI did provide a period of high growth in the 1990's, the growth was not self-sustaining. While the momentum of agricultural and price reforms created real progress and helped to reduce poverty, the lack of deeper reforms in the first decade set the table for a slowdown following the Asian Economic Crisis. This is in spite of rapid advances in electricity, roads, and other infrastructure. The problem was not "hard" but "soft" infrastructure - the lack of institutions and policies that recognized constraints to production and acted to reduce them, and thereby liberate and regenerate even more productive forces. The economy was still somewhat inward looking.

The limited positive role of the state shows up in changes in employment over the 1990's. State sector employment, including government and state enterprise workers, dropped from 4.1 million in 1987 to 3.1 million in 1991. It briefly dipped a bit more (2.9 million in 1993) and then crept back up to 3.27 million in 1997. (In 1987, total labor force was 28 million and in 1997, it was 37 million.) *So, over 100% of all new jobs created from 1987 to 1997 were outside of the state sector.*⁹ The state share in 1997 was only 9% of all jobs. This is a negligible role for the state in a critical variable. Without new job creation, there is no equity or stability.

In comparison, investment outlays from all state sources compared to total investment fluctuated at around 50% during the 1990's, with a distinct rise in the second half. It has to be said that only state and foreign investment estimates are even somewhat reliable – the domestic private sector was not only small, but was also often invisible to the statisticians – or at least was for much of this period up to 1995. Starting in 1995, when there was an industrial census, the coverage improves somewhat. In any case, the state share of investment was 42% in 1995 and 58.6% in 1999, a real increase of over 110%. The private sector grew 34% in the same period and the foreign sector actually declined 12% in real terms. By 1999, the foreign share had fallen to 17.3% (from 30% in 1995) and the private domestic share was 24% in 1999, down from 27.6% in 1995.¹⁰ While some of the state investment jump was due to needed increases in roads and other infrastructure, much of it went to ill-chosen projects or inefficient state enterprises that created few jobs. It is hard to have reform when the state takes a large, growing and inefficient role in investment, and that is where Vietnam was by the later 1990's.

Regional Equity?

⁸ Statistical Yearbook, 1999, Statistical Publishing House, p. 168.

⁹ Growth of state jobs from the low point in 1993 to 1997 still accounted for only 8% of all job growth.

¹⁰ The investment data change over time with revisions. These are taken from Table 174 of the 2002 Statistical Yearbook.

An important political and economic factor in growth is regional balance. That is, all of the growth should not take place in and around one or two cities. The *Doi Moi* agricultural reforms were notable in their wide impact – thus the rapid and large poverty reduction. Most FDI is concentrated in a few provinces – Hanoi, HCMC, Dong Nai, Binh Dung and BR-VT.¹¹ Therefore, there is political pressure to use state investment as an “equalizer” and ensure that growth spreads beyond the two major metro-areas. One notable investment decision, the Dung Quat oil refinery, was made with the justification of regional balance. Of course, it made no economic or financial sense. Many foreign oil companies, interested in participating in building a refinery, exited when that place was required. Why build a refinery far from either raw material sources or major markets in a typhoon area? Even Petro-Vietnam wanted to build it in a commercially sensible place, at least as expressed in private conversations with the author. However the decision was made to proceed in Quang Ngai.

The delays and cost increases that followed were predictable. High refining margins now¹² would allow an operating refinery to recoup part of its expense, but by the time Dung Quat is operating, the margins will probably again fall towards the \$4-5 per barrel (\$35 per ton) level that is more typical of most operating experience. In normal times, the higher transport and capital costs will simply mean either higher prices of petroleum products for consumers or subsidies from the government to cover losses or low returns. This will hurt all enterprises and consumers. Ironically, it will help Quang Ngai very little. In spite of putting large investments into infrastructure, there will be few jobs or linkages into the local economy not driven by further state investment. The neighboring province, Quang Nam, has a better chance to develop FDI and local industry and a sustainable and growing economy if it can implement its “open door” policy.¹³ Successful regional development is seldom achieved by uneconomic and capital-intensive heavy industry investments. A combination of smart infrastructure and a better operating environment, combined with training and targeted marketing, is far more likely to succeed. But the old system stays alive, using up capital and providing few of the equity benefits used in justifying itself, or doing so at a very high price.

If we take the period from 1993 to 1998 and use the two Living Standards Surveys, we find that real per capita spending jumped 79% in the Southeast, 57% in the Red River Delta, and only 19-33% in the Northern Uplands, Mekong Delta, Central Highlands or South Central Coast. So, while all regions were rising, the regional concentration began exactly in the period when state investment was increasing as a fraction of the total.¹⁴

¹¹ In The Real Situation of Enterprises, Table 14, the 2003 capital data of operating foreign enterprises shows 85% of capital in those five provinces. Licensed FDI is somewhat more evenly spread but still quite concentrated in and around the two major cities, even in 2006.

¹² The difference between the value of refined products and the cost of crude oil input is the “crack spread” and this tends to be cyclical. It can go as low as \$2-\$3 a barrel (159 liters) and as high as \$10 to \$15, but tends to average out to \$4-5 or so a barrel. The term is primarily used in commodity hedging.

¹³ A positive development is that Quang Ngai has adopted asked for many of the same degrees of policy freedom and received them. However, proper implementation in either province will be complicated.

¹⁴ From Living Standards During an Economic Boom – The Case of Vietnam, Houghton, Houghton and Phong (editors), 2001, Statistical Publishing House, Hanoi, p. 41

The Second Decade

Part of the large *relative* increase in state investment was due to aid and rapidly rising credit to state enterprises. But another part of the reason was due to actual declines in foreign investment and sluggish private investment growth. Part of the foreign decline can, of course, be tied to the Asian financial crisis, and the dire financial circumstances surrounding many of the firms that would normally have been investing. But it was not only that. As Vietnam expanded credit, it had its imports grow much faster than its exports. In 1992, exports and imports were about equal at \$2.5 billion each. By 1996, exports had jumped to \$7.3 billion but imports had soared to \$11.1 billion. The trade deficit in 1996 was more than the export or import **level** of 1992! The response to this was to impose various controls, including making it more difficult for import-competing firms to turn their *dong* profits into dollars and take them out of the country. In fact, a rule was made that most foreign exchange had to be converted to local currency, and the foreign exchange earned by the foreign firm had to be approved for their own external use. This did not impress foreign investors who backed away. FDI inflows (not just the amount licensed) had averaged \$2 billion from 1995 to 1997, but fell to under \$800 million in the next few years.¹⁵ That is a 60% decline.

In addition, the domestic private sector was weak and subject to demands from officials for payments for registration, permits and other necessary permissions. Private investment – more likely to be spread out among poor provinces than FDI and more labor intensive than state enterprises – was growing very slowly. In addition, the size of private firms was small and their level of technology was low. In 2000, there were exactly **ten** domestic firms without state or foreign capital that had total worth of at least \$33 million.¹⁶ The lack of supplier industries and FDI meant slower export growth and FDI inflows too, though the Asian Crisis also hurt. Exports had tripled in dollars from 1993 to 1997, an annual growth of 32%. From 1997 to 1999 they grew at 12%. With a weak private sector, low and declining foreign investment, and an inefficient state sector it was not surprising that GDP growth faltered. From the 8-9% rate up through 1997, the official GDP growth rate (thought to be overstated by many) was 5.8% in 1998 and 4.8% in 1999.¹⁷ Of course, this is much better than the crisis-affected economies, but Vietnam did not have a convertible currency or an international currency market in which banks or businesses could operate, so it was less vulnerable to capital flow shifts.

An Aside: Slowdowns, Socialism and Corruption

The slowdown caused some introspection among the leadership. Some had drawn the lesson from the Asian Crisis that a more closed and controlled system was safer than a

¹⁵ Table 3.1 from *Vietnam 2010: Entering the 21st Century*, World Bank Report 21411-VN, 2000.

¹⁶ *The Real Situation of Enterprises Through the Results of Surveys Conducted in 2001, 2002 and 2003*, Statistics Publishing House, Hanoi, 2004, Table 3. It should be emphasized that \$33 million is not a large amount considering the (much larger) cost of even one medium sized cement plant.

¹⁷ World Bank Report 21411-VN, Table 2.2B. The IMF estimated GDP growth in 1998-99 at under 4% a year, and in 2000 the official GDP growth figure of 6.8% contrasted with the IMF estimate of 5.5%. Note it is possible to underestimate the level of GDP and yet to overestimate the growth of real GDP.

more open one. Capitalism caused crises and who wanted to be like Thailand or even Indonesia? On the other hand, slow growth was not acceptable either. Young people needed jobs, and many did not want to work in the low-income farm sector, which had been forced to absorb 74% of new labor force entrants from 1997 to 1999, compared to only 58% from 1994 to 1997. Such low nonfarm job creation was not tolerable for a sustained period. Fundamental decisions had to be made. Would Vietnam negotiate a bilateral trade agreement with the US or not? (This was effectively a necessary prelude to joining the WTO and moving towards a more open economy.) Would it allow private firms to be created and grow with less interference? Some feared that doing so would undo socialism and give rise to instability. Others argued that instability would result from sluggish growth.

One of the more durable debates within some parts of the Vietnam establishment is about the correct definition of socialism. There are a variety of views. Some use the “classical” definition in which the state owns the means of production. Others say it is a philosophy, and others still say it is a political system with a single party that has essential control over the distribution of production. Those that might be called conservatives view a strong and large state sector, especially in industry, as critical to the strength of the Party. Those that might be called reformers or perhaps pragmatists are more willing to let efficiency dictate productive outcomes, which in practice means a relatively larger private and foreign share of output. This latter group argues that success is what creates stability and the Party will stay in power longer if it raises incomes broadly and creates a dynamic economy and fair society with basic social goods for all. In practice, these views overlap somewhat, and the usual overlay of ministry, provincial and personal competition will often determine the exact position of a person or group.

In addition, there is the force or factor of corruption. The Thai Binh troubles in 1997 illustrated the importance of reining in local officials who became too oppressive.¹⁸ The case was not unique – in other cases the central government has had to set aside local leadership because of questionable activities. The PMU-18 scandal in 2005-06 shows that sometimes quite large amounts of funds are diverted from their proper uses, and few believe these are the only example of such activities, especially if land deals are included. To the extent that offices or positions are bought, and corruption is necessary to rise within the ranks, the very existence of someone who is not corrupt threatens those who are. Thus, those who are corrupt will often try to sideline or eject those who are not equally vulnerable. If everyone has dirty hands, no one will demand that others take off their gloves! To the extent that this is true, it makes it difficult for honest and competent people to rise in organizations that have become corrupt. To the extent that it is widespread, it makes it less likely that the state will be capable of doing those necessary things that help to create a competitive and open economy. If roads and infrastructure are poorly built or much too expensive or too elaborate; if international loans are used for poorly planned and overpriced state enterprise investments; or if many positions go to those with connections rather than talent, then the economy will not work very well, at

¹⁸ Briefly, Thai Binh is a northern province close to Hanoi with a proud tradition of supporting revolutionary struggles. Veterans and mothers of soldiers who died in war marched on government and Party officials they regard as corrupt and “arrested” them. The matter was resolved peacefully.

least over time. Corruption threatens long-term stability and success. In extreme circumstances, it even leads to immediate discontent.

Thus, the debate in 1999 about the role of the private sector (above the household level) and of foreign investors was a difficult one. Was it safer to be more closed or open? Did a large and expansive state enterprise sector make it more or less difficult for the Party to remain in power? Did a more open system reduce or increase corruption? In effect, the answer was a compromise, but one skewed towards allowing foreign and private interests more of a role. The decision of China to enter the WTO was one factor, but the need for more job creation was also a consideration. However, there was still a commitment to have the state enterprise sector play a “leading role,” which can be understood as having a number of heavy industry “pioneer” state firms. It did not and does not mean that export, output or employment growth is mainly due to the state sector. Instead, it is a kind of industrial policy that seems to look at sectors that Japan or Korea developed in their earlier days, but tries to use state rather than private firms to implement the plans.

The Enterprise Law

The decision in 1999, implemented in January of 2000, to reduce regulatory barriers to private firms was a major decision, perhaps the largest since the agricultural reforms of the late 1980's. No longer did a business person need approval of an official to start a legal business – it was a matter of registering and submitting the form. Of course, it was not quite that easy, but surveys indicated that the time, money and uncertainty surrounding the registration of a new business dropped considerably.¹⁹ There had been fewer than 5000 new private business registrations a year from 1991 to 1999, and only 5000 in total prior to 1991.

The response over the next few years after the law was passed outstripped the expectations of nearly everyone. By 2005, over 120,000 new firms had registered – an annual rate of six times the 1990's!²⁰ While some businesses had existed as household firms and chose to “emerge” once it was safer²¹, most were really new. Of course, many of them died too. Estimates of gross industrial output growth from private domestic firms were typically 18-24% a year after the Enterprise Law took hold. Their share of industrial output was 33% in the first quarter of 2006, larger than the 30% state sector share. In terms of employment, there were about 1 million employed in both formal private and collective firms in 2000. (Collective and private are hard to separate in fact if not in theory; “private” includes single owners, partnerships and joint-stock companies.)

¹⁹ One Vietnamese expert, Madam Chi Lan, estimated that it still took 50-60 days and ½ of Vietnam's per capita income to register a private firm. However, this is much less than previously!

²⁰ Surveys of firms do not show nearly so many actually operating. Even so, The Real Situation of Enterprises show the nonstate firms to have numbered 35 thousand at the end of 2000 and over 64,000 at the end of 2003. There were 14.5 thousand private firms registered in 2000 and 69 thousand more in 2001 to 2003. Aside from those really operating but missed in the survey, some may not yet have started up and others had gone out of business. This is one reason to prefer employment or output to registration data.

²¹ A World Bank survey estimated that 45% of the firms had informally existed before 2000. It is unclear if these and the really new firms were growing as fast before and only now are being measured, or if the more liberal registration procedures also allow faster private growth. The latter is likely given labor force data.

By 2004, the labor force survey showed 3.3 million workers in collective and “private” [not household] firms. That is more than a tripling in five years. In the same time period, state enterprise employment in the economic sectors²² rose from 1.9 to 2.1 million, while total workforce rose from 37.6 million to 41.6 million. Thus the total workforce rose by 4 million or 11%. So, of the total increase in workers, the formal private sector had absorbed nearly 60% and the state enterprise sector only 5%. Agricultural workers and farmers remained stable, and workers in foreign-invested companies rose by perhaps ½ million, or 12-13% of the total increase in workers.²³ Those remaining, equal to one million or 25%, were absorbed in nonfarm household or informal sector work.

If the formal private sector continues to grow above 18% a year and the foreign sector in the 12% to 18% annual range, it is likely that they will be able to absorb an even higher fraction of workforce growth in the next few years than the last five, given their now larger share of the total workforce. (SOE industrial output growth is typically less than 10% a year, while total industry grows about 15 %.) Since agriculture and much of the household and informal sector is often viewed as a “sponge” that provides livelihoods but not much of a future for young workers, it would be desirable to offer formal sector jobs to all new entrants. While some will choose to stay on the family farm or work in a household job, most would probably prefer to switch to higher paying formal sector jobs. There are also those workers who are now in agriculture or household jobs that would prefer to switch, even if they are not new entrants to the labor force. If the labor market can be tightened with sustained and rapid growth, then real wage rates would be forced up as they were in South Korea and Taiwan. Indeed, there are already signs of this. This would allow further progress in poverty reduction, but would also necessitate better technology and management so that productivity would rise in line with real wage rates.

The Weak Private Sector

In spite of quite rapid growth, the private sector in Vietnam is still weak. In its current condition, it would have to improve considerably to deal with rising real wage rates. Using data from 2003, the wages of workers in private firms were only 50-60% of central-state or foreign firms. In terms of number of employees, only 144 private firms had over 1000 employees, compared to 446 state-owned firms. In terms of capital, in 2003 there were only 44 private firms with assets over \$33 million, including 17 joint stock companies with some state capital invested.²⁴ Note that these are the very largest out of over 60,000 firms covered in the survey – less than one firm in 1000 for the capital size of \$33 million. The average private firm has a few dozen employees and about \$3300 in capital per worker. These small and medium firms are not in a position to undertake research and development, or even serious technology surveys and acquisition. They find it difficult to penetrate foreign markets or even to qualify as suppliers in higher value-added supply chains. They are usually not well versed in using the Internet and their personnel often lack critical skills needed to compete in world markets.

²² These include agriculture, industry, construction, trade, transport and communications.

²³ Because of oil, the output share of the foreign sector is QI, 2006 was 37.4%.

²⁴ The Real Situation of Enterprises Through the Results of Surveys Conducted in 2002, 2003, and 2004, various tables

This weakness is one reason why non-oil exports are growing much faster from foreign enterprises than from domestic firms. Indeed, non-oil exports from foreign firms were \$3 billion in the first quarter of 2006 while non-agricultural and non-oil exports from domestic firms were \$2 billion.²⁵ It is, of course, possible to have foreign firms be the “leading sector” and this has worked well so far. But unless local firms develop low-cost supplier chains (and these local firms will almost certainly be mainly private), it may be difficult to compete with countries where this advantage exists. Moreover, if Vietnamese firms export themselves, rather than through other foreign firms, they will certainly become more familiar with foreign tastes, trends, and necessary technologies. It would be highly desirable to find ways to help the private sector grow stronger, both for deepening domestic supply chains and for direct exports. How would this be done?

There have been many surveys done asking private firms questions about constraints to growth. Many items are mentioned – capital, land, technology, markets, skilled workers, and – especially – unfair or excess competition. Interestingly, corruption is **not** often mentioned by the private sector, even though international surveys find it is growing. A skeptic will say that any sector growing at 20% or so each year is finding ways around the barriers that exist. So long as private sector output and employment grow quickly, and overall exports are strong, why should it matter if private firms have barriers?²⁶

Professor Ari Kokko, a specialist who studies private firms in Vietnam, argues that even if corruption is predictable and of relatively small amounts, it may still be a barrier. Bidding on construction and procurement is difficult or costly. Rules are set so that state enterprises get the primary contract and then dole out subcontracts to private contractors that do the work at a lower cost for little profit. Land development deals are often effectively reserved for state firms or officials. If the land issue is “solved” by renting in an industrial zone, there is no collateral for buying capital equipment. In short, as Kokko points out, there is a “missing middle” [and one might say, also a missing top] of the distribution of firms. “Most of the registered enterprises fall into the SME category...95% [if] defined in terms of employment (less than 300 workers) or registered capital (less than VND 10 billion (\$630,000),”²⁷ Meanwhile, the number of SOE’s continues to number into the thousands, and the larger ones by capital or output have not been equitized. The development of a legal system that would provide real security is proceeding very slowly. The new Unified Enterprise Law is supposed to create a “level playing field” but if comments on drafts are accurate, it falls far short of doing that. It could well be that SOE’s retain a favored position for some time. Given their small share of industrial output growth this might not matter, if they did not also absorb considerable capital and educated manpower and use them poorly.

²⁵ This is from Intellasia, April 7, 2006. It provides data for a limited number of export products and it is assumed that all enumerated agricultural and seafood products are exported by domestic firms. It also shows exports by ownership. There is nothing wrong with exporting agricultural products, but they do not constitute “manufactured” products that have a capacity for rapid growth.

²⁶ A recent paper by Katariina Hakkala and Ari Kokko, “The State and Private Sector,” February 2006, surveys the state of constraints and state policy nicely.

²⁷ Hakkala and Kokko, Op. Cit., p. 6

Vinashin: Industrial Policy or Wasteful Spending?

One example of how supporting SOE's can undermine efficiency comes from Vinashin. This is a state shipbuilding firm that has signed a contract to build 15 ships of 53,000 tons. The price per ship is reportedly \$26.5 million, an amount very nearly equal to the variable costs of labor, materials, supplies, power and insurance. Excluded from the amount is any significant return to the shipyard in which the ships will be built.

How much should a modern ship yard cost? In India, a modern shipyard with dual dry docks for 120,000 ton ships is being built for \$90 million.²⁸ Reports in Vietnam put the cost at about \$150 million. If two ships can be built side-by-side and if it takes 18 months to complete a ship, then (at 10% cost of capital a year²⁹), about \$10 million in fixed costs is not covered for each ship built.

Vinashin was at first reported to have been allocated all of the \$750 million commercial bond issue that was floated last year. They have an overall plan to invest \$3 billion in shipyards, steel mills, and other supplier industries. This investment would make Vinashin equal to ¾ the size of Hyundai, the world's largest ship builder with a 15% global market share. There is no indication that Vinashin has the technical or managerial capacity to justify such a large market share.

There is a plan for ship building in Vietnam to reach 5 million tons a year (about 10-12% of current global output) by 2015, with an export value of \$1 billion and exports equal to 30-40% of total output. This plan seems to focus more on sales than return to capital. In general, other governments subsidize shipbuilding so profit margins are often thin or even negative. Thus, the ability of Vietnam in general and Vinashin in particular to compete with more established nations like South Korea or China is uncertain at best.

It is not hard to understand the thinking of the Vietnamese government. Shipbuilding is an industry that other Asian nations have entered successfully. It involves large amounts of money. It can be considered a "critical" industry. State support is common. Why shouldn't Vietnam follow the same path? Perhaps it should, but probably not in the way it is doing it. If a foreign ship builder wanted to invest and bring its own capital to the project, along with its technology and management that would certainly improve the chances of success. Or, perhaps there should be *some* competition for subsidies, if any will be allowed under the World Trade Organization, which is doubtful. Indeed, the entire idea of setting a physical target over a decade and using subsidies to reach it while also wanting to enter the WTO betrays a certain confusion. It is simply inconsistent to try to mix gaining access to global markets with plans and subsidies of this magnitude and nature. There is no doubt, if one or the other had to be chosen, what would be of most benefit to the national economy and to workers. There are over one million jobs

²⁸ The data come from ABG Shipyard Limited, an Indian private firm which provided the data as part of an initial public offering in late 2005. How many Vietnamese private firms raise new funds this way?

²⁹ It is true that the cost of the loan was only 7.25%, but that was a sovereign debt taken on by the government. Onlending to a company should result in a higher cost of capital, and most companies would feel very lucky to get long-term hard currency finance at 10% a year, if it were available at all.

now in export industries, but only a few tens of thousands at most in shipbuilding and its supplier industries.

State Industry for What Purpose?

State enterprises are used for different purposes in developing nations. A common use, though one that had been declining but is now coming back, was to exploit national mineral and oil and gas deposits. The prices of these commodities tend to fluctuate and large amounts of capital and often technology are needed to exploit the deposits. Since a government tends to want high and stable revenue flows, it is hard for a nationally owned oil company (for example) to invest at a profit-maximizing rate while also being asked to provide high payments to the government and often to provide jobs as well. Vietnam has not, in general, established production facilities through state enterprises except in coal. However, the “downstream” activities including refining and distribution are being assigned to state firms. The placement of the Dung Quat refinery was clearly political, and this does not augur well for competitively priced fuel products. If the state oil company is not efficient, then the entire economy will suffer from high costs.

Another common reason to establish a state enterprise is to develop high technology. The FPT company illustrates this impulse. The question with high technology is, what kinds of firms induce high technology FDI, especially in joint ventures or tight supplier relations? While much remains to be seen, the biggest success thus far is in the “technology park” in HCMC in which both foreign and domestic, but overwhelmingly private, firms have invested. It was in HCMC that Intel has decided to invest. Can a firm like FPT truly promote high technology in Vietnam? Its favored status will lead firms like Microsoft to consider working with it, but primarily to localize Microsoft products into Vietnamese, and to provide “help desk” and updating support for them. This is a useful function, but not really more than supporting a necessary local service to sell their software. It is not a way to get into the outsourcing and export of services that has been so successful in India. (Probably the best thing that the government could do for outsourcing is to improve the quality of IT education in the universities and support any firm that emerges with few requirements in terms of registration, paperwork or inspections. Improving the capital markets might help too, though the IT services business is not terribly capital intensive.) If FPT gets a large fraction of government IT work, it will be able to hire large amounts of local talent, making it more difficult for other firms to compete on other large projects. This might stifle competition in the sector and actually retard the development of outsourcing in Vietnam. There can be costs to having one national champion, especially if it is not the most competitively managed firm.

A third reason, and this seems to predominate, is to have certain heavy or strategic industries run by the state. It is hard to know exactly what causes this desire. It could be a kind of leftover fascination with heavy industry, harking back to the time of Lenin and Stalin. It might reflect a desire to do what Japan and South Korea did with their industrial policy some decades ago, though those nations did it with private firms and far more competition. Finally, it might simply reflect a desire of SOE’s and ministries to have a larger role. Big contracts can be lucrative to award and jobs for friends and

relatives are always welcome. Whatever the mix of motivations, the cascade of decisions in oil refining, ship building, fertilizer, petrochemicals, steel and (earlier) sugar and cement seem to suggest a strong attachment to this form of industrial policy.

It has already been established that state enterprises provide a very small and falling share of job growth³⁰, a falling share of industrial output growth, and that they probably play a modest role in exports of manufactures.³¹ They do employ 1.5 million workers in industry and construction (out of 7.2 million workers in those sectors in total), and account for a large share of nonperforming loans. Their stated profit rate to capital in enterprise surveys is under 3%.³² None of these facts are compelling reasons to *increase* the investment in state enterprises. The chance of creating a competitive firm or industry with management having to be skillful in dealing with ministries and bureaucratic issues while also dealing with brutal global economic competition is nil. The announced trade strategy is to become more integrated with the global economy, while the industrial strategy seems to indicate continued large infusions of capital into firms likely to “earn” low or negative returns. This cannot help but to slow down growth, reduce equity, and increase friction with trading partners.

So, looking towards the future, it is likely that Vietnam will continue to try to have it both ways. It will try to establish or expand companies like Vinashin that enter into loss making contracts, while joining the WTO, AFTA and the Bilateral Trade Agreement with the U.S. If these SOE efforts are isolated and small in magnitude they will not upset very much. They will cause trouble and irritation, but not stop the larger development of a dominant and competitive private sector, which is already well under way. If the volume of SOE investments is large, it is likely to drain capital away from more efficient firms (that also create more employment) and also cause trading partners to retaliate by limiting exports of goods in which Vietnam is competitive. One question to ask is if the political needs that these investments reflect could be satisfied by less costly means. Could sensible infrastructure investment satisfy provincial desires for more local economic activity? Could better pensions, severance payments or job training relieve concerns of state enterprise workers? The answer to these questions is “probably.” The problem comes more from the ministries and upper management. They want empires, not a comfortable retirement. They will fight to maintain the share of state investment.

When To Say Enough?

Every nation has some wasteful spending. Politics is a fact of life everywhere, and Vietnam is in no way unique. The question is if the system is able to detect when the

³⁰ To repeat, state employment in industry, construction, trade, transport and communications rose 13% from 2000 to 2004 while total nonstate nonfarm employment rose 55% in the same period.

³¹ Non-oil export growth in 2004-2006 was twice as fast in FDI firms as from domestic firms. Many of the successful exporting firms were private. Aside from processing and trading companies, the contribution of the state sector to manufactured exports may be quite modest. It is surely smaller than FDI firms.

³² It is true that private firms show almost no profits, but this is widely viewed as under-reporting. The FDI firms that are jointly owned show profit rates of 15-20%, but not those that are 100% owned. The latter could be due to transfer pricing, whereby profits are shifted to low-tax jurisdictions. See Table 7 in The Real Situation of Enterprises for specifics.

waste is reaching unacceptable levels and a self-correcting mechanism cuts in and reduces the waste to a level that prevents severe damage. The strong economic and social growth in Vietnam might seem to argue that, whatever the problems, they are not severe. However, the high level of inflows from oil, remittances, FDI and aid suggest that the supposition might be turned around. Crude oil exports in 2006 will probably equal about \$8 billion and net revenues about \$5 billion. Remittance estimates vary but they could easily be another \$5 billion – many estimates go much higher. FDI inflows are also debated – the IMF data suggest \$2-\$3 billion while government sources (which are not quite conceptually the same) suggest \$4 to \$5 billion. ODA disbursements less repayments are \$1.5 to \$2 billion. This totals perhaps 25% to 30% of 2006 GDP³³ from foreign flows or natural resource rents. If nonoil savings added 10% (of GDP) to savings and investments, and if the total were invested wisely, we would expect to see real GDP growth of 9-10% as in China, not 7-8%. If this reasoning is correct, the waste is costing Vietnam over \$1 billion a year in lost growth – and that is just from this year. If this has been true for several years, the difference becomes very large, amounting to many billions of dollars each year as yesterday's waste depresses next year's output.

Even if the “lost” growth is less than \$1 billion a year, there are still serious questions. Stability is necessary and less growth and equity reduces stability. If corruption were increased by this kind of industrial policy (as was true in Korea), that would create additional problems. There is some disagreement within the leadership about the best policy choices, and even about the degree to which news media should be allowed to report on the corruption and other issues that arise. These disagreements are normal and not a threat to stability, but they do frame the right questions. If there is to be a *systemic* check on excess waste, it is likely to be from a more open discussion and airing of facts. As the saying goes, “sunlight disinfects.” Sunlight by itself does not prevent large errors, but it makes them less likely and increases the probability they will be caught earlier. The future stability and efficiency of policy probably depends on the ability of the leadership to allow this kind of reporting and discussion. Only if outside analysis and information can inform those who are not already decided can the system learn to say “enough!” Without this airing, one group or another might be able to gather massive illicit resources, buy off those supposed to oversee them, and create a seriously inefficient set of policies. Avoiding this is a key to sustaining the past successes.

One More Example – Education

Vietnam has done a good job of increasing enrollments in education. Primary enrollment is very nearly universal and secondary enrollments have risen to over 65%. These are very good levels for a low-income country. Enrollments at the tertiary level have risen from 137 thousand in 1992 to 1320 thousand in 2004 – nearly a ten-fold increase. (But college and university teachers have only risen from 21 thousand to 48 thousand in the same period.) Even where the number of teachers has risen more or less adequately, as in secondary schools, there is still a deep and probably justified fear that the quality of schooling is well below the standards needed to compete in a global job market. Many families try all sorts of strategies to get their children out of Vietnam even for secondary

³³ The IMF projects 2006 GDP for Vietnam at 890 trillion dong or about \$55 billion.

school and certainly for college. Stories of grade buying via “tutoring” by the same teacher who grades the student and of other abuses are common. Those who knew the system prior to 1990 complain that standards are lower in both an ethical and intellectual sense. In the colleges, it is widely accepted that levels of research and the quality of the curriculum, with some exceptions, is lagging badly³⁴. Not one Vietnamese university is listed in the top Asian university lists created by various magazines or lists based on published research. This is in sharp contrast to China, India, Thailand, Indonesia, and the Philippines which have universities that are listed.

Why should it be so hard to find a way to create universities as strong as those in Indonesia or Thailand? Vietnam has a proud history of distinguished writers, intellectuals and scientists. It has a culture that has respected learning. It has a literate people and wide access to education, which is currently seen as very important by most families for their children. Yet in spite of this high demand, there is thought to be a poor quality of supply. (Vietnam does not allow standardized international testing of secondary students, unlike Thailand, Indonesia, Malaysia, the Philippines, Singapore and South Korea so direct comparisons are not possible.) With so much demand and so much capacity, why is it so hard to produce better results?

The answer has to do with the slow pace of institutional change in Vietnam. The Ministry of Education has tended to delay fundamental reform and discourage competition from “free lance” or private schools. It tended to insist (at least in the past) on a standardized curriculum when experimentation might have allowed better materials for different types of students. This inefficiency and lack of internal reform is a huge problem in education, but is also true elsewhere. Note that no argument is made that “the free market” will solve all problems. Standards are needed and professionalism needs to be nurtured. But the quality of state oversight and supervision needs to be improved, as does the freedom to try out different approaches. Pressure on the bureaucracy from either elected officials or parents of students or the press needs to be focused in a way that better results are created. Right now, many want change but few know how to get it productively.

This lack of effective reform is a huge long-term stumbling block for Vietnam. It curtails the development of local centers of excellence, R&D capacity, and an ability to move to higher value-added activities. It creates political tensions, as normal families feel trapped and angry that some are able to “exit” and send their children abroad. It can even have an impact on the ability of Vietnam to attract its brightest workers back to the country. If only poor jobs are available in small and weak private firms, with few other well-trained workers, why not stay abroad? If good SOE jobs (or promotions) go mainly to the well connected, why not work for a multi-national that will train its workers and treat them fairly? The lack or slow pace of institutional reform will only become a larger burden as Vietnam opens up itself more in economic and cultural terms. The ability of Vietnam to

³⁴ The Vietnam Education Foundation, a US sponsored scholarship group, has had success placing numbers of Vietnamese in IT and electrical engineering graduate programs in the US. This is probably based on the strong historical foundation in mathematics, partly from Russia, and the low capital requirements for successful work in this field. On-line training and communication also help in this field.

design a “top tier” university and use it to promote reform throughout the educational system will be a litmus test of its ability to accelerate needed educational reforms.

Some Bright Spots

This paper has focused on critical comments and problems facing Vietnam. Some might argue that any country increasing exports at 25% a year and growing at 8% is not doing so badly, especially if this progress is accompanied by tolerable to rapid progress on social and poverty indicators. That is a fair comment. The point is not that the present is so bad, but that it will take efforts to make the future equally good. As per capita output rises, it gets harder to continue rapid growth without improving all around. But it is useful to consider some areas of exceptional success and the reasons for them.

The SARS epidemic and the current bird flu situation allow a contrast between Vietnam and some other nations. In both cases, Vietnam’s response was better than many others. With SARS, Vietnamese leaders brought international experts in quickly, and needed precautions were taken with little delay. In contrast, the disease reportedly festered for months in China amidst cover-ups and suppressed information. It was only when a famous Chinese doctor “broke” the story about cases in Beijing that the full scope of problems began to be addressed. It required the resignations of major Chinese officials. With bird flu, after some initial stumbles, an aggressive campaign that included vaccinations and culling helped to reduce the incidence of the disease in birds and seems to have eliminated it this year in people. In Indonesia, the response has been more fragmented and cases in both birds and humans continue to mount. While it is too early to evaluate the ultimate success of the bird flu efforts, the initial consensus is that Vietnam has been open and effective.

While many problems persist with health care, the decline in mortality rates is striking especially compared to other nations with much higher incomes. The following data are taken from the 2006 World Development Indicators of the World Bank. (Tables 1.1 and 2.19) Life expectancy is in years; mortality rates are per 1000; and income is per capita.

<u>Country</u>	<u>Life Expectancy</u>		<u>Child Mortality Rate</u>		<u>PPP Income 2004</u>
	<u>1990</u>	<u>2004</u>	<u>1990</u>	<u>2004</u>	
Brazil	66	71	60	34	\$7940
China	69	71	49	31	\$5890
Thailand	68	71	37	21	\$7930
Vietnam	65	70	53	23	\$2700

It is not just that Vietnam is about equal to or better than nations with two or three times their income per capita, but that it is improving as fast or faster. No other nation in this group had child mortality declines as large in either relative or absolute terms.

Similar comments could be made about HIV-AIDS. While it remains a serious disease, the 2003 prevalence, even using unofficial (and higher) numbers of 300,000 infected

cases, is only 0.4%. Most cases are in injecting drug users and sex workers. While cases are rising, the mobilization has begun and levels are well below the worldwide prevalence rate of over 1% or regional (South and Southeast Asia) levels of 0.7%. Vietnam appears to be one of the nations that caught the disease early enough and is acting to contain it before it becomes a major cause of mortality. Similar successes have been achieved in the control or treatment of malaria, TB, child malnutrition, and vaccinations.

What explains this success? Part of the explanation is timely public health program, utilizing a well-organized apparatus down to the village or block level along with a serious commitment to actually executing the plans. In addition, there has been a loosely regulated, overlapping, and not entirely efficient mix of providers from traditional herbalists and healers to pharmacists to retired military medical workers and nurses to private doctors to public clinics to hospitals. Sometimes pharmacists sell inappropriate, out of date or counterfeit medicines. Sometimes doctors insist on mixing their own medicines and charging more for them – even to the point of not informing their patients what they are getting. But people have choices and there are many sources of service. Increasing the variety and level of expertise of different types of medical personnel while also providing as much information as possible to patients and the general public, while continuing to give them choices about where to go, is likely to improve health care. A combination of appropriate government spending and policies, regulation of providers for knowledge and ethical behavior, and competition helps to provide these outcomes. There is no doubt that health care at existing spending levels (5.4% of GDP – about the same as China) could achieve even better outcomes, but it is already doing as well as much richer nations that started out healthier even a decade ago.

Switching sectors, the rise of trade is another bright spot. It would not be surprising if exports and imports in 2006 equaled \$72 billion, or about 130% of GDP, up from 75% in 1995. By lowering tariffs and allowing easier licensing of trade, Vietnam has accelerated the specialization of its production. So long as this process continues, it will be very difficult for seriously inefficient sectors (outside of nontraded services) to remain untouched. While some observers, such as Oxfam, have attacked the WTO conditions³⁵, most conclude that the gains are likely to far outstrip the costs. The critics may be correct that the world in general and trade negotiations in particular reflect power realities, but that is a separate point from whether or not an economy and the poor on balance will benefit or not. In other words, if there are significant gains from trade and investment flows, how are they to be distributed among nations and within them? If increasing trade is so dangerous, why has poverty plummeted, social indicators soared and incomes broadly gained so much over the last decade? Apparently, the flexibility of farmers and the private sector, the responsiveness of FDI, and the ability to learn quickly have resulted in many more winners than losers. A continuation of this trend is likely to continue to be beneficial, though sudden and severe instability in the global economy remains a threat to all but the most closed of economies. Still, Vietnam appears to be more flexible than most and is fairly well diversified by product and country market.

³⁵ Do as I say, not as I do: The unfair terms for Viet Nam's entry to the WTO, Oxfam, May 2005

The Financial Sector

Turning from bright spots to less certain sectors, the future development of the financial sector is a major question. The relative size of the financial sector has grown rapidly. Domestic credit grew from 35% of GDP in 2000 to 68% in 2005. While this level is still well below those in other developing Asian economies, it is certainly rapid growth. Indeed, the IMF has expressed concerns about the pace of credit growth, the inability of (especially) state owned commercial banks to control loan quality, and generally weak balance sheets.³⁶ The legal system is also questionable, so even if a borrower *might* have the assets or capacity to repay, it is less than certain that they actually will do so, or could be compelled to at a reasonable cost. Yet, bank credit to nonstate borrowers rose at 45% in 2004, suggesting remarkable optimism. (Bank credit to state enterprises grew 36% in 2004, but they also were able to access nonbank credits, such as the Development Assistance Fund, growing about as fast as overall bank credit.) If credit grows at 25% a year for five years and current price GDP at 15% a year, credit/GDP would exceed 100%. That would put Vietnam in the same range as other Asian economies.

The recent conclusion of WTO negotiations with the United States resulted in an agreement to let foreign banks own 100% controlled subsidiary banks. While it remains to be seen if these banks are regulated in an even-handed manner, the direction of this policy change would be to “regularize” the banking system. Foreign banks are generally acknowledged to be better at credit analysis and less prone to political pressure than state-owned commercial banks – though even the SOCB’s have improved in recent years³⁷. If banks were able to provide private firms with credit more readily, it could only help them to expand more rapidly and perhaps with the help of specialist expertise that foreign banks often provide small and medium businesses. Certainly, the creation of more effective competition would help make the banking system a more effective accelerator of private sector expansion. (Efficient state enterprises would also benefit.) The concern, of course, is to prevent excessive risk taking and to avoid credit crashes that create contractions in economic activity, or expensive government bailouts. Dealing with the remaining bad loans and controlling corrupt or inefficient lending will remain major goals of the monetary authorities.

The other end of the financial system is the stock exchanges. The HCMC exchange, with a few dozen companies, has yet to prove itself much more than an exit mechanism for established companies (mostly equitized state companies) looking to offload shares. It is not yet a serious source of finance for new investments, and it will probably be some time before it becomes one. It lacks the depth and liquidity needed for general Asia-centric or emerging market funds, but has attracted Vietnam specific funds in limited amounts³⁸. The OTC market in Hanoi is even younger. The informal or dealer market is perhaps the

³⁶ “Vietnam: 2005 Article IV Consultation,” IMF Country Report 06/22, January 2006.

³⁷ The “big four” state-owned commercial banks control over 2/3 of all bank credit. If the Development Assistance Fund is added in, these five control nearly ¾ of all credit, including the DAF. The DAF lends about 90% of its assets to state enterprises according to a 2006 IMF Report.

³⁸ A typical day’s trading has a total value of about \$10 million. This amount is often a minimum for general equity funds that wish to establish or liquidate a position. The total value of all assets is \$1.5 billion.

most interesting but is hard to follow or readily analyze. The reasons why many companies choose not to list, but are still actively traded, is worth a special study by itself. Some have guessed that the value of trading on this dealer market is several times that of the official exchanges. With the accession of Vinamilk, Kinh Do and some banks, this is less likely than it had been a year or two ago. Still, the development of this institution has a long way to go before it takes an important place in the overall portfolios of Vietnamese (who still prefer land, gold or cash for the most part) or in the plans of company executives looking for finance. Until corporate and overall legal governance improves, it will be a risky place to put more than a fraction of one's savings. And, if it remains a risky place to invest, the cost of floating shares will be higher than many companies wish to pay. Progress has been made, but it is a few steps on a long road.

Tentative Conclusions

The authors were asked to look both backward and forward with respect to the *Doi Moi* reforms. Looking back, they have been a great success, propelling Vietnam from a poor backwater to a leading developing country. They have liberated productive forces throughout the population and across the country, improving most aspects of life for most people. Where serious reform has been allowed and pursued, it has succeeded. Where it has been avoided or curtailed, there have been setbacks. Looking to the future, more reform is likely to pay more dividends in purely economic terms. The question for this paper might be if there is a political consensus to pursue reforms. That probably depends on how further reforms are pursued.

Vietnam is a paradox right now. It has a good deal of corruption and also a relatively open society and competitive (if still somewhat controlled) press and mass media. It is not an equilibrium to have people stealing money and to have many others knowing about it. Something has to give. Either there is a movement towards a stronger and more serious rule of law and less corruption, or there will have to be serious retrenchment and reduction of press freedom to report on problems. As argued, if the second option were to be followed, this would increase the prospect of instability and slower progress. If the former, then Vietnam would have an extended period during which political options could be worked out amidst a generally vigorous economic expansion. As Professor Benjamin Friedman argues in his recent book, The Moral Consequences of Economic Growth³⁹, there is a greater chance of social and political inclusion and progress when times are good than when they are bad. If these arguments are accepted, that alone would argue for a continuation of reform. Adding to this, the examples of sugar, Vinashin, and Dung Quat vs. most rice and coffee, the Enterprise Law and FDI, and there would seem to be both a political and economic case for deepening reform.

Yet these are not reason enough for the system to move quickly. Many provinces will remain skeptical that they have much to gain from reform. They see rapid progress in some major cities, but wonder if that means they will be left behind. In order to induce them to support reform, a different set of incentives is needed. Public investment should

³⁹ Professor Friedman is a macro-economist at Harvard University. His book has been widely acclaimed as a cogent defense of the moral benefits of economic growth, not merely the (considerable) material benefits.

be more responsive to provincial reform rather than to provincial backwardness. Where measures such as the provincial competitiveness index⁴⁰ finds improving governance, there should be flexible support aimed at improving hard infrastructure where soft infrastructure has also improved. If pro-reform behavior is rewarded by Hanoi⁴¹, and if it also results in more private and/or FDI activity, it is likely that more provinces will become supportive of more reforms. While this is not absolutely assured, it is likely.

Beyond this aspect of political support, there is education. If the state manages to switch from trying to control all education to fostering the growth of diverse but quality educational institutions, it will reap large political benefits. A better educated populace will earn more, attract more investment, start more productive firms, and generally be more supportive themselves of further reform while also supporting the government. It may be that Singapore is an example of this scenario – some limited political competition, but an effective one-party system with wide general support. So long as the state provides quality public goods such as health, education and housing, it is viewed as legitimate. Of course, Singapore is viewed as one of the least corrupt nations in the world.⁴²

The third forward-looking challenge is to either reduce the ambition of state industry investment or to attempt to improve the efficiency of what is undertaken. This author is not optimistic that competent managers will often be allowed to run efficient state enterprises. It is possible that this could happen, as is true now in Singapore and a very few other places. But unless the pressures on managers change significantly, the state would be better advised to be modest and focus its energies on running a very few state enterprises that it really believes need to be public, rather than to expand aggressively. If SOE's expand aggressively, controlling corruption will be harder. There would be more frictions with trading partners, and useful private or FDI investment would be suppressed as capital and skilled workers are siphoned off.

The fourth challenge is to find a way to incorporate input from the private sector without letting it dominate policy making. Given the weakness of the private sector, this may seem to be an idle concern. But many private firms are run by well-connected people with close ties to leaders. It is quite likely that they would ask for, and possibly receive, various advantages which would be hard to identify and thus elude legal or WTO challenges. Diminishing public monopoly and inefficiency will have only modest benefits if it is replaced by private monopoly and inefficiency. This will become an ever-larger concern over time. It has proven to be the bane of several Asian economies.

⁴⁰ This is an index developed by the Vietnam Competitiveness Initiative (VNCI), a group supported by USAID. The Vietnam Chamber of Commerce and Industry and the Asia Foundation have played a leading role in VNCI, and Dr. Eddy Maleski is the lead author who developed the index. It reflects both structural and policy factors such as entry costs and access to land in arriving at evaluations of 42 provinces.

⁴¹ An obvious danger is that if the score really matters, there will be attempts to make it look better than it really is. This may already have occurred and is certainly something to guard against. Using performance-based indicators such as the amount of private employment or output growth is one way to deal with this.

⁴² Transparency International, a European NGO, ranked 159 countries in 2005 by perceived corruption. Singapore was the fifth most honest. Vietnam was tied with Belarus and Zimbabwe in the bottom third.

Overall, though, most countries would like to have Vietnam's problems. Few have the chance to do so well. Good choices will continue to produce great results.