THE ASIA-PACIFIC REGIONAL PROGRAMME ON MACROECONOMICS OF POVERTY REDUCTION

THE MACROECONOMICS OF POVERTY REDUCTION: THE CASE STUDY OF VIET NAM

Seeking Equity within Growth

Ha Noi, April 2004

This publication presents some of the principal findings from the UNDP's Asia-Pacific Regional Programme on The Macroeconomics of Poverty Reduction.

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OF POVERTY REDUCTION:
THE CASE STUDY OF
VIET NAM

Seeking Equity within Growth

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This is an independent report commissioned by United Nations Development Programme and the authors remain responsible for its contents.

Special Message

Macroeconomic policies affect both the rate of growth of the economy and the distribution of the benefits of growth across economic sectors and social groups. The process of structural change that is currently underway in many Asian countries adds new dimensions to the linkage between macroeconomic policies and poverty reduction. With these considerations in view as well as in the context of supporting the achievement of the Millennium Development Goals, UNDP's Regional Bureau for Asia and the Pacific launched in early 2002 the Asia-Pacific Regional Programme on the Macroeconomics of Poverty Reduction.

The objective is to identify and promote more pro-poor macroeconomic policies in the region. With two-thirds of the world's poor living in the region such pro-poor approaches are critical to the process of poverty reduction. Fostering greater consistency between country's macroeconomic framework and its national poverty reduction strategy and broadening the policy options and dialogue on poverty reduction issues have been the pillars of the programme.

As part of the programme, policy-oriented research in Bangladesh, Cambodia, China, Indonesia, Mongolia, Nepal and Viet Nam have been carried out by teams of international and national consultants together with policy advisors from the UNDP's Bureau for Development Policy. These reports help to identify practical policy options to foster more pro-poor stabilization, economic restructuring and growth. These draft reports were presented and discussed in the first regional workshop on the Macroeconomics of Poverty Reduction in January 2003 in Kathmandu, Nepal. The representatives from governments and other relevant stakeholders gave various comments and suggestions in the context of increasing the usefulness of the reports for policy formulation. After incorporating these comments and suggestions into the country reports, a series of national workshops were organised during March-November 2003 in partnership with respective governments to discuss these reports with wider audiences. After refining these reports in line with the comments and suggestions received in these national workshops, six thematic case studies have now been completed on Fiscal, Monetary & Exchange rate Policies, Trade & Financial Liberalisation and Privatisation / De-regulation.

I would like to convey my appreciation to the authors, to the focal points of the programme from UNDP country offices and Bureaus as well as the UNOPS-Asia office for their hard work and diligence. I would also like to record my special appreciation to the Programme

Coordinator and staff of the Regional Programme based in Kathmandu, Nepal for their support and substantive contributions to the case studies.

I hope that the independence of views and the professional competence of the authors ensure that the conclusions and recommendations will have the greatest possible audience and that the thematic case studies will be read with great interest.

Hafiz A. Pasha
UN Assistant Secretary General &
UNDP Assistant Administrator and
Regional Director of the Bureau for Asia and the Pacific

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List of Acronyms

ADB	Asian Development Bank
AMC	Autonomous management companies
BDP	Bureau for Development Policy
CDPR	Centre for Development Policy & Research, SOAS
CG	Consultative Group
CMEA	Council for Mutual Economic Assistance
CPRGS	Comprehensive Poverty Reduction and Growth Strategy
DAF	Development Assistance Fund
DFID	Department of International Development (UK)
FCD	Foreign currency deposits
GDP	Gross domestic product
GSO	General Statistics Office
HEPR	Hunger Eradication and Poverty Reduction
IAS	International Accounting Standards
IDA	International Development Agency
IDT	International Development Target (aka MDG)
IFI	International Financial Institution
IMF	International Monetary Fund
IMWU	Inter-ministerial Working Unit
INGO	International Non-governmental Organisation
I-PRSP	Interim Poverty Reduction Strategy Paper
JSA	Joint Staff Assessment (of the IMF & IDA)
LWU	Loan workout units
MARD	Ministry of Agriculture and Rural Development
MDGs	Millennium Development Goals
MIS	Management information systems
MOLISA	Ministry of Labour, War Invalids, and Social Affairs
MPI	Ministry of Planning and Investment
MTEF	Medium Term Expenditure Framework
NGO	Non-governmental Organisation

O&M	Operations and Maintenance (expenditures)
ODA	Official Development Assistance
PER	Public Expenditure Review
PIP	Public Investment Programme
PPA	Participatory Poverty Assessments
PRGF/SAC	Poverty Reduction and Growth Facility & Structural Adjustment Credit
PRS	Poverty Reduction Strategy
PRSC	Poverty Reduction Support Credit
PRSF	Poverty Reduction Support Facility
PRSP	Poverty Reduction Strategy Paper
PTF	Poverty Task Force
QR	Quantitative Restriction (on imports)
SBV	State Bank of Viet Nam
SEDS	(Ten-year) Socio-Economic Development Strategy
Sida	Swedish International Development Organisation
SME	Small and Medium–size enterprises
SOCB	State owned commercial banks
SOE	State Owned Enterprise
SOAS	School of Oriental & African Studies
UNCT	United Nations Country Team
UNDP	United Nations Development Programme
USBTA	United States Bilateral Trade Agreement
VAS	Vietnamese accounting standards
VAT	Value Added Tax
VDGs	Viet Nam Development Goals
VDR	Viet Nam Development Report
VLSS	Viet Nam Household Living Standards Survey
WB	World Bank
WTO	World Trade Organisation

Acknowledgements

This report is based on a review of relevant documents and other sources, and field interviews conducted during April and August of 2002. The preliminary findings were presented to a seminar at UNDP Ha Noi in August 2002, and the first full draft to a conference in Kathmandu in January 2003. A revised draft was then presented to a national seminar attended by officials from the government and national research centres. The current draft incorporates the comments received at the seminar and subsequently.

The authors wish to thank the UNDP Ha Noi for its support, and Vietnamese government officials for their cooperation. Especially useful were comments by the Ministry of Planning and Investment. Thanks go to Terry McKinley of the Bureau for Development Policy of the UNDP for his comments and guidance. Melanie Beresford, Adam McCarty and Nguyen Viet Cuong (of Mekong Economics), Rodney Schmidt, and Vu Quoc Huy provided background papers.

Preface

This report is part of the United Nations Development Programme's Regional Programme for Asia on the macroeconomics of poverty reduction. The programme is on-going, and at the time this report was published on the UNDP website seven case studies had been completed (Bangladesh, Cambodia, China, Indonesia, Mongolia, Nepal and Viet Nam), all under the supervision of Dr. Terry McKinley of the Bureau for Development Policy of the UNDP.

The primary focus of this and the other case studies is macroeconomic policy and its impact of the poor. The case studies seek to identify macro policies that would generate a pattern of growth which is 'pro-poor' in the specific sense that the increment in growth becomes more equally distributed than initial income (implying a reduction in income inequality). Given the focus of the study, it does not treat all issues related to poverty reduction. For example, poverty reduction among Viet Nam's ethnic minorities and in disadvantaged regions enters our discussion if it is affected by macro policies and national programmes. The sparce of treatment of this aspect of poverty, which has been addressed in detail in other studies, does not reflect an implicit view of its importance, but rather the judgement that the 'value added' of the study lies in its presentation of pro-poor macro policies.

As the deadline for the study approached, the processing of the Viet Nam Household Living Standards Survey of 2002 (VLSS 2002) was not complete. Therefore, the poverty analysis in Chapter III is based on the two earlier surveys. It remains to be seen whether the VLSS 2002 will support the conclusions we reach about trends in poverty and inequality. There is a more general data issue of which the VLSS is but a part. Compared to two other case study countries, Cambodia and Nepal, Viet Nam has relatively good data, but quite inferior to Bangladesh, for example. Our ability to analyse the impact of macroeconomic policies on poverty was seriously constrained by the absence of basic data sources, the most important being labour force, agricultural and industrial surveys. In the absence of such surveys it was not possible, or professionally responsible, to draw strong conclusions about trade policy or employment generation. We strongly recommend that the government, with the support of donors and lenders, initiate regular rounds of these surveys based on internationally standard methodologies.

At the time of completion of the study, the Vietnamese government had concluded or was in the process of negotiation of treaties relevant to its trading regime. The impact of these treaties will remain an issue of speculation for some time. Nothing in this report, particularly in Chapter 5, is intended to conflict with the government's treaty obligations, which allow for considerable policy flexibility in the near future.

Finally, the team involved in this report conferred closely with donors and lenders, both bilateral and multilateral. With regard to the latter, we were encouraged to find no fundamental disagreement over the major positions taken in this report: 1) that increased inequality is major threat to Vietnamese society; 2) that the government should pursue an active fiscal policy; and 3) to the extent they are administratively feasible and fiscally supportable, universal entitlement programmes can play a major role in curbing inequality and reducing poverty.

Executive Summary

Redistribution matters

The international community now, as in the 1970s, recognises the importance of equity and distribution as essential parts of a programme to rid the world of the scourge of poverty. This report is part of a regional UNDP project to place considerations of equity at the centre of the poverty reduction agenda. Even in Viet Nam, a low-income country, distribution matters. As we show in this report, the distribution of income has become more unequal over the last fifteen years. Thus, how society divides the benefits of growth is not a natural, inexorable process insensitive to policy. On the contrary, distribution is a dynamic process that governments can influence, to the benefit of society as a whole.

Increases in income and wealth inequality have and will continue to accompany Viet Nam's growth unless policies are put in place to alter this growth pattern. *The central message of this report is that in Viet Nam increased inequality is the single most important constraint to sustainable poverty reduction*, and perhaps political and social stability.

Analytical Framework

Viet Nam is a country in the process of transition from central planning to market regulation, which is a process of regime change. Analytically, this process can be divided into two parts: the dismantling of the central planning regime (regime change), and the phase of regulatory change. In the first phase the old system is destroyed; in the second, a system of market regulation is established.

Regime change unleashes previously constrained sources of economic dynamism that can result in rapid growth and development of the economy. The gains come from the shedding of the dead weight of central planning restrictions. Though powerful, these are once-and-for-all gains. Viet Nam is approaching the end of the period when regime-change dynamism allows for extraordinary growth rates of output and exports.

As the government seeks to establish a stable regulatory framework, the past rapid rates of growth and equally impressive rates of poverty reduction will be difficult to maintain. Thus, the first decade of the twenty-first century is the appropriate moment to concentrate public policy on establishing a sustainable pro-poor growth strategy.

Poverty in Viet Nam

Analysis of available data shows that Viet Nam made impressive achievements in poverty reduction during 1993-1998. Poverty fell due to an across-the-board rise in per capita expenditure. The major reason for these achievements is the process typical to transitional economy in a booming period. The gains of the earlier period are unlikely to be sustained in the coming years. Statistics from the household survey of 2002 indicate that poverty reduction has slowed down, and inequality continues to rise. The causal mechanisms are the growing differentials among various income groups in access to employment and to land, capital and education. Our analysis of the data implies a pressing need for pro-poor policies that would achieve a more equal distribution of the benefits of growth.

Fiscal Policy for Pro-poor Growth

Our review of fiscal policy concludes that the government's fiscal position is sound, so that expansion of existing social protection programmes, and the initiation of new programmes is possible within the budget constraint. The report suggests the following policy recommendations:

1. The government should change the rule that restricts the rate of growth of current expenditures to that of capital expenditures.
2. The magnitude of defence and security-related expenditures need review. There is a *prima facie* case for improving the pro-poor content of fiscal policy by switching expenditures away from this area. In keeping with international best practice, the government could report defence expenditures, facilitating a debate over their appropriate level.
3. Concerns about social subsidies and capital spending are overstated. Social subsidies seem pro-poor in content and impact. These expenditures should be expanded.
4. The Public Investment Programme for 2001-2005 is sensitive to poverty concerns and quite sophisticated in the fiscal plan for mobilising and allocating resources. This could be complemented by more intensive assessment of the benefit incidence of capital spending.
5. A clear distinction should be made between capital formation and financial investments in the public sector, particularly given the ongoing restructuring of state enterprises and the banking system. Cutting the former to sustain the latter would have adverse consequences for the poor, especially in rural areas.
6. The recent review of the Development Assistance Fund commissioned by the government indicates a move towards correcting the problems with this institution. Further review should include impact on poverty reduction as a major component.

7. A universal old age pension is well within the fiscal resources of the government. In addition to its poverty reducing effect, such a programme would initiate a shift in approach from targeted to universal social support. We recommend that the government initial a study of implementation, with an eye to introducing such a programme during the life of the next Socio-economic Plan.

The Financial Sector

To sustain the high growth and impressive performance of Viet Nam, the monetary and financial sectors require strengthening, with effective regulation in order to prevent volatilities and vulnerabilities that may threaten the economy. In light of these requirements and the discussion of this chapter, the following conclusions and recommendations are reached.

As agreed with the IMF, past rates of growth of monetary and credit aggregates of up to twenty percent should be adequate in the future to accommodate GDP growth rates of five to eight percent, and allow for necessary financial deepening. The considerably higher growth rates in 2003 should be reviewed, though their inflationary impact seems small. The principle concern would be to trace the credit expansion to its end-use and assess its poverty reducing potential.

In recent years the government has acted prudently to avoid the high external indebtedness of the late 1980s and early 1990s, and to reduce dependence and exposure to short-run commercial loans. Given the instability in regional capital markets, it is prudent to continue the controls on short-term capital flows, including trade credits. The shift back toward long-term and more concessional loans is an astute policy to reinforce a healthy capital account.

The main tensions arising from financial reforms between the government and the multilateral institutions lie in the fear of the multilateral institutions that the government and the SOCBs give preferential credits to SOEs, many of which the multilaterals perceive as unviable or uncompetitive. They view this as increasing the dangers associated with non-performing loans, which may lead to a financial crisis. Thus, the controversy over financial reforms mirrors that associated with the SOE restructuring.

The Vietnamese Government follows sound economic principles by channelling credit to basic infrastructure, public services and priority areas in the country. Thus the DAF can be justified by economic and social arguments. The DAF would be more beneficial if the areas given preferential credit were clearly identified by the government. This might be done in the national development plans, jointly by the Ministry of Planning and Investment, the Ministry of Finance, and the Office of the Prime Minister. A clear identification of the priority areas will reduce the tendency to give preferential credit to state enterprises due to political connections or in order to prevent SOE bankruptcy.

Once the SOCBs focus on commercial lending, policy lending could be moved to DAF and the Social Policy Bank, as is the current policy. If DAF justifies and identifies the preferential credit to priority areas, then there will be little need for differential limits on credit growth, with credit growth to SOEs lower than the overall growth. Competitive and viable SOEs should be allowed to compete for the commercial loans.

The government could take a clear position on its view of the mixed economy it seeks to foster. This implies legislation to identify which property and usufruct rights could be traded. Based on clear and unambiguous legislation, rules on bankruptcy and creditors' rights would follow.

The government seems also to be eager to adopt modern accounting and credit management techniques for monitoring and supervision of the financial sector. There is official recognition that the shift to commercial lending requires stronger and more effective supervision and regulation of loan transactions, and improved risk assessment capacities. While necessary, measures to achieve this must be implemented cautiously. As this chapter has shown, the financial sector remains basically sound, amenable to restructuring consistent with macroeconomic stability. However, the rushed adoption of internal financial rules, especially overly strict capital and loan-loss requirements, may create the possibility of a credit crunch and loss of confidence in the financial sector.

From a poverty reduction perspective, the basic function of the financial system is to foster rapid, pro-poor growth. To the extent that restructuring of the financial system facilitates such growth, it should be implemented purposefully. It is by this criterion that the government might assess the advisability of the various aspects of the complicated process of financial restructuring. The most important impact that this process will have on fostering pro-poor growth will be the budgetary implications, considerably more important than financial policies to increase the access of the poor to credit. Overall, Viet Nam has the institutions that can widen credit access, though some changes in practice may be required for greater effectiveness.

However, if restructuring results in a substantial increase in the need for bank recapitalisation, the budgetary implications could be severe. The government would be well-advised to review the experience of Indonesia, where the recurrent costs of recapitalisation have crowded out both development expenditure and social programmes that affect the poor, as well as eliminating for the foreseeable future any new pro-poor budgetary programmes.

Trade Policy

Over the last fifteen years, the government has carried out radical changes in trade policy, moving from a state monopoly regime to a regulated system designed to simultaneously promote exports and foster domestic production of importables. The balance of payments position of the country is fundamentally sound. This, associated with extraordinarily rapid export growth, suggests that rapid changes in trade policy are not required to sustain the country's impressive growth performance, though they may be desired to achieve other goals.

It is obvious that trade liberalisation has been coincident with rapid growth. Little, if any, reliable research exists on the likely impact of further trade liberalisations. Indeed, there is almost no work on the extent to which or the mechanisms by which past liberalisation has facilitated growth. While some draw strong conclusions on this issue, the conclusions are typically based upon *a priori* reasoning derivative from special-case assumptions.

Given the country's amazing export performance, it does not appear that changes in trade regulations are required to enhance export growth. Policy changes may be appropriate to alter the composition of exports; however, there is insufficient empirical research linking export composition to existing regulations. Whether further liberalisation steps would foster faster employment growth and/or enhance poverty reduction remains at the level of speculation. Therefore, it would be prudent for the government to commission studies on the impact of policy change on the poor to insure that such policies have the maximum feasible poverty reducing effect.

Unlike in many countries, the government of Viet Nam is in the enviable position of being able to design its trade policy on criteria of poverty reduction. At present, these criteria cannot be applied because of lack of information.

Elements in a Pro-poor Growth Strategy

Formulating a pro-poor growth strategy is feasible for Viet Nam and well within the capabilities of government's cadre of civil servants. Given the government's demonstrated success in policy implementation, it is also within its ability to execute. The resource requirements of such a strategy are not seriously budget constrained. Because the country's level of inequality is relative low, vested interests favouring a more inequitable growth pattern have not consolidated their political power.

Thus, it only remains to formulate the strategy. While such a strategy would be nationally owned and developed, we provide suggestions as inputs into its construction.

Macro policies with indirect pro-poor effects:

1. The government should continue its policy of using fiscal policy to counter cyclical movements in the economy. Since inflationary pressures are weak, counter-cyclical fiscal policy is unlikely to have negative side-effects.
2. The overall budget deficit should not constrain poverty reduction. The government has consistently run a current account surplus, following the so-called Golden Rule that only investment should be financed from borrowing. This policy should be continued.
4. The current policy of low, positive real interest rates should be continued.

5. Great care should be taken with the policy of restructuring state enterprises and recapitalizing the financial sector. A lesson should be taken from the Indonesian experience, in which an open-ended commitment to recapitalisation resulted in fiscal disaster. The priority of the government is equitable growth; this should not be undermined by restructuring and recapitalisation commitments. The government should consider placing an explicit ceiling on annual restructuring and recapitalisation costs.

6. The policy of maintaining a stable real exchange rate, pursed though the late 1990s and into the present decade, is, on balance, pro-poor. Given the country's extraordinary export performance over the last fifteen years, a stable exchange rate does not seem to weaken trade performance. And,

7. To the extent that the deficit in the external current account is funded by direct foreign investment (i.e., the foreign investment funds imports for the projects of those investments), its rather large level is not a cause for concern. Should this not be the case, or only partially so, the economy is vulnerable to external shocks. The government should undertake a careful study of the causes of the deficit, as the basis for future policy action, if required.

Policies directly affecting the poor:

1. Current targeted anti-poverty programmes should be regulated by a national standard, rather than on a decentralised basis. Under the current arrangement, local officials can set 'poverty lines' derivative from the funding available and the number of households they wish to support. This results in major anomalies across provinces.

2. The military budget could be made public, allowing for a debate over its appropriate level, and the possibility of shifting funding to anti-poverty programmes.

3. To combat urban poverty, the government should a) review its minimum wage policy with intent to improve enforcement; b) increase the capacity of MOLISA to enforce health and safety regulations; and c) facilitate development of independent workers organisations to protect worker rights.

4. As recommended in the CPRGS, user charges for public health and education should be abolished. And,

5. The government should investigate the feasibility of a universal old age pension, as a vehicle for reducing poverty, increasing purchasing power in rural areas, and protecting the elderly. Set at an appropriate level, the pension would be within the fiscal capacity of the government.

Chapter 1
Viet Nam in Transition

1.1. The Purpose of this Study

Accumulating evidence suggests that growth in the developing world over the last two decades has been slower than for the previous twenty years, and accompanied by increasing inequality. Slower growth was not the case for many of the Asian countries before the financial crisis of 1997, but increased inequality appears to apply to the region with few exceptions. Increasing inequality has been particularly notable for Viet Nam, which we consider in some detail.

Concern over increasingly inequitable growth prompted the United Nations Development Programme to initiate its Asian Regional Programme on Macroeconomic Policy for Poverty Reduction. The programme's emphasis is on policies to generate a growth pattern that, at the least, would be less inequitable, and, at best, would redistribute the gains from growth toward lower income groups. The fundamental point of departure for the country studies within the programme is that 'trickle down' growth accompanied by 'targeted' programmes for the poor is not satisfactory by either social or economic criteria, though some targeted programmes may be essential to reducing poverty among groups not benefiting from growth.

First, increasing inequality after some point proves dysfunctional, resulting in social exclusion, crime, and political unrest. Second, economic growth is desirable in itself; though increasing the rate of growth is not always economically rational, because it has an opportunity cost in foregone consumption. In all countries, the growth target set by public policy is implicitly or explicitly linked to judgements about the social rate of time preference.[1] Rational public policy maximises the growth rate subject to the opportunity cost derivative from this time preference; seeking to maximise the growth rate unconstrained by time preference is the domestic equivalent of mercantilism. Thus, rational choice of the appropriate poverty reduction strategy requires consideration of the resource tradeoffs between the costs and benefits of increasing the growth rate and the costs and benefits of redistribution (see Box 1.1, *Distribution Matters in Viet Nam*).

[1] This was demonstrated by neoclassical growth theory some four decades ago. See, for example, the seminal article by Swan (1956).

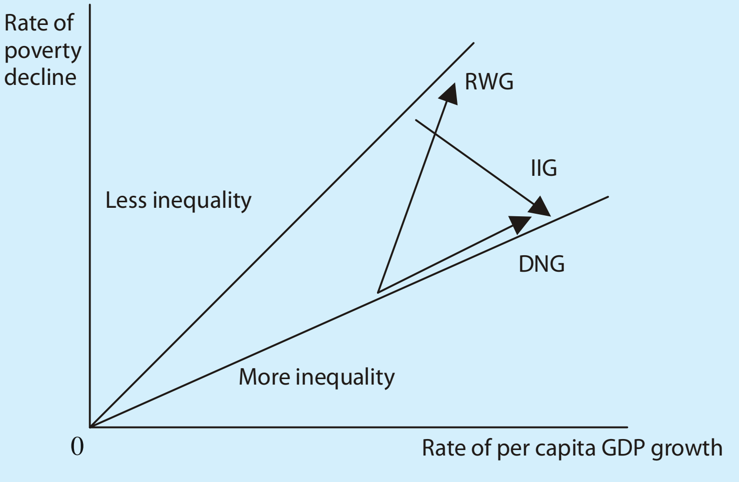
Box 1.1: Redistribution Matters in Viet Nam

Contrary to what the prevailing orthodoxy might suggest, income redistribution can have a major impact on poverty. The validity of this general principle is demonstrated in the diagram below. The relationship between economic growth and poverty reduction is determined by the overall distribution of income and the distribution near the poverty line. The economy-wide distribution sets the potential for redistribution, while the distribution near the poverty line determines the impact of a redistribution on the poor. If the poor are clustered just below the poverty line, then a given redistribution will reduce poverty more than if most of the poor are well below that line.

The diagram treats the distribution near the poverty line as an extension of the distribution function for the entire population. The steeper line reflects a more equal distribution of income. Three possible growth paths are shown. On the basis of recent empirical work (Kornia 2001), it would appear that a common outcome in the 1990s was growth with increased inequality (line GII). In this case, the poverty- reducing effect of growth declines. Alternatively, growth can be distribution neutral (argued by Dollar & Kraay 2000), and the rate of poverty reduction is constant as the economy expands (line DNG). Most favourable for the poor is redistribution with growth (line RWG), in which any growth rate is associated with more poverty reduction.

The practical importance of these logical possibilities is substantial for Viet Nam. On the basis of reasonable assumptions, in 2000, a rate of growth of one percent per capita that was distribution neutral would reduce poverty by .6 percentage points. That same rate of growth, were it distributed in equal absolute amounts across all households, would reduce poverty by 1.2 percentage points. In other words, with regard to poverty reduction, a one percent per capita redistributive growth is equivalent to a distribution neutral growth rate of two percent.

Alternative Growth Paths and Poverty Reduction



The difference between poverty reduction with distribution neutral growth and redistributive growth has important resource implications. To achieve the same poverty reduction as a one percent increase in redistributive growth, DNG must rise by an additional one percentage point. Assuming the aggregate capital-output ratio in Viet Nam is 3.0, this increase would require a rise in net investment of three percentage points. By any reasonable estimate of the administrative costs of redistribution, the opportunity cost of reducing poverty through redistribution should be less than for growth alone.

For further discussion, see Dagdeviren, van der Hoeven & Weeks (2002).

1.2. Common Analytical Mistakes about Transitional Economies

Considering growth and poverty in Viet Nam requires prior discussion of common analytical fallacies about transitional economies. The first step is to clarify terms. It is unfortunate that in the literature on transitional economies terms which previously had straight-forward, dictionary-based meanings, have to come to assume heavy ideological implications. One of the most important of these, and particularly relevant for Viet Nam, is 'reform'.

Strictly speaking, a 'reform' is a policy change of any type. For example, a trade regime can be reformed through imposition of tariffs or quotas to alter the level and composition of imports; similarly a trade regime can be reformed by cutting tariffs and eliminating quotas. In the discourse of current economics, 'reform' always mean actions of the latter type, and is by definition a 'good' thing. Those in favour of the latter are described are called 'reformers', and viewed as progressive (typically judged to reflect the 'national interest'), while those in favour of the former are branded as 'anti-reform' and reactionary (typically judged as motivated by 'special interests'). These value-laden terms are misleading, because, for example, at times it may be rational to favour tariff reduction, and other times rational to oppose it. This study avoids use of 'reform', in favour of specific terms: tariff reduction, enterprise restructuring, financial sector reorganisation, etc.

Other ideologically-abused terms are 'open' and 'closed' economies, 'controlled' and 'liberalised' economies, and perhaps most value laden of all, 'market-friendly'. To take but one example, the Vietnamese economy is extraordinarily open if one defines openness by the ratio of trade to gross domestic product. However, many would judge it as relatively closed because of its non-tariff barriers to trade. Attempting to encapsulate the trade position of Viet Nam as 'open' or 'closed' is an essentially ideological exercise that provokes controversy without providing insight. Controversy with insight can be achieved by debating specific policy measures without assigning them value-laden labels.

Perhaps the most fundamental analytical mistake in analysing transitional economies is to treat centrally planned economies as if they were more extreme versions of market economies with a large public sector and numerous regulatory interventions. The two types of economies are not on the same analytical spectrum. The purpose and outcome of centrally planned economies was to eliminate private ownership and, by doing so, to eliminate the market as a regulating force in society to the extent possible. In such economies, prices were not 'distorted', because they had no allocative function. They served merely as accounting tools. The purpose and outcome of regulated market economies was and is to manage and control private markets. The effect of regulatory interventions can accurately be described as 'distortionary' only if one accepts neoclassical general equilibrium welfare economics.[2]

The qualitative distinction between centrally planned and regulated market economies is essential to understanding transitional societies. Transitional societies pass through two phases of policy change before a market based economy is institutionalised: first, there is the radical shift from central planning (the term 'controlled' economy strictly applies) to market based (a 'regulated' economy); and, second, public policy then addresses the question of what degree of public intervention is required for effective functioning of the new, market economy. We shall refer to these two phases as the *regime change transition* and the *regulatory transition*. In Viet Nam, some confusion arises because the term *doi moi* is sometimes used to refer to both phases. The fundamental policy difference can be illustrated by referring to public sector enterprises (aka, state owned enterprises, SOEs). Within central planning, enterprises (the modifier 'state' is redundant) are part of an integrated system of non-market production, in which market demand, even household demand, is largely irrelevant. In a regulated market economy, state enterprises (now the adjective becomes necessary) are part of a market system. The central government may grant SOEs monopoly positions, protect them through trade policy, and extend them subsidies, but such enterprises remain market-based.

The mistake of not distinguishing between regime change and regulatory change gives rise to another, closely related one, which is concluding that if regime change stimulated growth, then a rapid programme of deregulation will bring higher growth. When the system of central planning collapsed in Europe and Central Asia, these systems were defined as inefficient in all aspects, and all problems during the central planning period were the result of central planning inefficiencies. It was a short step to conclude that all subsequent problems of transitional countries result from the lingering effects of central planning. The dominant tendency was to presume that post-central planning problems would not arise from inappropriate changes in regulatory policies ('reforms'), or from changes made too hastily or in the wrong order. This approach ignores the distinction between regime change and regulatory change. Market deregulation is not a continuation

2 The term 'distortion' has meaning only in relation when one specifies a non-distorted outcome. To take an analogy, one can say that mirrors in carnivals distort one's reflection because a true image can be defined scientifically. Similarly, a price is said to be distorted if it varies from the price which would prevail under conditions of full employment general equilibrium. However, if that equilibrium is not unique, or if one does not accept the analytical framework that generates it, then the term 'distortion' loses objective meaning. Rejecting the term 'distortion' does not stop one from describing prices and allocation to be dysfunctional, but the judgement is empirical and specific, not general and theoretical.

of the dismantling of central planning, and the impressive gains in Viet Nam from the latter would not necessarily be associated with greater regulation. Each deregulation policy must be inspected empirically for its economy-wide effects.

This analytical fallacy, some reform is good so more is better, has assumed a new lease on life recently in Viet Nam as the economy has manifested signs of weaker growth and export performance. No study has decomposed the perceived problems by the range of possible causes (for example, slow growth of the world economy, domestic production bottlenecks, and specific policy measures). It would be ideological rather than analytical to jump to the conclusion that the problems primarily arise from a 'slow pace' of 'reform'.

Related to the above, one must avoid the error of 'policy optimism', which is especially virulent in transitional countries. We support the common view that the Vietnamese government managed the process of regime change notably well. However, at many points in time the growth rate of a country may be only loosely related to its policies, unless those policies are unusually dysfunctional. Many factors beyond the control of the government influence growth, such as the state of the international economy, weather, and the efficiency of national markets. With regard to the latter, 'good policy' may fail to achieve its intended outcome because the instruments available to the government have limited impact on private decisions.

Further, there is the fundamental issue of the stochastic element in policy. Assume that the government seeks to achieve an inflation rate not higher than five percent. It sets monetary policy such that the mean outcome will be two percent. If the standard deviation associated with the policy outcome is three percentage points, then about one-third of the time the outcome will be 'bad', even though, technically, the policy was 'good'. When this report makes its recommendations, it should not assign to the government more influence over the economy that its policy instruments, exogenous environment, and efficiency of markets allow it.[3]

1.3. Analytical Framework

Inequality in Transitional Societies

As in all policy analysis, the goal sought by this study is the enhancement of human welfare. The most important outcomes affecting this welfare are levels of household income, social provision, and inequality. Growth, trade, and structural change are instruments to achieve those outcomes. In the context of human welfare, per capita income provides limited information, especially since the more unequal the distribution of income, the less accurately it approximates a measure of the welfare of the majority of the population.[4]

[3] More discussion on this point can be found in the case study of Indonesia, chapter 2.

[4] The more skewed the distribution of income, the greater the difference between mean and median income, by definition.

Our policy judgements and recommendations on the desirable level of inequality derive from the context of Viet Nam as a transitional economy. Centrally planned economies had low levels of inequality, because prices and incomes were set administratively to generate that outcome. Major items of household subsistence were provided outside mechanisms of exchange, notably housing, education, and health care.[5] Further, employment was guaranteed for all, though much of it may not have been productive. By contrast, exchange based on private ownership of assets is the fundamental distribution mechanism of market societies, even ones with a large public sector.

Therefore, one should expect asset and the associated income inequality to increase during the transition from central planning to a market society. Part of this increase reflects the inherent inequalities of market societies, and is essential to their effective functioning. Another part arises from an emerging differential access to assets, services, information, political power, and, it should be added in light of corporate behaviour in the developed countries, fraud and theft. The increased inequality associated with the transition from central planning to the market can be divided conceptually between that which is functionally necessary and that which is not. The increased inequality which is not necessary for the operation of a market system can itself be divided between that which is judged by society to be acceptable and that which is not. For example, it might be decided by explicit or implicit social consensus that inherited wealth is acceptable, even though much of it might not be necessary on allocative grounds.

Among the many social choices unavoidably presented to Vietnamese society is the degree of inequality that would be acceptable. All societies face this choice. In established market societies the division of political power associated with a country's degree of inequality may restrict the debate over the issue. In transitional countries, the situation is quite different for two reasons: first, asset and income distribution undergo rapid change, with a major impact on all other social policies and choices; and, second, the temporary and transitional nature of distribution makes it amenable to public policy.

The social choice confronting Viet Nam is illustrated in Figure 1.1, which calibrates a measure of degree of income inequality on the vertical axis (the Gini coefficient in this case), and per capita income in Purchasing Power Parity US dollars of 2000 on the horizontal. As indicated in the diagram, Viet Nam's income inequality in 1990 was quite low (a Gini coefficient of about .25).[6] By 2002, the Gini had risen to about .37, suggesting

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[5] That the level of income inequality in socialist economies was quite low is not controversial. Relative magnitudes are indicated by calculations that show that the Gini coefficients in the early 1990s for twelve European and Central Asia countries in transition were all lower that for thirty-eight developing market countries, with the exception of only two, Sri Lanka and Rwanda (Dagdeviren, van der Hoeven & Weeks 2002, 406-407).

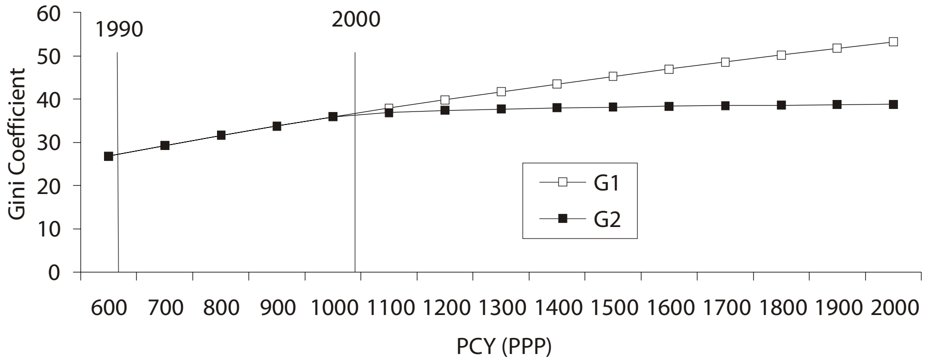
[6] As discussed in Chapter 2, in Viet Nam there are limited data with which to calculate measures of inequality, and there are no such data for 1990 and 2000. These years are chosen for illustrative purposes, and the Gini coefficients assigned to them are what one would expect from the years with data.

a substantial increase in inequality. Were inequality to increase in the future as it has done in the past (curve G1 in 1.1), Viet Nam would reach a per capita income (PPP) of US$ 2000 with a Gini coefficient well over .4, which would be similar to that of Thailand in the early 1990s. This would represent a moderately high level for Latin America, and extremely high for Asia. The curve G2 represents an alternative scenario, in which the rate of increase of inequality progressively slows, and inequality converges toward a Gini of .4, slightly below that of the Philippines in the mid-1990s.

Since the institutions of society determine the income distribution in any country, one can treat the alternative growth paths as converging to a 'steady-state' degree of inequality. The key question for social policy, and for this study, is which path of inequality and growth is implied by the institutions of Vietnamese society. If those institutions would result in a steady-state degree of inequality that is contrary to social consensus, then the policy issue is how they might be changed.

It might be argued that in the early 2000's, inequality was relatively low in Viet Nam,[7] and socially excessive inequality can be addressed by policy once it is reached, following the principle of 'sufficient to the day is the evil thereof'. There are several problems with this approach. First, the information needed to identify changes in distribution typically reaches policy makers well after the inequality has been established.[8] Second, once a high degree of inequality has established itself, the power relations generated by it may make corrective policy action politically difficult or impossible without social strife. This would seem the lesson from Latin America, where inequalities are huge and policies to alter them have

Figure 1.1: Alternative Growth Paths of Inequality for Viet Nam



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7 This view, which was expressed by several officials from both donor agencies and the government, recalls the well-known joke in which one woman says to the other, 'how is your husband?', and receives the reply, 'compared to what?'

8 The results of living standards surveys typically are not in usable form until a year or more after the surveys have been carried out.

been ineffective through democratic processes. Third, virtually all other social and economic policy action is based on the principle of implementing ameliorating policies before an undesired outcome is realised. For example, the multilateral financial institutions advise governments not to wait to act until excessive inflationary pressure manifests itself, but to take action in anticipation of such pressures. The same principle would apply to the prospect of excessive inequality.

From the experience of East and Southeast Asian countries during their period of rapid growth, 1970-1996, it would appear that the growth rates to which Viet Nam aspires in the future are consistent with the level of inequality currently prevailing in the country. Thus, there is no obvious technical argument for greater inequality on the grounds that it would be necessary to maintain a strong growth performance. Indeed, arresting the growth of inequalities could contribute to social cohesion, while growing inequality would cause the poverty reducing effect of growth to decline.

For policy purposes, it is important to distinguish between poverty and inequality, because different, but complementary, policies are needed to reduce both. Poverty reduction programmes that are targeted at those below a given income level (or some other criterion) may be successful in reducing the number of poor households, but have little or not impact on the level or trend in inequality. Reducing inequality requires, in addition to raising the incomes of the poor, preventing excessive concentration of wealth in the hands of a few, and fostering the growth of a middle class. In discussions in Ha Noi, and IMF official ventured the opinion that since poverty has been dramatically reduced in Viet Nam, inequality concerns should focus on the 'middle quintiles', where incomes will rise with the development of small- and medium-scale private business. It is the view of this report that poverty reduction should remain the principle focus of policy because of dynamic changes that are likely to generate new forms of poverty as structural poverty is reduced (see discussion below). However, we very much agree that the rise of a middle class is centrally important to preventing the emergence of gross inequalities, as well as important to long term political development.

In consequence of the foregoing considerations, the recommendations of this study are based on the policy judgement that inequality in Viet Nam is close to or above its socially optimal level, and mechanisms are required to ensure that inequality reaches a steady state not far above the current level. Even in a low-income country, which Viet Nam is, fiscal and monetary policies, trade policy, and the structuring of state enterprises and the financial system can be effective instruments to achieve this objective.

Dynamics of Poverty in Transitional Societies

The distinction between the phases of transitional countries, regime change and regulatory change, provides insights into the dynamics of poverty in Viet Nam. During the central planning period, Viet Nam was an extremely low income country, with relatively high indicators of human development (e.g., life expectancy and literacy). The poverty in that period was not of the type that a market economy manifests. To understand the dynamics of poverty in Viet Nam, it is necessary to distinguish between two different sources of poverty.

Poverty before Viet Nam's regime change might be called 'basic poverty', which resulted from the country's very low level of development. The rapid, market-based growth of GDP that followed the regime change created new income generating activities, especially in trade and services, and also redistributed income from the public sector to households, through the reorganisation of agricultural production from administrative allocation to market control. The vast majority of Vietnamese enjoyed rising incomes as a result of the fundamental reorganisation of economic activity. The impressive fall in the national poverty level, discussed in detail in Chapter 3, resulted primarily from economic growth as such. The government used various targeted welfare programmes to protect and subsidise those households not benefiting from this process, or benefiting only marginally (for example, the Hunger Eradication Programme and programmes for 'disadvantaged' areas). This process, 'a high tide raises all boats', is a common consequence of economic growth, and the tidal metaphor is more accurate than the frequently used term, 'trickle down'. One would expect basic poverty to decline towards a steady-state level determined by the social mechanisms that exclude households from the benefits of growth.

Market-based economic growth generates poverty, especially in transitional countries. Unlike in low-income market societies, prior to the regime change Viet Nam had little or no poverty resulting from landlessness or unemployment. Fundamental to the transformation of the economy to market-regulated was a reallocation of assets on the basis of private ownership. On the one hand, this created new mechanisms for private income generation; on the other it produced a phenomenon new for Viet Nam, poverty resulting from loss or lack of access to productive assets.[9] Gainful employment became dependent upon use rights to land, wage employment by those who had productive assets, or access to credit for self-employment. The poverty resulting from unemployment and landlessness might be called 'market generated' poverty.

This distinction between basic and market generated poverty can be used to interpret the impact of economic growth on poverty reduction. On the positive side, growth reduces basic poverty by raising incomes in existing economic activities, and creates new activities into which people are drawn. On the negative side, inherent in the creation of new activities are allocative changes that generate unemployment and landlessness. A schematic presentation of these two effects is shown in Figure 1.2 (where BasPov is basic poverty, MarPov is market generated poverty, and TotPov is the sum of the two). The vertical line labelled '2000' is an approximate indication of poverty levels by that year (levels are sensitive to the income measure used for the head count estimation, see Chapter 3).

[9] The emergence of this type of poverty is discussed in a recent World Bank report:

> …[U]rban households will represent an increasing share of the poor. Losses associated with distress sales of land, migration to urban and suburban areas without basic services, exposure to crime and environmental degradation in neighbourhoods growing out of control. These are some of the emerging challenges for poverty reduction efforts in Viet Nam. (World Bank, *et. al*. 2003, p. 1).

The rapid fall in poverty during the 1990s was the result of economic growth reducing basic poverty, while the emergence of market based poverty was incipient. Whether poverty levels will continue to decline with economic growth depends on two broad processes: 1) the steady state level to which basic poverty will decline, which might be called 'structural poverty'; and 2) the balance between market-based employment creation and market-generated landlessness and unemployment. From this analysis it follows that the rapid poverty reduction associated with economic growth of the 1990s is not a trend that can be projected into the next and subsequent decades. Increasingly, the relationship between poverty reduction and growth will reflect the balance between employment growth and poverty-generating structural change.

There are several reasons to anticipate a fall in the elasticity of poverty with respect to growth. In the densely populated areas of rural Viet Nam, a shift from rice cultivation to 'higher value added crops' *may* result in land and labour use systems that reduce employment per unit of land. The restructuring of state enterprises, including their privatisation, has generated considerable unemployment, and could do so in the future if implemented rapidly. These and other structural changes, discussed in subsequent chapters, create the possibility that rising household incomes for the population as a whole could be accompanied by a period of rising poverty levels.

This possibility is indicated in Figure 1.2 by the area to the right of the line noted as 'poverty reversal'. The diagram should not be interpreted to suggest that growth is not poverty reducing. The point is that in a transitional society, structural changes, some generated by public policy, some the inexorable outcomes of impersonal markets, and some the consequence of private monopolisation of markets, can result in a period of substantial labour dislocation that overwhelms the poverty reducing effect of growth. If the structural change associated with income growth is biased against lower income deciles, to unemployment and landless poverty could be added the 'working poor'.

Poverty reduction in Viet Nam in the 1990s was impressive, generated by rapid growth based on an equitable distribution of land, *ad hoc* limits to private concentration of income, and social safety nets. Sustaining poverty reduction may require a more focused policy combination. The preliminary results of the living standards survey indicates that the elasticity of poverty with respect to growth declined between 1997 and 2002, compared to 1993-1997.[10]

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10 This is discussed in more detail in Chapter 3. We note that the *Viet Nam Development Report 2003* deduces an elasticity of unity between poverty and growth, with the following argument:

In annual terms, a growth rate of output of roughly seven percent was associated with a reduction in poverty of about seven percent too, implying an "elasticity" of poverty reduction to economic growth of close to one. (World Bank, *et. al.*, 2003, p.1)

The same method of calculation is given in more detail on pages 56-57 of the report. This statistic seems to have been generated by using the familiar formula for a compound rate of growth:

$$\square = \{[P_{2002}/P_{1993}]^{(1/9)} - 1\}/\{\text{annual GDP growth rate, 1992-2002}\}$$

(Continued on page 11)

1.4. Growth Prospects for Viet Nam

Of the wealth of confusion about the relationship among growth, distribution and poverty, perhaps the richest vein of obfuscation is the debate over whether growth or redistribution is 'more important'. In a market economy, growth always involves redistribution, because the price system associated with a market economy is a mechanism of resource allocation, and the price-driven reallocation of resources results in the redistribution of incomes. The issue is not redistribution or growth, but whether growth generates a redistribution that is neutral, biased against, or biased in favour of the poor.

Anticipating changes in income distribution and economic growth is central to projecting poverty reduction in Viet Nam. Applying the distinction between regime change and regulatory transition facilitates assessing the growth potential of the economy in the medium and long term. While centrally planned economies had periods of rapid growth of production, the controlled economy is characterised by the suppression of the dynamic flexibility of the economy. As a result, the potential exists for a rapid growth 'spurt' immediately following the regime change, as the dead weight burden of the *controls* (not regulations) is shed. This arises from a fundamental change in the incentives for production, organisational restructuring, and access to previously unavailable technology. In practice, very few centrally planned systems realised this growth spurt, and only China and Viet Nam did so impressively. During the growth spurt, an economy can achieve a rate of expansion well in excess of its inherent potential, which is determined by the growth of technology, capital accumulation, growth of the labour force, and external conditions.

Slowly or rapidly, the advantages of regime change are institutionalised, and the economy will seek a sustainable growth rate dictated by its inherent potential. The rapid growth of the Vietnamese economy in the 1990s cannot with confidence be viewed as its sustainable rate that was interrupted by the Asian financial crisis, to which it will return in

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(Continued from page 10)

Where P is the head count poverty ratio for 1993 and 2002, which yields a negative rate of decline of 8.4 percent per annum.

By definition this calculates the compound rate of change of the head count ratio, but not the rate of poverty reduction. The relevant elasticity, between the change in the number of people in poverty and growth of GDP is the following:

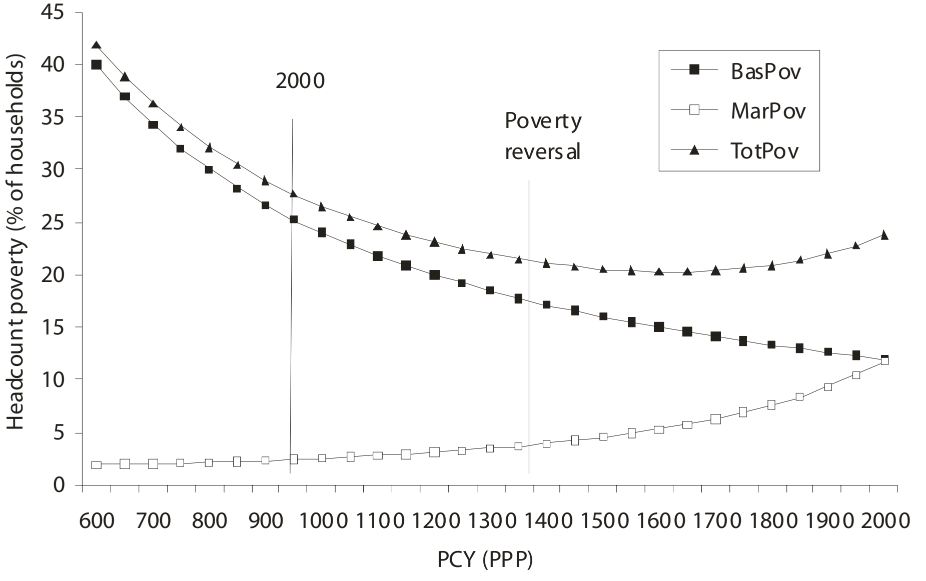
$$\square = \{[N_{2002}/N_{1993}] - 1\}/\{[GDP_{2002}/GDP_{1993}] - 1\}$$

where N is the number of poor households and GDP is the absolute, constant price level.

The second calculation yields an elasticity of .77 for 1993-1998, and .66 for 1998-2002.

Market-generated poverty is considerably easier to prevent that to remedy once it is institutionalised, because it derives from the distribution of assets and the concentration of power associated with that asset distribution. Viet Nam has a great advantage that most of the countries covered by the Regional Programme do not: with market-generated poverty in its incipient stage, it is open to the government of Viet Nam to 'nip it in the bud'.

Figure 1.2: Poverty and Growth During Viet Nam's Transition: A possible scenario



due course with appropriate policies. The growth potential of the economy should be viewed as presented in Figure 1.3. From the late 1980s to the mid-1990s, the economy grew impressively on the basis of a sound strategy of regime change and the shedding of the deadweight losses associated with central planning (dead weight loss phase, DWL), and this was followed in the 1990s by a slowing of growth as the economy adjusted to the new institutional structure ('Adjustment Phase'). In the present decade, one can anticipate a further decrease in growth, towards the country's long term potential.

While one cannot precisely specify the sustainable long-term growth rate, the factors determining it can be identified. First, there is the rate of capital accumulation and the capital-output ratio associated with that accumulation. On the basis of historical experience in the Asian region, this factor will probably set a growth rate in the range of five to eight percent. Complementary, rather than additive, will be acquisition of more advanced technology and raising the skills of the labour force. External conditions, and particularly export demand, are likely to be considerably less favourable that during the rapid growth period of the so-called Asian miracles, at least in the medium term.[11] The world economy

[11] This point is made in World Bank consultant's report: Viet Nam's prospects for export growth largely depends [*sic*!] on the ability to attract foreign direct investment and technologies that permit it to use efficient infrastructure… Yet weak external demand conditions and unfavourable factors affecting Viet Nam's competitiveness could undermine the sustainability of the country's strong export growth prospects. (Lord 2002, p. v).

entered a recession in 2001, with the pace of recovery uncertain. As a result, growth of world trade declined, and foreign direct investment flows fell sharply (the former down over four percent and the latter over fifty percent in 2001-2002 compared to 20000). Viet Nam is likely to be affected by these declines, as are other countries in the region. Thus, an optimistic but realistic assessment of Viet Nam's growth potential in the medium term would be about six percent per annum.

The distinction between regime change and the regulatory transition phase also suggests that the rapid growth of exports experienced in the 1990s is unlike to be sustained. In the 1980s, Viet Nam had an export share in GDP far below the potential for the country, less than ten percent. With the shift to a regulated market regime, the economy began to seek the ratio of exports to GDP implied by the country's inherent competitiveness. Once an economy reaches this level, exports will tend to expand at the rate of GDP growth. At some point in the 1990s, the Vietnamese economy reached this level, and beyond that level export growth greater than GDP growth can only temporarily and occasionally be achieved, though the application of merchantilist export promotion policies.[12] Thus, the structural constraints to export growth set by the size of the non-tradable goods sector, will limit the external stimulus to growth in the future.

It might be argued that even if export growth has a practical limit, foreign direct investment need not, and could in the future foster higher growth rates than domestic factors alone would allow. But foreign domestic investment also has practical limits. During the early phase of the transition to a market economy, the Vietnamese economy offered a large number of highly profitable investment opportunities that either had not been exploited by the central planning process or had been in an inefficient manner. Further, the gap between national and foreign technologies was enormous in many sectors. As the transition has proceeded, projects of extraordinary profitability have declined in number, and the technology gap has narrowed. FDI will continue to play an important role in stimulating growth in Viet Nam, but that importance will decline as the overall rate of return to investment approaches that in other countries of the region. Further, one cannot take the naïve view that foreign investment is a net addition to the investment capital available to the country. With the domestic private sector expanding,

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12 See discussion in the next chapter. The limit to the rate at which exports can grow over an extended period can be shown as follows. Assume there are no re-exports (commodities merely 'passing through' without being processed in any way), and that there is a lower limit to the size of the export sector set by the non-traded sector (government services and transport being the most important). Then, the ratio of export value added to GDP cannot exceed some maximum value, X*. As X_t approaches X*, export promotion policies will become less and less effective. If the main determinants of export growth (x_t) are the exchange rate (e_t), world demand (w_t), and a vector of 'structural' determinants of competitiveness (C_t), and y* is the sustainable rate of GDP growth, then the long run export growth function would tend to take a form such as the following (where the o_i terms are all positive):

$$x_t = y^* + [\, e^{\square 1} w^{\square 2}\, C^{\square 3}][1 - (X^*/X_t)],$$

as $[X^*/X_t)]$ approaches unity, x_t approaches y*.

foreign and local investors will to an increasing degree 'crowd out' each other. This is especially the case in a rapidly growing economy constrained by underdeveloped infrastructure and other growth 'bottlenecks'.

The purpose of the foregoing discussion was not to be 'pessimistic' about Viet Nam's growth prospects. Rather, it has been argued that the country's economy is out of its youthful, exuberant stage of the transition, and maturing as a market economy. As the economy matures, it will be increasingly governed by the basics of growth: the level and quality of capital formation, the rate of technical change, and the rate at which the population acquires skills. Each of these has an associated cost, and adjusts to an appropriate (or 'equilibrium') level in a market economy. This asymptotic adjustment of the country's sustainable growth rate implies that growth-induced poverty reduction will be slower. This likelihood makes the consideration of a pro-poor growth policy, including redistributive mechanisms, all the more timely.

The analysis can be summarised graphically, as shown in Figure 1.4, divided between actual (through 2002) and hypothetical (ending arbitrarily in 2006) rates of growth as three-year moving averages, of GDP, exports, and poverty reduction. The actual rate of growth conforms to our analysis, moving towards six percent in the early 2000s. As one would expect, after the extremely high rates of export growth in the early and mid 1990s, there followed a sharp decline at the end of the decade and the beginning of the next. This we explain by the limit set to the share of export production in GDP set by the necessity to produce a complementary supply of non-tradables. If one were quite optimistic, it could be argued that Viet Nam's further trade opening through accession to the WTO might allow for a sustained export performance well in excess of GDP growth (indicated by 'exports 2', at a hypothetical 15 percent). While this might be possible temporarily or intermittently, at some point the non-tradable constraint will dictate that the share of export value added in GDP will stabilise, probably close to the forty percent level of the early 2000s. The rate of poverty reduction is calculated from the actual elasticities implied by the household surveys (.77 during 1992-1998, .66 during 1998-2002), and assume to decline slightly after 2002 (to .56) if inequality continues to rise.

The policy implications of analysis summarised in Figure 1.3 are as follows: 1) growth will be increasingly dependent on policies affecting the quantity and quality of private and public investment, rather than by export growth as in the 1990s; 2) sustained and successful poverty reduction will require a focus on restricting the growth of inequality; and 3) export policy will also shift towards a focus on 'quality', with an emphasis on moving to more technologically advanced products for new markets, as the markets for existing exports become more competitive. The chapters which follow are directed primarily to the first two: investment policy, and especially policies affecting public investment; and concrete steps to address the principle obstacle to poverty reduction in Viet Nam, growing income and wealth inequality.

Figure 1.3: Conceptualising Viet Nam's Long-term Growth Potential

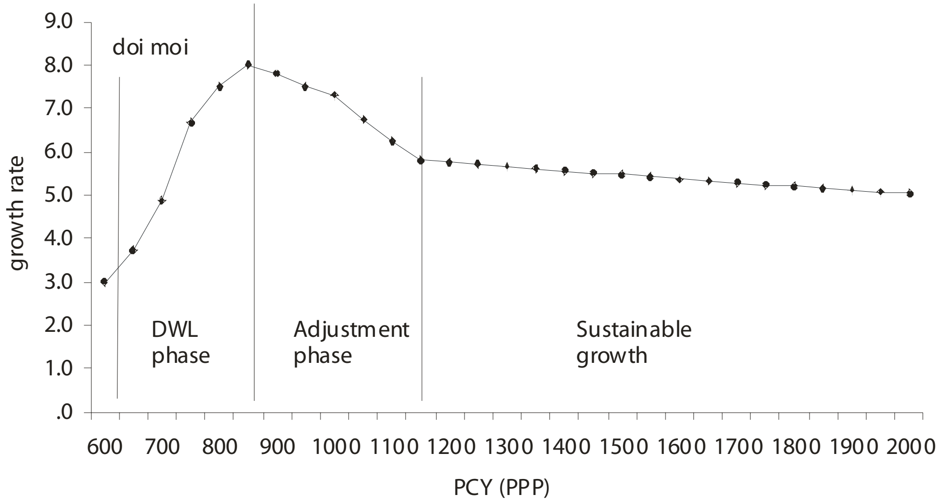
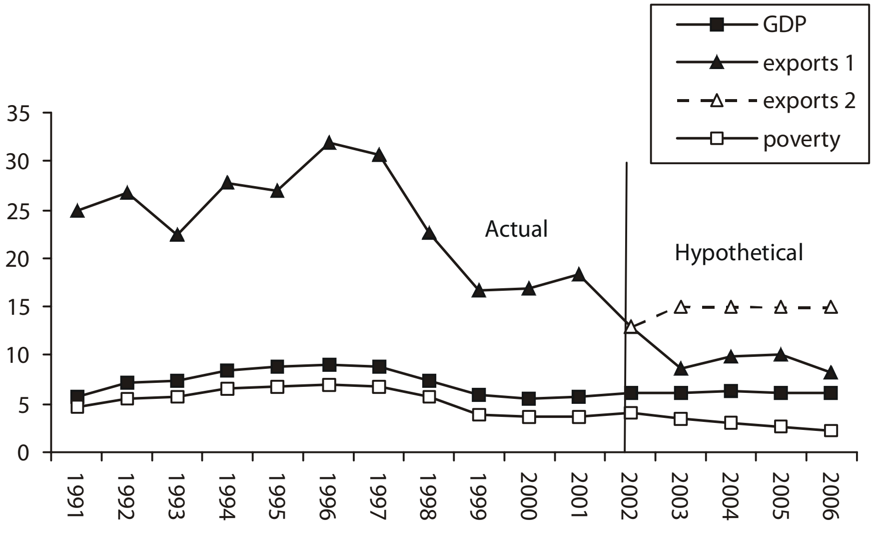


Figure 1.4: Viet Nam: Actual & Hypothetical Rates of Growth, 1991-2006



Chapter 2
Economic Performance and Structural Change since *Doi Moi*

2.1. Growth, Trade and Structural Change

Export-led Adjustment [13]

Viet Nam represents one of the few economic successes of the transition from central planning to market regulation. The growth rate prior to the collapse of the Soviet Union in 1991 was quite respectable, about two-thirds that of the average for the so-called High Performing Asian Economies (HPAE, see World Bank 1993a). Over the next four years, the growth rate exceeded that of the HPAEs. Viet Nam had the fastest growing economy in East and Southeast Asia during 1994-1997, with the exception of China. The country achieved this growth performance, first, by closing the trade gap through export growth, then, by combining export growth with inflows of capital. In every year, 1991-1995, capital inflows to Viet Nam exceeded the trade gap.

In this context, the World Bank, in its 1993 report on Viet Nam, commented that 'Viet Nam has shown strong growth throughout its adjustment program'. It went on to write, 'Viet Nam's recent economic success is attributable to an ambitious adjustment and reform program which it has undertaken without significant support from outside' (World Bank 1993b, pp. iii & i). A distinguishing feature of this adjustment and reform programme was the central role played by the state in managing the transition, rather than leaving adjustment completely to the dictates of the market.[14]

Also relevant to Viet Nam's long term performance was that before the adjustment programme of 1989, the country's growth rate was quite high for countries in transition. At an average of five percent per year during 1986-1989, national income increased

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13 This sub-section draws on Brundenius and Weeks (2001, Chapter 2).

14 The World Bank interpretation of the Vietnamese stabilisation success was that policy makers achieved price stability through implementation of tight monetary and fiscal policy. In the World Bank view, the reduction of bank financing of the government deficit was especially important. This interpretation is noted by Irvin: 'a problem [i.e., inflation] — it is argued – [was] rectified mainly by the adoption of an IMF-style stabilisation package in 1989' (Irvin 1994, pp. 5-6).

significantly faster than population growth (see Figure 2.1). This statistic is important,because stabilisation is considerably easier to achieve when growth performance is strong, especially export growth.

The success in reducing inflation can be attributed to the reduction of the trade deficit, which allowed the government to stabilise the exchange rate (see Annex 1 to this chapter for an empirical presentation). During 1985-1988, the trade deficit averaged almost 100 per cent of exports (imports were double exports). Then, during 1990-1992, it fell to an average of less than three percent of exports (and less than one percent of GDP). The trade deficit was almost eliminated by the dramatic increases in exports of marine products, rice, and petroleum, with exports of the latter two products having been close to zero in 1985-1986. The government enjoyed some good fortune to be modestly endowed with petroleum reserves, and their export contributed to the rapid overall expansion of exports. However, the dramatic increase in rice exports, from zero in 1988 to over US$ 400 million in 1992, occurred as a result of government policy.[15] The increase in rice exports reflected a dramatic increase in production, while the expansion of marine product exports probably involved a diversion from domestic consumption.[16] These three products together accounted for nine percent of total exports in 1985, and almost half in 1989.

Thus, Viet Nam's success in transition can be explained as *a process of export-led stabilisation*. Faced with an unsustainable balance of payments position in the mid-1980s, the government embarked upon a policy that had two aspects: institutional changes to make the economy responsive to standard macroeconomic instruments in the medium-term, and emergency measures to increase exports to stabilise the economy in the short-term. Expansion of petroleum exports would not have been sufficient, in itself, to achieve external balance; nor could rice or marine products alone have done this. But, the combination of the three, along with capital inflows, stabilised the exchange rate by 1992. Once the economy entered into an export-led stabilisation process, it was possible for the authorities to maintain a relatively expansionary monetary and fiscal policy.

In summary, Viet Nam's adjustment to the collapse of the Soviet trading system can be explained in terms of short-term measures of expediency taken within a longer-term strategy of state-led development. In the late 1980s and early 1990s the government used a range of direct interventions to force a higher ratio of exports to GDP, combining this with exchange rate devaluation. By the mid-1990s, tactics had shifted to fostering foreign direct investment and negotiating concessional capital flows from multilateral institutions.

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15 The system of interventions is briefly described in World Bank 1993, p. 130. Rice production increased from an average of less than sixteen million tons during 1985-1987, to over twenty million during 1990-1992 (Tran Hoang Kim 1996, p. 302).

16 Rice production increased from an average of less than sixteen million tons during 1985-1987, to over twenty million during 1990-1992, or twenty-nine percent. The increase for marine products was just over four percent for the same years (Tran Hoang Kim 1996, p. 302, 322).

Growth and Structural Change in the 1990s

After being ravaged by four decades of war from the 1940s through the 1970s, Viet Nam entered its transitional phase a predominantly agrarian society. The current relative prosperity of the country and the rapid growth rates that brought that prosperity have obscured the extraordinarily low productive base of the economy in the early 1980s. As a result of the recent success, outside observers, including some from donor and lender agencies, have tended to ignore the extremely difficult circumstances out of which it arose. As discussed in Chapter 1, this non-contextualised approach has given rise to policy criticisms based upon an excessive optimism about what could have been achieved. The phenomenal achievements in Viet Nam tended to be lost in the rhetoric of 'liberalisation' and 'reform', and each hint of weakness seized upon as compelling evidence for the urgency of further 'reform'.

During the second half of the 1990s, Viet Nam continued its economic success, despite the Asian financial crisis that undermined growth and stability in almost all the other countries of the region. Over the years, 1995-2001, GDP grew at close to seven percent, and per capita GDP at just below five percent. Even more impressive, during the pre-crisis and crisis years, 1995-1999, while Viet Nam averaged seven percent GDP growth rate. Korea, Indonesia, Malaysia, and Thailand were all below four percent. Along with that robust growth performance went remarkable price stability (see Figure 2.2), seven percent per annum measured by the GDP deflator, which fell to three percent in 2000. And while other countries in the region were suffering balance of payment pressure, Viet Nam improved its trade and current account balance, to maintain a sustainable balance of payments position through the late 1990s and into the new millennium (see Figure 2.3 and Chapter 5).

As to be expected, structural change accompanied the rapid growth of national income. This structural change conformed to the pattern familiar to successfully developing low-income countries, a shift from primary to secondary production. The manufacturing sector increased its share of GDP from 15.5 percent in 1995, to close to twenty percent in 2001, while agriculture declined from twenty-two to nineteen percent (see Table 2.1). The robustness of the growth is indicated by the decline in the broad category, 'services'; that is, commodity-producing, tradable sectors (primary and secondary production) expanded faster than non-tradables.[17] A striking characteristic of the structural change was the growth of agriculture (see Table 2.2). While the sector declined relatively, its absolute growth rate was more than double the growth rate of population (less than two percent per annum).

Thus, Viet Nam's rapid growth was 'high quality', as defined and demonstrated in Annex 2 to this Chapter. Growth involved a modernising shift of production to manufacturing, price stability, a strong export performance, and rising agricultural productivity. This benign combination comes under closer inspection in the following section.

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17 Note from Table 2.1 that this statement is true when one excludes construction, electricity and water from 'industry'.

2.2. Sources of Growth

The strong growth performance of the Vietnamese economy was accompanied by an even stronger export performance. For most observers this represented more than coincidence, resulting in the conclusion that the transitional growth performance of the Vietnamese economy was export-led, and continued to be through the 1990s.[18]

The sources of growth on the demand side of the economy can be analysed formally by use of a standard national income model, in which consumption and imports are a function of GDP itself (as well as other variables). If one assumes interest rates, expectations, and real wealth to be given, then the GDP identity can be converted into a simple behavioural model:

$$GDP = \alpha[GDP - tGDP] + I + G + X + \beta GDP$$

Where α is the propensity to consume out of disposable income, t is the tax rate (so [GDP – tGDP] is disposable income), and β is the marginal propensity to import. This simplifies to:

$$GDP = [I - G - X]/[1 - \alpha + \alpha t + \beta]$$

18 It is somewhat surprising to read the following in the July 1999 IMF report, *Viet Nam: Selected Issues,*

During the high-growth period…the main impetus to growth came from private consumption and FDI inflows…The external sector, by contrast, made a large negative contribution to growth in this period. This suggests that the mid-1990s were a period of domestic demand-led growth…

Exports were growing [during 1993-97] rapidly… but were outpaced by growth in imports. (IMF 1999, 5, 7, emphasis added)

The report goes on to reach a gloomy conclusion,

In summary, the structure of output growth in the mid-1990s has been relatively unfavourable: growth has been to a large extent generated by import-substituting and nontradable industries. (IMF 1999, 10)

The method used to reach this conclusion employs the standard national income identity. If one assumes inventory change to be zero, then by definition GDP is equal to the sum of consumption, investment, government spending, and exports minus imports, or:

$GDP = C + I + G + (X - M)$

The IMF report treats these as additive, and (X-M) as a single term (see IMF 1999, p. 7). For 1993-1997, the period for which the IMF growth calculation is made, (X – M) was negative. Therefore, 'the external sector… made a large negative contribution to growth'. Were this conclusion accepted, it would follow that the external sector makes a 'positive' contribution to growth if and only if there is a trade surplus. Few economists would take such a position. First, the calculation does not refer to the 'contribution to growth' (Table 2.4), but to the components of effective demand; a contribution to growth analysis would, strictly speaking, require consideration of the supply side. Second, it is not analytically consistent to treat imports to be the result of exports, which is implicitly assumed by combining them into a single term and calling it the contribution of the external sector. In graphical presentations of the simple Keynesian model the external sector is sometimes presented in a single term, (X – M), but it is a reduced form, not a full behavioural specification. However, imports result from all the categories of effective demand, not exports alone. Indeed, the component of import demand generated directly by exports is typically smaller than for either consumption or investment.

The denominator of the expression on the right is the 'multiplier'. For changes in GDP,

$$\Delta GDP = \Delta[I + G + X]/[1 - \alpha + \alpha t + \beta]$$

And the growth rate can be written as:

$$y = [S_i i + S_g g + S_x x]/[1 - \alpha + \alpha t + \beta]$$

Where the S symbols stand for shares in GDP, and the small letters are the growth rates of GDP, investment, government consumption, and exports, respectively. Using this model, one can investigate the sources of effective demand in the Vietnamese economy. We do so over the period 1995-2000, because for these years there are internally consistent statistics for all the national income aggregates required for the calculations.[19] The result is shown in Table 2.4. First, we can note that the multiplier for the economy over these years was quite low, 1.08 (a one unit increase in autonomous expenditure increases in GDP by 1.08 units). This low value reflects the high marginal propensity to import, of slightly over three-fifths. A low multiplier resulting from a high propensity to import is neither good nor bad. It tends to be a characteristic of low-income countries undergoing rapid industrialisation. The underdeveloped nature of the industries producing intermediate and capital goods dictates a high import coefficient.

Inspection of the table shows that growth during 1995-2000 was strongly export-led, in the sense that two thirds of final demand arose from export growth. Aggregate investment generated an additional twenty-one percent, and government current expenditure eleven percent (with inventory change the residual category). The contribution of aggregate investment was less from the central government budget than from the category 'other', which includes capital expenditure by state owned enterprises, joint venture firms, and the private sector as such. The second column in the table converts these percentages into components of the aggregate growth rate of 6.7 percent per annum. With regard to the components of net expenditure, non-budgeted investment minus private savings was negative (contractionary), fiscal policy was expansionary on current expenditure (a current account deficit), and exports minus imports were negative (contractionary).[20]

Data are insufficient to repeat the exercise for 2001, but one knows that for the entire year exports increased by only four percent in current value, and declined in the last two quarters (World Bank 2002, p. 10). Since exports were about 55 percent of GDP in 2001, it follows that exports contributed about 45 percent of final demand. Two important factors will determine the contribution of export growth to overall growth in the coming years, one positive and one negative. On the positive side, because exports grew faster than GPD during the 1990s so that its share in GDP rose, a given rate of growth of exports

19 The table on which the IMF calculation is based does not include gross national savings or government revenue.

20 This sentence refers to marginal, not average values.

will impart a greater growth impetus than before. For example, in 1995 a ten percent rate of growth of exports would have contributed 3.3 percentage points to the aggregate growth rate, and 5.5 percentage points in 2000. On the negative side, in the medium term the world economy is unlikely to recover sufficiently to generate the export growth of the 1990s.[21]

If during 2002-2010 Viet Nam's export growth sustains an average of ten percent per annum, then an aggregate growth rate of seven percent is both feasible and likely (requiring growth of other sources of demand of less than four percent). In the more likely case that exports grow at seven percent or less, investment and government current expenditure must expand considerably faster than in the past.

On the basis of our analytical framework presented in Chapter 1, we conclude that the export performance of the 1990s is unlikely to be repeated. Those extraordinary rates were part of the once-and-for-all growth gains associated the transition from central planning to a regulated market system. Further dampening export performance will be the state of the world economy. Thus, if a seven percent rate of GDP growth is achieved, it will not be export led to the degree it was in the 1990s. As the government of Viet Nam sets its growth target, it must seek sources of demand to replace the previously dominant role of exports.

This shift in economic strategy is a practical necessity that can prove a virtue for poverty reduction. Various government instruments could be used to make foreign direct investment more employment generating, which would be poverty reducing if *via* the labour market effect it raises the average level of incomes of the poor. Two factors limit the extent to which this would be realised. First, as for exports, direct investment inflows have been extraordinarily high, again reflecting the particular nature of the transitional period. Second, there can be little doubt that such investment would be concentrated in the most developed regions, so the impact on poverty in the less developed regions would be indirect.

Central government investment could be expanded to replace the lost impetus from export growth in a *public investment-led growth strategy* similar to what the government has pursued in the past. More so than before, public investment could enhance (crowd-in) employment-generating foreign investment, while channelled to projects that are directly poverty reducing (pro-poor investment, see Chapter 4). This benign combination would require conscious and purposeful planning of central and local government

21 A World Bank report on Viet Nam (World Bank 2002, p. 4) notes that 'The deceleration in world GDP growth in 2001 was the sharpest in the last forty years, except for the first oil crisis in 1974. This slowdown coincided with an unprecedented 14 percentage point deceleration in world trade, from 13 percent growth in 2000 to a 1 percent contraction in 2001.' It goes on to the obvious implication, 'Viet Nam's economy was adversely affected by these developments due to its openness…' (p. 5, emphasis added).

investment. Along with this, current targeted programmes for poverty reduction could be complemented by 'universal' entitlements.[22]

The expansion of government investment and current expenditure should face no serious budget constraint (again, see Chapter 4). The constraints that bind some other governments in the region are much less serious in Vietnam. For example, there is less fiscal pressure from service payments on internal and external debt as in Indonesia. In 2000, total government expenditure was 24 percent of GDP, and total revenue 21 percent (with a current account surplus). A percentage point rise of three-to-four percent for both would be feasible and not out-of-line with the size of the public sector in other countries of the region (Weeks 2001).

Sound policy and good fortune combined to make Viet Nam's transition to a regulated market economy relatively smooth with impressive growth rates. The extremely rapid growth of exports resulted in an economy that is at or above its optimum ratio of tradable to non-tradable goods. For the economy to continue to be export-led, in the sense of the export share rising, would border on merchantilism. Changes in the trade regime should be aimed at altering the export composition and reducing imports, since export promotion has been spectacularly successful.

If we compare across countries, Viet Nam's export share exceeds what one would expect from its level of development and the size of the country, as Table 2.5 shows. The table gives the export-GDP ratio for the forty-eight low-income countries with sufficient data, organised by region. Of the forty-eight, only six had ratios greater than Viet Nam's. Of these six, four were small countries, with populations less than ten million. As is well-recognised, the ratio of trade to GDP is inversely related to size of country. Only one country among the six, Ukraine, approached Viet Nam in population. While a more rigorous statistical exercise is required to assess the extent to which Viet Nam was 'excessively' export oriented, one can sustain the conservative judgement that the country's export share was well in excess of what one would expect from historical and contemporary international evidence.

The explanation for Viet Nam's extraordinary export share lies in the government strategy for the transition from central planning to market regulation. Aware of the experience of other transitional countries, in which the balance of payments presented a severe and binding constraint on growth, the government of Viet Nam in effect pursued a merchantilist policy of maximising export growth. Unlike the merchantilists, who called for trade surpluses, the Vietnamese government used the growing foreign exchange inflows to finance an import-dependent growth process. This import dependence arose not from 'distortionary' import substitution policies, but from the government's desire to overcome the technological isolation and backwardness of the economy.

22 This could be part of the changes in fiscal rules that involve greater autonomy to provincial authorities (World Bank 2002, p. 18).

The strategy achieved its purpose of financing the transition through export growth. It would be unrealistic to think that the export growth rates of the 1990s could be sustained, no matter what the buoyancy or stagnation of the world economy. Nor would rational policy seek to maintain such rates. If an economy can have an export share 'excessively low' due to an anti-trade policy bias, then the reverse must also be possible. *Prima facie* evidence suggests that Viet Nam falls into the latter category.

2.3. Changes in Ownership Structure

Under the central planning regime, prevailing in its most complete form in Viet Nam through 1986 when *Doi Moi* was initiated, production was organised through state and collective enterprises, complemented by a weak household sector. When Viet Nam started to move towards a market-based economy, ownership structure became increasingly diversified, with the emergence and relatively fast growth of a private sector, including both domestic firms and those with partial foreign ownership, the latter called 'foreign-invested firms'. From 2001, the foreign-invested sector was officially recognised as an integral part of the Vietnamese economy, and received equal treatment as other ownership forms.

In terms of ownership, enterprises fall into two broad groups, state or non-state. The latter is further divided into cooperatives, household enterprises, foreign-invested firms and domestic private firms (see Box 2.1). However, there has been confusion in the debate over the private sector, and inconsistency in data and analysis. Official statistics on private companies are difficult to obtain, and the GSO's methods for calculating private sector statistics have varied across years. Further, methodologies appear inconsistent across provinces (Steer and Taussig 2002, pp. 6-7). This should be made explicit and taken into account when examining changes in ownership structure.

Figure 2.4 shows that the share in GDP of the state sector steadily increased in the first half of the 1990s, and then stabilised at around forty percent in the second half of the decade. The employment share of state sector dropped slightly in the first two years of the decade and then fluctuated around the ten percent level. Not withstanding major steps taken by the government towards a market-oriented economy, the state sector continued to play a large role in the economy, though the employment share did not match the output share. The substantial mismatch between the output share and employment share of state sector has been attributed to relatively high capital-intensity of state sector.[23] To some, this seems a mystery, employment growing slowly, at a rate of 2.2 percent per annum, as opposed to output growth in industry and construction of 18.4 and 11.5 percent, respectively, during the same period (Figure 2.5). Rapid growth of the economy in the aggregate, and of the export, industrial, and construction sectors has not generated impressive employment expansion.

[23] Niimi et. al. 2002, p. 14 also attributed to the very likely inconsistency between GDP data of GSO and employment data of the Ministry of Labour, Invalids and Social Affairs (MOLISA).

This low employment absorption by definition represents increased efficiency in labour by of state enterprises. While there are not data to test whether this represented the shedding of redundant labour or increases in productive use of the remaining labour, it is consistent with the general characteristic of state enterprises under central planning as 'hoarding' labour for non-economic reasons. It would be logically inconsistent both to argue that state enterprises are inefficient, and critique them for slow growth of employment. The assertion that state enterprises were excessively capital-intensive is an inference from assumptions, rather than an empirical conclusion. The inference is based on deductions from two premises, one theoretical and the other pseudo-empirical: 1) that the state firms are pre-dominantly trade-protected import-substitution enterprises, thus capital-intensive by definition; and 2) that the industries in which one finds these firms are by their nature capital-intensive. The first premise ignores the possibility of technique re-switching, and a wealth of empirical evidence that shows a great variation in techniques within industries. The second derives from a factor-intensity ordering derivative from developed country evidence. It may be the case that that state enterprises in Viet Nam generated slow growth of employment in consequence of low potential for employment absorption. This remains a hypothesis that cannot be rigorously tested with existing data.

Figure 2.6 shows shares of various private ownership forms in non-state GDP. Share of the foreign-invested sector increased rapidly during this period.[24] As with state enterprises, the foreign-invested firms are typically blamed for the slow employment growth 1990s. Again, the argument is that these firms, being trade-protected, were the most capital-intensive sector of the economy. Yet again, one must distinguish between inferences based upon special-case theoretical assumptions, and hypotheses that must be empirically tested. Further, it is not analytically rigorous to assess the employment impact of any enterprise by looking at that enterprise alone. Aggregate employment is generated through an input-output matrix, and it is quite possible that an enterprise with low labour absorption would provide a crucial input into an enterprise of high labour absorption.

More fundamentally, slow employment growth combined with rapid output growth is the expected pattern in a society in transition from central planning to market regulation. Under central planning, enterprises do not set employment levels on the basis of profit maximisation. The employment decision derives from the goals of meeting an output target set by the central authorities; that is, the enterprises are not economically efficient in the market definition of that term. Because the enterprise surplus results from administered prices, there is no incentive for them to operate at technical efficiency (i.e., using the minimum inputs for any level of output). With the transition to market regulation, state enterprises must adjust to the rules of profitability, by reducing employment to achieve technical efficiency, then adjust techniques for economic efficiency. A graphical presentation of the adjustment is shown in Figure 2.7. Under central planning, the typical

[24] Foreign invested firms are further broken down into joint-ventures and firms with 100% foreign capital. SOEs normally have some shares in the former and therefore share of state sector out of total GDP is generally underestimated.

state enterprise operates at point a. Assuming only one technique, or that altering techniques is costly in terms of time and investment resources, the technically and economically efficient level of employment for the same level of output in the short run would be point b. In response to the change to market regulation, as output grows, the enterprise must move its employment level to the technology vector A. Three possible adjustment paths are shown: path I, rapid adjustment resulting in a decline in employment; path II, adjustment by holding employment constant as output grows; and path III, in which adjustment is protracted to allow for employment growth, albeit inefficiently.

Figure 2.8 shows that the share of foreign-invested firms in total investment, and Figure 2.9 contributions to growth. The investment share of foreign-invested firms declined during the Asian crisis period of 1998-1999, though not absolutely. Over the same period, investment by state sector grew substantially, both in absolute and relative terms. Share of domestic private sector fluctuated around the average level of 24.3 percent. This reinforces an earlier observation that the role of state sector in the economy has not declined. The major economic constraints to domestic private sector investment include limited access to capital, land, skilled labour and foreign markets, as compared to firms with other ownership forms. Non-economic constraints include relatively high tax rates, regulatory inconsistency, and uncertainty about the policy regime.

Regulatory uncertainty must be placed in context. Moving from central planning to market regulation is essentially a political process. First, it involves creating a consensus in the political sphere, in the face of considerable opposition. Second, there is no international policy consensus on the appropriate sequencing of policy changes. Third, there is no consensus on the appropriate regulatory regime, which will vary by country. Therefore, it would be expected that during the transition process policy reversals would occur, creating uncertainty for the private sector. This uncertainty would be preferable to the dogged pursuit of an inappropriate policy. Fourth, public attitudes in Viet Nam towards the private sector are not notably favourable, which influences government policy.[25]

There is evidence that domestic private firms were on the rise from the late 1990s onwards. This resulted partly from the Enterprise Law that took effect in January 2000, which has marked a new era for the private sector in Viet Nam. The number of registered domestic companies more than doubled from January 2000 to mid-2002. In 2002, the non-farm private sector in Viet Nam provided employment for about five million people, with large and medium enterprises private sector accounting for one fifth of this total. Of the more than 35,000 enterprises registered after 2000, around seventy percent were new (World Bank, 2002, p. 12). Domestic private enterprises and foreign-invested firms were the most important contributors to Viet Nam's export performance during 1998-2002.

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25 This is well documented in numerous studies (CIEM 2002; Liesbet & Taussig 2002; and World Bank 2002). Anecdotic evidence suggests many workers still perceive that working in SOEs is more prestigious and more secure, and as a consequence, domestic private firms normally have to pay higher wage for labour with the same level of quality and effort.

While it may be premature to make a definitive judgement about the radical change in ownership structure of the economy, there are a number of reasons for anticipating an increase in the share of the private sector in to the end of the decade. First, official government policy explicitly endorsed private sector development. Following the introduction of Enterprise Law in 2000, the fifth Party Plenum passed a resolution that expected to facilitate further development of private sector.[26] The resolution cites the private sector as an important contributor to job creation, income generation, and budget revenues, to help maintain political and social stability. Another significant endorsement of private sector development was the decision to allow party members who own private businesses to retain their membership of the Communist party. The Party's Plenum and subsequently the Vietnamese government also adopted a number of concrete measures towards further improvements of business environment for private sector.[27]

[26] The rather long title of the topic of the meeting was the 'Continuation of Renovating Policies and Mechanisms to Promote and Facilitate Private Sector Development'.

[27] World Bank 2002, pp. 12-14 provides details of concrete policies and measures.

Box 2.1. The Four Forms of Ownership

Sole Proprietorship. A sole proprietorship has only one single owner who has unlimited liability for both business and non-business debts. Full liability matters less for such firms, as they are small and rarely access bank financing. They rely on internal savings and informal borrowing. Sole proprietorships also enjoy a special exemption from taxation during times of inactivity, a benefit of particular value for small firms in industries with seasonal fluctuations.

Limited Liability Company (with one or more owners). Limited liability companies come in two forms. The first form has only one owner, which must an organization, not an individual. The second, and more common, form is legally required to have two or more individuals as its owner. Owners' liability is limited to the owners' capital contributions. Financing can be obtained from family or banks (like sole proprietorship) but also by increasing capital through existing and new owners.

Shareholding Company. Shareholding companies have two or more owners. They have the same limited liability as Limited Liability companies but differ from the latter in a number of respects. First, they are unaffected by death or bankruptcy or withdrawal of the shareholder. Second, decisions are carried out by a board of management and a shareholders meeting. Apart from family, banks and owners, financing can also be obtained by issuing bonds or shares.

Partnership. This new form of private enterprise was introduced for the first time in the 1999 Enterprise Law. It offers an alternative to sole proprietorship in case there is more than one owner. Partners are unlimited and jointly liable for all obligations of the partnership. Liability of capital contributors is limited to the amount of capital contributed. Financing can be obtained through family and bank loans, capital mobilization through owners and issuing of bonds. This form has so far not proven very popular among entrepreneurs.

Source: CIEM (2001) cited in Steer and Taussig 2002

Figure 2.1: Rates of Growth of GDP and GDP per Capita, 1985 - 2001

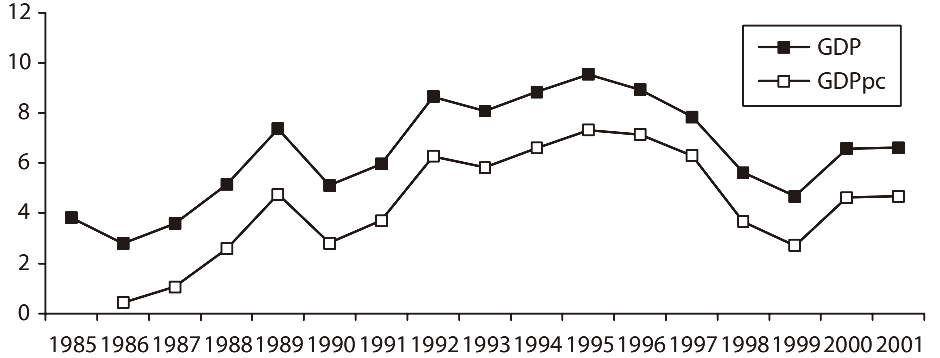


Figure 2.2: Rate of Change of the GDP Deflator, 1996-2001

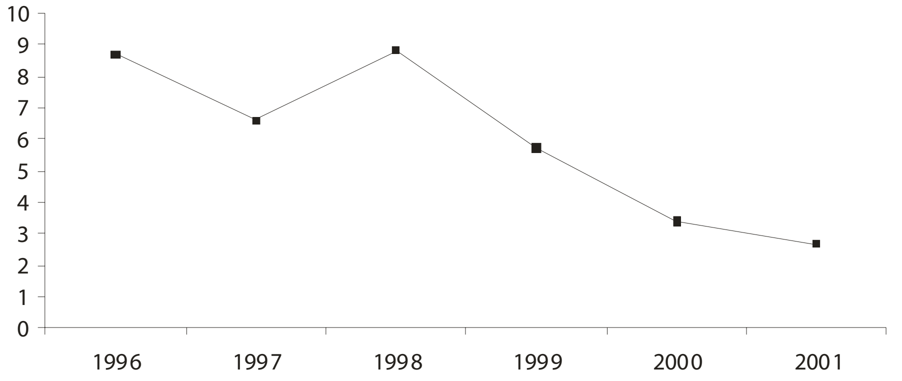


Figure 2.3: Balances on the External Account, 1995-2001

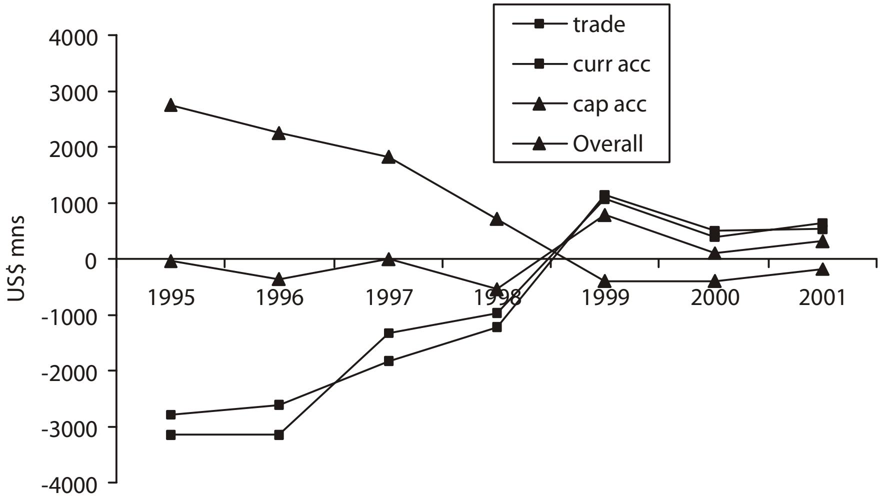
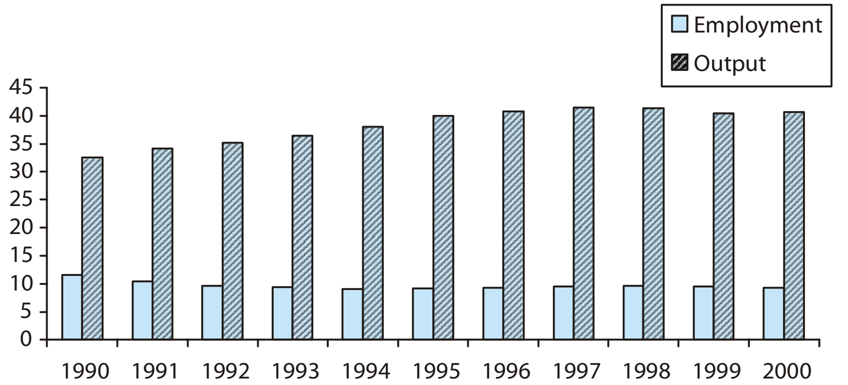
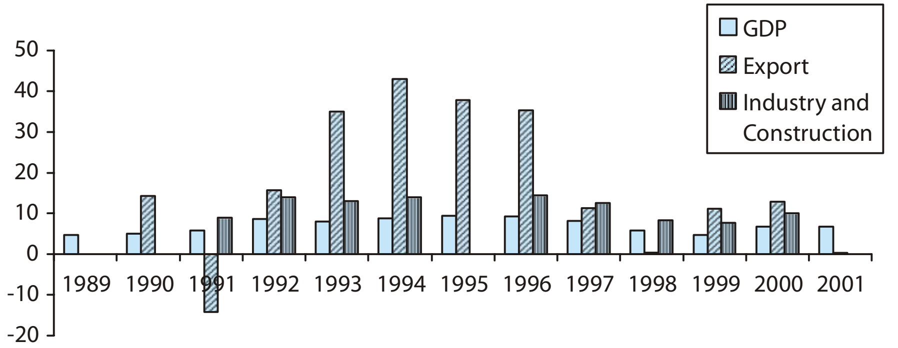


Figure 2.4: Shares of State Sector in GDP and Employment (%)



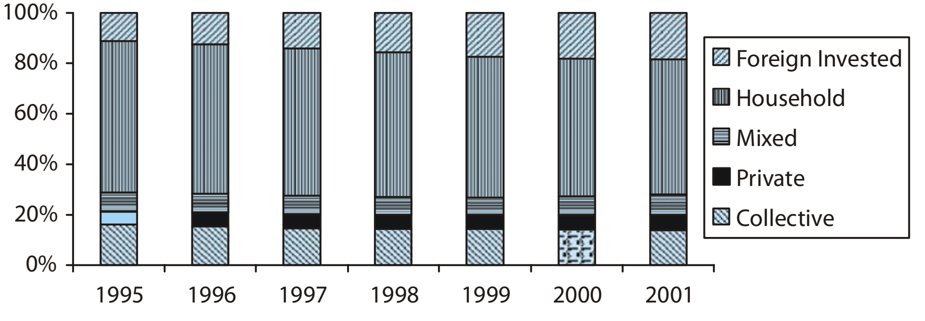
Source: GSO Statistical Yearbooks for 2000 and 2002.

Figure 2.5: Growth Rates of GDP, Exports, and Industry and Construction (%)



Source: GSO Statistical Yearbooks for 2000 and 2002.

Figure 2.6: Breakdown of Non-State Sector Output



Source: GSO Statistical Yearbooks for 2000 and 2002.

Figure 2.7: A Graphical Presentation of State Enterprise Adjustment to Market Regulation

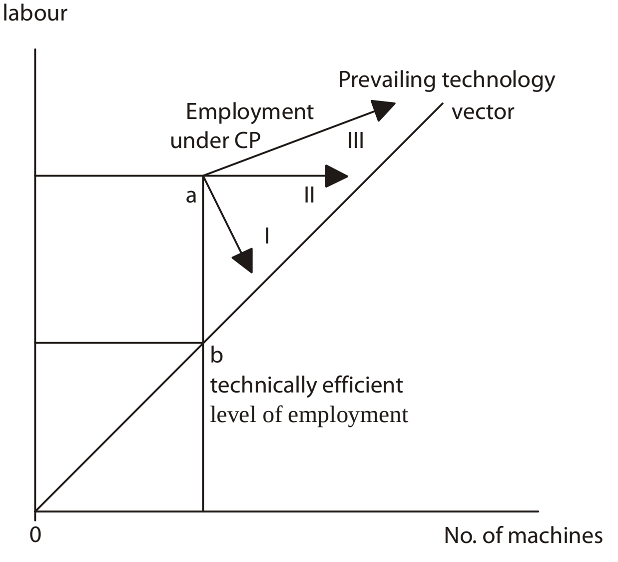
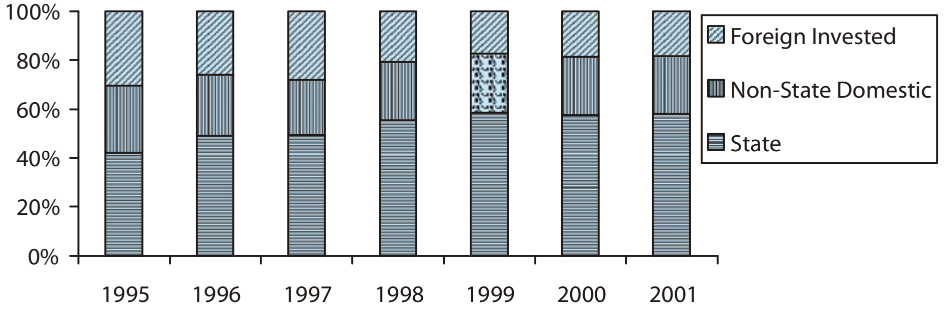
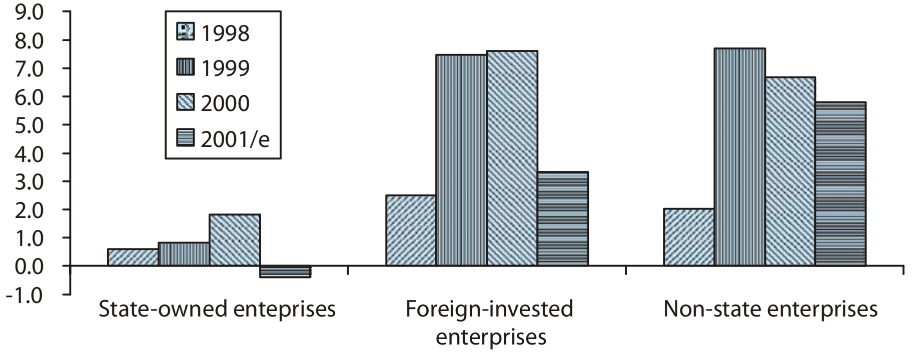


Figure 2.8: Investment by Ownership 1995-2001



Source: GSO Statistical Yearbooks for 2000 and 2002.

Figure 2.9: Contribution to Non-Oil Export Growth (%)



Source: General Statistical Office, cited in World Bank 2002, p. 10.

Table 2.1: GDP by Sector, Percentages of Total, 1995-2001 (constant prices of 1995)

Category	1995	1996	1997	1998	Rev 1999	Prel 2000	Prel 2001
AgFr,Fsh	26.2	25.1	24.2	23.7	23.8	23.3	22.4
Agric	22.3	21.3	20.7	20.3	20.4	19.9	19.0
Forestry	1.2	1.1	1.1	1.0	1.0	.9	.9
Fisheries	2.7	2.6	2.4	2.4	2.3	2.4	2.5
Industry	29.9	31.3	32.6	33.4	34.4	35.4	36.6
mining	5.3	5.5	5.8	6.2	6.7	6.7	6.6
manuf	15.5	16.1	16.8	17.5	18.0	18.8	19.6
elect/water	1.7	1.9	2.0	2.1	2.2	2.3	2.5
const	7.5	7.9	8.2	7.7	7.5	7.5	8.0
Services	43.8	43.6	43.2	42.9	41.9	41.3	41.0
Trade	17.2	17.2	17.0	16.8	16.4	16.3	16.4
Hotels	3.4	3.5	3.4	3.4	3.3	3.2	3.2
Trans/Tele	4.0	3.9	4.0	3.9	4.0	3.9	3.9
Finance	2.0	2.1	2.0	2.0	2.1	2.1	2.0
RealEst	5.0	4.8	4.8	4.8	4.7	4.5	4.3
PubAdmin	3.6	3.5	3.4	3.3	3.0	2.9	2.9
Educ	3.6	3.5	3.5	3.5	3.4	3.3	3.4
other	5.0	5.0	5.1	5.2	5.0	5.0	4.9

Source: World Bank website for Viet Nam.

Table 2.2: GDP by Sector, Growth Rates, 1995-2001 (constant prices of 1995)

Category	1996	1997	1998	Rev 1999	Prel 2000	Prel 2001
AgFr,Fsh	4.4	4.3	3.5	5.2	4.6	2.8
Agric	4.6	5.0	3.6	5.5	4.0	2.0
Forestry	2.0	.1	.4	3.1	.4	.3
Fisheries	4.1	1.0	4.3	3.8	11.6	10.6
Industry	14.5	12.6	8.3	7.7	10.1	10.3
mining	13.6	13.2	14.0	13.4	7.2	4.1
manuf	13.6	12.8	10.2	8.0	11.7	11.3
elect/water	17.8	14.7	12.3	7.7	14.6	13.2
const	16.1	11.3	-.5	2.4	7.5	12.7
Services	8.7	7.1	5.1	2.3	5.3	6.1
Trade	9.7	6.9	4.4	2.0	6.3	7.2
Hotels	10.2	7.0	4.5	2.5	4.1	6.9
Trans/Tele	7.4	8.9	3.9	6.3	5.8	6.6
Finance	11.4	4.3	5.8	10.0	6.1	5.3
RealEst	6.2	7.1	5.5	2.1	2.6	3.3
PubAdmin	7.0	4.0	4.0	-5.5	3.9	4.0
Educ	8.0	7.1	6.8	2.3	4.0	7.0

Table 2.3: The Growth of Employment, 1995-2001 (millions)

Category	1995	1996	1997	1998	1999	2000	Prel. 2001
Total Emp	33,031	33,761	34,493	35,233	35,976	36,702	37,721
grw rate		2.2	2.2	2.1	2.1	2.0	2.8
By sector							
Agric,Fr,Fish	23,535	23,874	24,196	24,504	24,792	25,045	—
grw rate		1.4	1.3	1.3	1.2	1.0	
Industry	3,756	3,888	4,021	4,157	4,300	4,445	—
grw rate		3.5	3.4	3.4	3.4	3.4	
Services	5,740	5,999	6,276	6,572	6,884	7,212	—
grw rate		4.5	4.6	4.7	4.7	4.8	

Source: General Statistical Office, Statistic Yearbook 2000 (Ha Noi).

Table 2.4: Sources of 'Growth': Viet Nam, 1995-2000

Category	Macro-Analytical	
	Percentage	Growth rates
Private consumption	napp	napp
Total Investment	**20.6**	1.4
Public budget	8.2	.5
Other	14.0	.9
[inv'tory change]	1.6	.8
Public current expend	**11.2**	.5
Net External	napp	napp
Exports	**66.6**	4.5
Imports	napp	napp
Total	100.0	6.7

Notes:
marginal propensity to consume = .69
marginal propensity to tax = .12
marginal propensity import = .61

Source: National income aggregates from IMF August 2000, pp. 3, 4, 16; and IMF July 2002, pp. 30 and 33.

Table 2.5: Low Income Countries, Average Export/GDP Ratios, 1995-1999

	Countries number	Share>VN	Average
Africa	30	3	24.0
Asia	7	0	21.9
Latin	2	0	23.7
America	9	3	36.0
In transition	48	6	26.1
Viet Nam			41.9

List of countries with shares > Viet Nam, excludingpetroleum exporters & those without data.

Countries with population in millions((in parenthesis), 1999:

Africa: Cote d'Ivoire (15.5), Gambia (1.2) & Mauritania (2.6)

In transition: Moldova (4.3), Mongolia (4.8), & Ukraine (50.0)

Viet Nam (77.5)

Annex 1: 'Export-led' Stabilisation

It is the conventional wisdom that Viet Nam achieved macroeconomic stability in the early 1990s by the government on its own initiative implementing an 'IMF-type' stabilisation programme. If this were true, it could be used as an argument for further and future implementation of such policies by the government, as well as elsewhere. It can also be interpreted as undermining support for what might be called 'heterodox' stabilisation packages.

The theoretical basis of IMF stabilisation programmes is the Mundell-Fleming model. In an open economy without import controls, the 'law of one price' holds. This means that inflation for tradables cannot exceed the international rate of inflation. For non-traded goods and services, the rate of inflation will be determined by the excess supply of money (monetary expansion), part of which will increase imports and part of which will bid up the price of non-tradables. If a country has a restrictive trade regime, which Viet Nam does, limits on imports absorbing the excess demand will generate inflation in tradables also.

Inspection of a scatter diagram of the fiscal deficit and inflation reveals no clear relationship between the two variables (Figure 2A). To test the hypothesis more rigorously, a simple orthodox model is used. If p_t is the rate of change of the GDP deflator, m_t is the rate of money growth, and dt_t the trade deficit, then the orthodox stabilisation hypothesis can be formulated as follows:

(1) $$p_t = \alpha_0 + \alpha_1 \ln[m_{t-1}] + \alpha_2 \ln[dt_t] + \varepsilon$$

Since the orthodox approach views inflation as having no structural component (purely a monetary phenomenon), the intercept is predicted to be zero. The rate of growth of money is lagged one period in order to avoid inter-correlation with the trade deficit. The coefficient α_1 should be positive and significant, and α_2 negative and significant. To the extent that it is monetised, the fiscal deficit, df_t, generates money growth. In other words, fiscal deficits are inflationary because they generate an excess supply of money, not because of their real demand affect.[28] Thus, one can specify:

(2) $m_t = [df_t]^{\phi}$ and, substituting:

(3) $$p_t = \beta_0 + \beta_1 \ln[df_{t-1}] + \beta_2 \ln[dt_t] + \varepsilon$$

Using annual data from the Asian Development Bank (ADB 2001, pp. 430-438) and defining the variables as the GDP deflator, the overall fiscal deficit, and the trade deficit on goods and services, the equation can be estimated for 1985-2000 for Viet Nam. The result is not supportive of the hypothesis that the fiscal deficit generated inflation; i.e, that reducing the deficit was the key achieving to Viet Nam's macroeconomic stabilisation. The significance of each coefficient is shown in parenthesis under that coefficient. None

[28] The excess real demand would be eliminated by the inflation they generated in the absence of expansion of monetary demand.

of the coefficient is significantly different from zero, and the overall is also significant (the F statistic is far below its critical value).

$$p_t = -1.04 + .00\{\ln[df_{t-1}]\} + .16\{\ln[dt_t]\}$$
(.54) (.99) (.59)

$AdjR^2 = .03$, F-statistic = .16,

Durb-Wat statistic = .20, DF = 12

A heterodox analysis would formulate the inflation relationship differently. Nominal exchange rates and domestic inflation are highly correlated. In the case of Viet Nam, for 1985-2000 the adjusted R-square between the percentage rates of change for these two variables is .41, with an F-statistic of 9.8, and elasticity not significantly different from unity. On the basis of this empirical relationship, we can formulate the following inflation model, where xn_t is the rate of change of the nominal exchange rate:

(4) $$p_t = [xn_t]^{\mu}$$

The nominal exchange rate itself is a function of balance of payments pressure. The trade deficit is used to measure this pressure on the current account, and net foreign direct investment flows on the current account.

(5) $$xn_t = tf_t^{\theta_1} dfdi_t^{\theta_2}$$

Substituting, one obtains the following estimating equation:

(6) $$p_t = \phi_0 + \phi_1 \ln[td_t] + \phi_2 \ln[fdi_t] + \varepsilon$$

As we have defined the variables, both coefficients on the behavioural variables are predicted to be negative and significant. Though the degrees of freedom associated with this estimation are small (because FDI data begin in 1989), the relationship proves to be significant.

$$p_t = -4.09 - .22\{\ln[tf_{t-1}]\} - .86\{\ln[fdi_t]\}$$
(.09) (.06) (.05)

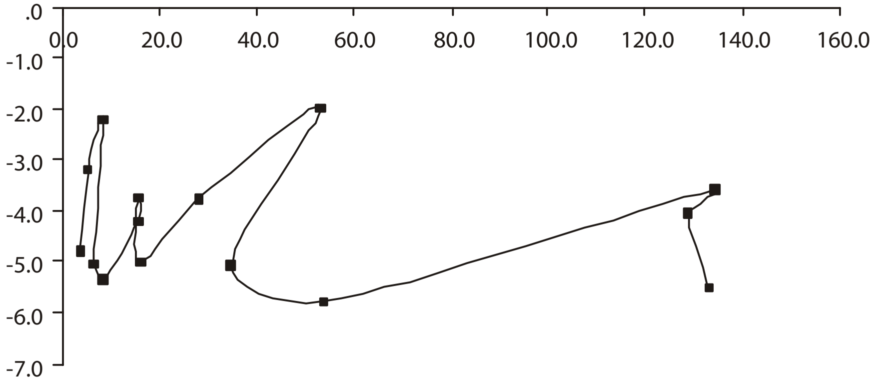
$AdjR^2 = .35$, F-statistic = 3.94 (significant @ .05),

Durb-Wat statistic = 1.38, DF = 9

The model has several problems: 1) the very small number of observations make the results highly sensitive to inclusion of later data; 2) if one adopts the five percent rule for statistical significance, only one coefficient is significant and only marginally; and 3) the Durbin-Watson statistic is consistent with serial correlation. None-the-less, the results are sufficiently supportive of 'export-led' stabilisation to adopt it as a working hypothesis.

Figure 2A

Fiscal Deficit and Inflation, Viet Nam 1986-2000



Annex 2: 'High Quality' Growth

Despite the impressive performance of the Vietnamese economy, some observers have raised concerns about the quality and sustainability of the country's growth.[29] A review of the writings on the Vietnamese economy would be appropriate in an academic paper, rather than a policy report. This annex restricts itself to a review of the principle economic indicators on which we base our conclusion that growth was of a 'high quality'.[30] Objective judgements about the economic performance of a country can be made on two bases: theoretical criteria or comparison to other countries. The discussion below relies primarily, though not exclusively on the latter. The countries chosen for comparison are those in the Southeast Asian region and the Republic of Korea. To achieve comparability, all data are from the ADB's Asian Recovery Information Centre. China is not taken as a comparator; its enormous size and diversity limits the countries to which it can be usefully compared, perhaps only India and Brazil.Since the allegations of serious weaknesses of the Vietnamese economy refer to recent performance, the discussion covers the second half of the 1990s to the latest year for which statistics are available. In all the tables, the averages in the last rows exclude Viet Nam.

With regard to GDP growth itself (Table A2.1), the conclusion is obvious: Viet Nam's growth rate was above the average in six of the seven years, the highest in three of the seven years, and was the highest for the seven year period. Further, the country's growth performance during 2001-2002 showed no sign of weakening relatively to regional performance, being the highest in both years.[31]

One putative sign of weakness, or lack of sustainability, of Viet Nam's growth is an allegedly low aggregate investment rate. By comparison to the other countries, Viet Nam's investment rate was above average for all years after 1997 (Table A2.2). However, this in itself is limited interest. A high investment rate is not in itself desirable. It should be judged on the basis of the growth rate it can sustain. For any given rate of growth, the

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29 A paper that has had some influence on those disposed to pessimism is that by Dapice (2002), with the rather opaque title, 'Viet Nam's Economy: Success Story or Weird Dualism? A SWOT Analysis'. While the paper raises some interesting issues, these are not placed in an analytical context, but discussed as if they were independent of each other. Some of the 'weaknesses' of the economy identified in the paper are based on old or inaccurate statistics (such as the allegation that the structural capital output ratio has risen). Others would seem to be subjective, such as assessing FDI flows as 'disappointing', which is contrary to the consensus view, including the IMF. And in still other cases, the alleged 'strength' and weakness' are part of the same economic process (e.g., rapid growth and a widening of urban rural incomes).

30 The best review of Viet Nam's economic performance is van Arkadie and Mallon (forthcoming 2004), and we thank the authors for making this study available to the mission.

31 In the IMF's November 2001 Staff Report on the economy, one reads:

Economic performance has been positive so far in 2001. Despite slowing exports, real GDP growth has been relatively robust, inflation subdued, and the external position has strengthened. Macroeconomic policy implementation has been broadly on track, characterized by a prudent fiscal stance, credit restraint…and a more flexible exchange rate management. (IMF 2001a, p. 4) lowest investment rate possible is desired, since this implies that the efficiency of capital is being maximised. The more relevant statistic is a country's capital output ratio. By this criterion, Viet Nam's performance was excellent. Along with the Lao PDR, it had the lowest capital output ratio among the countries. Inspection of Table A2.3 suggests that the observed capital-output ratios conform to what theory predicts: that the ratio rises as countries develop. The five middle income countries had ratios in the 4.5 to 5.6 range, while the two low income countries show capital-output ratios well below four.

With regard to overall investment performance, the statistics reveal a weakness in the performance of Viet Nam. On the contrary, the aggregate investment rate conforms to what theory would predict. In other words, Viet Nam's investment rate appears neither high nor low, but appropriate to its level of development and actual growth rate.

A second alleged sign of weakness is the performance in attracting direct foreign investment. As with aggregate investment, more is not necessarily better. The question in each country is whether the level of inflows is appropriate and efficient. Unlike for aggregate investment, there is no clear theoretical guideline by which to judge the appropriate and efficient level. Therefore, one must revert to the crude criterion of comparing absolute levels across countries (Table A2.4). For the five years, 1996-2000, this criterion yields and unambiguous judgement: Viet Nam had the highest ratio of FDI to gross domestic investment in four of the five years, and the highest average for the period. We can conclude that there is no evidence that performance on FDI indicates weakness.[32]

It would be surprising if any observer would point to *aggregate* export performance as indicating weakness. Over the period 1996-2002, Viet Nam had the highest rate of export growth in four of the seven years, and for the period as a whole. Export growth declined to single figures in 2001 and 2002, which was well above the rate of growth of international trade. In other words, Viet Nam, like the other countries of the region (and the world) is not completely immune to recession in international markets. We conclude this review with Table A2.6, which shows the current account deficit as a proportion of GDP. In all years Viet Nam had a deficit larger than all its comparators. Whether this signals a problem is a complex question, which is treated in detail in Chapter Five. Neither the IMF nor the World Bank considered this a pressing problem in 2003.[33]

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32 If we were to use the ratio of FDI to GDP, Viet Nam's performance would appear less strong. Because we previously demonstrated in the discussion of the capital-output ratio, the ratio of FDI to GDI seems more appropriate than FDI to GDP. Our positive judgement on FDI flows is shared by the IMF: Inflows of foreign direct investment (reported equity inflows plus foreign borrowings by joint ventures) are expected to reach about US$ 1.2 billion this year [2003]… For a sense of perspective it can be noted that as a share of GDP, this is slightly more than in China. (IMF 2003, p. 9)

33 For example,
…[S]trong growth has been accompanied by a rapid rise in imports of almost 30 percent in the first ten months of 2003… At this juncture a trade deficit of this magnitude [5.6 percent of GDP] can be justified by the need for investments in new production capacity. Moreover, art of the imports of machinery and equipment are "financed" by foreign direct investments that have been realized. (IMF 2003, p. 7)

We conclude that Viet Nam's growth was 'high quality': well above the average for comparators, showing a capital-output ratio appropriate to its level of development, enhanced by strong flows of foreign investment, and sustained by impressive export growth. No comparator country matched this performance. If major problems are in the offing, they are not signalled by the macro economic indicators that pessimists cite.

Table A2.1: GDP Growth in Viet Nam and Comparator Countries, 1996-2002

Countries	1996	1997	1998	1999	2000	2001	2002	Average
Viet Nam	**8.9**	**7.8**	**5.6**	4.7	**6.5**	**5.8**	**6.4**	**6.5**
Indonesia	7.8	4.7	-13.1	.8	4.9	3.4	3.7	1.7
Malaysia	10.0	7.3	-7.4	6.1	8.5	.3	4.1	4.2
Philippines	5.8	5.2	-.6	3.4	6.0	3.0	4.4	3.9
Rep Korea	6.8	5.0	-6.7	10.9	9.3	3.1	6.3	5.0
Thailand	5.9	-1.4	-10.5	4.4	4.6	1.9	5.3	1.5
Lao PDR	na	6.5	3.0	6.8	5.9	5.7	5.8	5.6
Average	7.3	4.6	-5.9	5.4	6.5	2.9	4.9	3.6

Note: In this and all subsequent tables, the values for Viet Nam are in bold if they exceed the average of the other six countries, and in bold and underlined if they are higher than for all the other countries.

Table A2.2: Investment/GDP in Viet Nam and Comparator Countries, 1996-2002

Countries	1996	1997	1998	1999	2000	2001	2002	Average
Viet Nam	28.1	28.3	**22.5**	**22.2**	**23.9**	**25.9**	na	25.2
Indonesia	30.7	31.8	16.8	11.4	16.1	17.4	14.3	20.7
Malaysia	41.5	42.9	26.7	22.4	27.2	24.0	24.5	30.8
Philippines	24.0	24.8	20.3	18.8	21.5	20.6	19.3	21.7
Rep Korea	37.9	34.2	21.2	26.7	28.2	26.9	26.0	29.2
Thailand	41.8	33.7	20.4	20.5	22.7	23.9	23.8	27.2
Lao PDR	29.0	26.2	24.9	22.7	20.5	21.0	na	24.1
Average	34.2	32.3	21.7	20.4	22.7	22.3	21.6	25.6

Table A2.3: Observed Capital/Output, Viet Nam and Comparator Countries, 1996-2002

Countries	1996	1997	1998	1999	2000	2001	2002	Average
Viet Nam	*3.1*	*3.6*	*4.0*	*4.8*	*3.7*	*4.5*	na	3.7
Indonesia	*3.9*	*6.8*	-1.3	14.4	*3.3*	*5.1*	*3.9*	4.6
Malaysia	*4.1*	*5.9*	-3.6	*3.6*	*3.2*	74.0	*6.0*	4.8
Philippines	*4.1*	*4.8*	-35.3	*5.5*	*3.6*	*7.0*	*4.4*	4.8
Rep Korea	*5.6*	*6.8*	-3.2	*2.4*	*3.0*	*8.7*	*4.1*	5.6
Thailand	*7.1*	-24.0	-1.9	*4.7*	*4.9*	12.6	*4.5*	5.3
Lao PDR	na	*4.0*	8.2	*3.3*	*3.5*	*3.7*	na	3.7

Note: Numbers used to calculate the averages are in italics.

Table A2.4: FDI/GDI in Viet Nam and Comparator Countries, 1996-2002

Countries	1996	1997	1998	1999	2000	2001	2002	Average
Viet Nam	**27.0**	**12.4**	**5.9**	1.3	**2.3**	2.4	2.4	**7.7**
Indonesia	7.6	-6.9	-82.5	-44.8	-22.9	-9.6	19.9	-29.9
Malaysia	na	-10.1	-35.8	-21.8	-10.1	-3.1	-7.4	-19.4
Philippines	na	na	na	3.5	1.3	7.1	12.3	2.4
Rep Korea	7.7	8.7	-2.7	8.0	9.2	5.7	.1	6.2
Thailand	4.9	8.5	1.4	-.4	-2.5	-4.4	-4.6	2.4
Lao PDR	na	na	na	na	na	na	na	na
Average	6.7	.1	-29.9	-4.9	-5.0	-.9	4.1	
(not Indo)	6.3	2.4	-12.4	5.1	-.5	1.3	.1	

Table A2.5: Export Growth in Viet Nam and Comparator Countries, 1996-2002

Countries	1996	1997	1998	1999	2000	2001	2002	Average
Viet Nam	**41.2**	**24.6**	**2.4**	**23.2**	**25.2**	**6.5**	**7.4**	**18.6**
Indonesia	9.7	7.3	-8.6	-.4	27.7	-9.3	3.7	4.3
Malaysia	5.9	.4	-6.8	15.3	16.1	-10.4	6.0	3.8
Philippines	17.8	22.8	16.9	18.8	8.7	-15.6	9.5	11.3
Rep Korea	3.7	5.0	-2.8	8.6	19.9	-12.7	8.0	4.2
Thailand	-1.9	3.8	-6.8	7.4	19.5	-6.9	5.7	3.0
Lao PDR	2.6	-1.4	6.4	1.5	2.6	-.3	2.7	2.0
Average	6.3	6.3	-.3	8.5	15.7	-9.2	5.9	

Table A2.6: Current External Account/GDP in Viet Nam and Comparator Countries, 1996-2002

Countries	1996	1997	1998	1999	2000	2001	2002	Average
Viet Nam	-8.2	-6.9	-4.6	4.1	1.7	1.5	-2.8	-1.2
Indonesia	-3.4	-2.2	4.3	4.1	5.3	4.9	4.3	2.5
Malaysia	-4.8	-5.2	13.5	15.9	9.1	8.3	7.8	6.4
Philippines	-4.8	-5.3	2.4	9.2	8.4	1.8	5.4	2.4
Rep Korea	-4.4	-1.7	12.6	6.0	2.7	1.9	1.3	2.6
Thailand	-7.9	-2.0	12.7	10.2	7.6	5.4	6.1	4.6
Lao PDR	-16.5	-16.2	-10.1	-8.9	-8.3	-6.9	-5.6	-10.4
Average	-7.0	-5.4	5.9	6.1	4.1	2.6	3.2	

Chapter 3
Poverty Reduction, Inequality and the Poor

3.1. Poverty Lines, Data Bases and the Poor

The evidence presented in this chapter supports the assertion at the start of this report: that the

This report benefits from a long history of policies and programmes for poverty reduction in Viet Nam, which date from independence. Even before *doi moi*, Viet Nam's social indicators, for example, life expectancy and infant mortality, were remarkably high given the extremely low per capita income of the country and the devastating effects of three decades of war.

In 2000, the government sought concessional finance from the World Bank and IMF (through its Poverty Reduction Growth Facility), which required entering into the process of producing a poverty strategy document tailored to the specification of those agencies.[34] Both formally and in practice, the government's strategy was and is embodied in other planning documents produced for the domestic political process rather than for external agencies. The documents produced for donors and lenders, the Interim Poverty Reduction Strategy Paper and the Poverty Reduction Strategy Paper, are treated briefly in the annex to this chapter. Here we consider the characteristics of the poor in Viet Nam, the diagnosis of poverty derivate from those characteristics, and recent progress in poverty reduction.

This section sets the stage for discussion of macroeconomic policies that will be presented in the subsequent chapters. This will be done by analysing the process of poverty reduction, and characteristics of the poor, in Viet Nam in the period 1993-2002. We identify the major reasons for Viet Nam's impressive achievements in poverty reduction during this period, as well as possible changes in the pattern of poverty in the first decade of the twenty-first century. The results of the analysis have important implications for poverty

[34] For reviews of the poverty reduciotn strategy process in Viet Nam, see UNDP (2004), Lerche, Pincus & Weeks (2004), and Pincus & Thang (2004).

projections, as well as for policy recommendations for achieving reducing poverty in Viet Nam.

The analysis is based on studies of poverty for the country, which relied on specific poverty lines. The major source will be the Viet Nam Living Standard Surveys carried out by the General Statistical Office of Viet Nam (GSO) in 1993, 1998 and 2002 (VLSS1 and VLSS2, with VLSS used to refer to the first two sets of household surveys, and VHLSS02 to the last one). Some studies have used data collected through Multipurpose Household Survey conducted by the GSO every year. Since issues of measurement are critical for our analysis, the first sub-section is devoted to a discussion of poverty lines used in Viet Nam, and possible biases in various surveys. The rest of the chapter considers the characteristics of the poor and what they imply for policy.

Selecting the most relevant poverty line for Viet Nam is controversial, most notably between the Ministry of Labour, Invalids, and Social Affairs (MOLISA) and the GSO. We shall not enter into this controversy. Rather, we treat each poverty line as providing its particular view. While the absolute level of poverty is important, it is the characteristics of the poor that should guide policy.

The GSO poverty line differs from that of MOLISA in a number of ways (see Box 3.1). First, GSO poverty line is based on a criterion of 2,100 calories per person per day. In contrast, the MOLISA definition is in practice discretionary. It was constructed on the basis of resources available to the government for supporting the poor, and may be altered by provinces and cities depending on the resources of these administrative units.[35] The GSO absolute poverty line is measure of poverty in constant prices, and adjusted over time for changes in the price level. The MOLISA poverty line is *relative*. Second, in calculating poverty lines, GSO takes into account not only cash income, but also imputed own-use production. MOLISA considers the only former; that is, it seeks to estimate the cash income required for minimum needs, exclusive of own-use production. As a result, GSO and MOLISA provide quite different estimates of poverty incidence. The former reported a poverty rate of thirty-seven percent for 1998, while the latter reported a rate of seventeen percent in 2001. The difference is much too large to be explained by economic growth over the three years. In light of this discrepancy, the CPRGS called for common criteria of estimation:

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35 Conway (2001) found that different communes in Cao Bang province used different poverty lines. He argued that the calculation of income equivalents for the rice-based hunger and poverty lines is problematic. When looking at the results of the most recent poverty survey by MOLISA (MOLISA 2001), one finds that Tuyen Quang, a mountainous province that qualified for numerous poverty alleviation programmes funded by the Vietnamese Government and the donors community, outperforms major cities of Vietnam in poverty reduction. Poverty incidence in Tuyen Quang by the new poverty line was 6.9 percent in 1999 and 3.6 percent in 2000. These figures were 10.9 and 9.1 percent for Ho Minh City, which has the highest income per capita in Viet Nam. For Da Nang the percentages were 12 and 9.4, and 7.2 and 5.p for Hai Phong. The figures for Tuyen Quang are hard to be believed.

> In the future, Viet Nam will move towards using one common poverty line for estimating poverty incidence in the country, taking into consideration international poverty standards for comparison purposes. (CPRGS 2001, p.17)

On the assumption that the GSO will establish the common poverty line, this study adopted the absolute poverty line methodology and estimates. This has the advantage of facilitating comparisons with case studies of other countries being done under the umbrella of this regional project.

The major data sources for poverty analysis, VLSS1, VLSS2 and VHLSS02, had sample sizes of 4,800, 5,999, and 30,000[36] respectively. These surveys provide high quality data and were based on a sound sampling methodology. One of the most useful features of VLSS is that they have a panel data set of 4,305 households, which were interviewed in both surveys. Data analysis shows that the distribution of these 4,305 households by expenditure quintiles almost exactly mirrors that of the 4,800 households in the VLSS1. The panel set can be taken as representative of the population of both VLSSs. The questionnaires used in both VLSSs are similar, though refinements and additions were made in the second one. These nationally representative sample surveys provide data on a wide range of topics, including: expenditures and incomes; education; health, fertility and nutrition; employment; migration; housing; agricultural activities; small household businesses, credit and savings. While the VHLSS02 is similar in many ways to the VLSS, there are also some important differences. The VHLSS02 does not have a panel dimension to link it with previous VLSSs, although it would have so in the future. Next, the size of the VHLSS02 sample is much larger than that of the VLSSs. However, the VHLSS02 covers much fewer topics and is planned to be conducted more frequently (every two years) than the VLSSs.

However, there are a number of caveats that need to be made explicit (Haughton *et. al*. 2001, p.12; and World Bank 1999a, p.12 for more detail). First, the urban poverty is likely to have been understated. The VLSS 1998 data show that only nine percent of urban households were poor. The VLSS2 sampling frame probably excluded migrants who did not have a permanent residence registration in those areas. Such migrants are likely to have been among the poorest members of urban areas, and since the survey might not include them, poverty in urban areas may have been under-estimated. VHLSS02, which uses 1999 Census as the sampling frame, covers all residents for more than six months. However, the definition of residence appears to vary across communes. Second, newly formed households are under-sampled in the VLSS2, and this reduces its usefulness for analysing some crucial issues such as migration. There is no migrant identifier in the VHLSS02's questionnaire, thus making it impossible to do differentiated analysis for migrants and non-migrants based on this dataset. Some studies, including one by the UNDP (2001), make use of data collected for Multi-Purpose Household Survey. However,

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36 In VHLSS02, detailed expenditure data are gathered from 30,000 households and used for calculation of various expenditure-based poverty indicators. However, income data are collected from an additional 45,000 households, and thus total sample size is 75,000 households.

Box 3.1. Poverty Lines in Viet Nam

The GSO and MOLISA (Ministry of Labour, Invalids and Social Affairs) both generate estimates of poverty in Viet Nam, one using an internationally comparable methodology, and the other a national methodology and definition of poverty.

The **international poverty line** was applied to the Viet Nam Living Standards Surveys (VLSS) undertaken during 1992/1993 and 1997/1998, by the General Statistical Office (GSO). These surveys received funding from the UNDP, the World Bank and the Swedish International Development Agency (SIDA). The poverty line includes the minimum consumption level for food (70%) and non-food items (30%), and is determined by a two-step procedure. The first step established the price of a Vietnamese-specific basket of food items deemed necessary for good nutritional status. The absolute amount of the basket is based on the international standard of 2100 calories per adult per day. The actual consumption of the third quintile of households was closest to this level of minimum food intake. The second step added the costs of the non-food items, which were derived from the levels of the consumption of the third quintile. Taken together, the resulting poverty line is equivalent to US$109 in 1993 and US$128 in 1998 and 2002 (using nominal exchange rates). It should be noted that this poverty line is not directly comparable to the more common measure of US one dollar per person per day (Purchasing Power Parity). A new household survey is planned for implementation in early 2002.

The **national poverty line** is determined by MOLISA throughout the 1990s as the income equivalent of buying fifteen, twenty and twenty-five kilograms of rice per month for all parts of the country; i.e., in mountainous and remote regions, and rural and urban areas. In order to broaden the definition of poverty beyond a sole focus on adequate food supply ,and to allow more poor households access to government anti-poverty programmes, MOLISA recently increased the poverty line and set different ones for different areas: VND 80,000 (US$5.5) for mountainous and remote regions; VND 100,000 (US$6.9) for rural areas, and VND 150,000 (US$10.3) for towns and cities. Under certain conditions, provinces and cities are authorized to raise the poverty line; that is, to allow more households to qualify for poverty funds. Due to the increase in the poverty line, the MOLISA estimate was adjusted from eleven in 2000 to seventeen percent in early 2001. The Government target for the reduction of poverty by 2010 (ten percent) is based on the new poverty line.

Source: United Nations 2001, p.8

little is known about the characteristics of the survey, sampling strategy, sample properties, and the interview procedures. As a result, most studies rely on data of the VLSS.

As noted in Chapter 1, Viet Nam is one of the few countries in the world in which poverty, however measured, declined dramatically within a relatively short period of 1993-2002. That poverty levels fell sharply across the country is not in dispute. Controversy arises when one seeks to explain the decline, and project into the future. Non-income indicators of household welfare also improved impressively. During the 1993-1998 period, primary school enrolment rates, which were high for both girls and boys, rose from eighty-seven to ninety-one percent for girls, and from eighty-six to ninety-two boys. Lower secondary enrolment rates doubled for both girls and boys, to sixty-one and sixty-two percent, respectively. In 2002, overall enrolments rates at primary and lower secondary schools were 90 and 72 percent respectively.

Malnutrition among children below the age of five remains high in relation to other child health indicators, but declined dramatically from about half the population to a third during the period 1993-1998, and further down to slightly above a quarter in 2002. Infant mortality rate was reduced to 33 per 1000 live births (World Bank 1999a, World Bank 2003). The consultation process carried out by the Participatory Poverty Assessments (PPA) in 1999 and 2003 confirmed these improvements in household welfare.[37] However, the changes on poverty and in per capita expenditure were distributed unevenly across geographical regions, ethnic communities, and demographic groups. Both urban and rural poverty dropped considerably, but the rate of reduction was higher for urban population.[38]

As poverty and poverty reduction in sub-periods 1993-1998 and 1999-2002 are quite different from one another in terms of speed, and some determinants of poverty reduction, it is useful to do poverty analysis for these sub-periods separately.

3.2. Growth, Inequality and Poverty, 1993-1998

Poverty reduction occurred across all seven regions of the country, though with different speeds (Figure 3.1). Below, we list the regions in descending order of the fall in poverty for 1993-1998, with the decline measured in percentage points, and the levels in parenthesis (World Bank 1999a, p. 14):

1. Red River Delta, 34 (63 to 29%);
2. North Central Coast, 27 (75 to 48%);
3. South East, 25 (37 to 12%);
4. North Uplands, 18 (82 to 64%);
5. Central Highlands, 18 (70 to 52%);
6. South Central Coast, 11 (47 to 36%); and
7. Mekong River Delta, 10 (47 to 37%)

Poverty also declined across ethnic groups, from 54 to 31 percent for the Kinh majority, but by much less for ethnic minorities, 86 to 75 percent (World Bank 1999a, p. 30). The differential rates of reduction resulted in concentrating eighty-two percent of Viet Nam's poverty in four regions: Northern Uplands (25 percent); Mekong Delta (21 percent); Red River Delta (18 percent) and the North Central Coast (18 percent).

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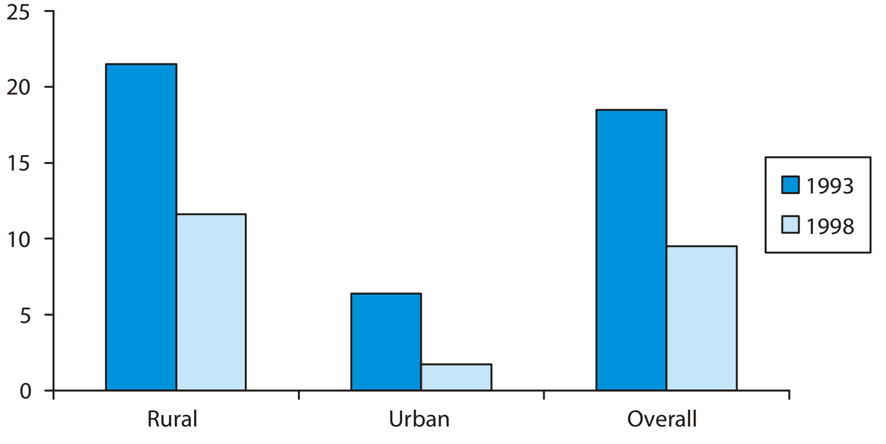
37 The findings of these PPA are summarised in World Bank 1999b and World Bank 2003.

38 This is true even though urban poverty was under-estimated, which was discussed above.

Figure 3.1 Poverty Indicators in 1993 and 1998 (percentages)



Source: World Bank. 1999, pp. 11,12.

Rapid economic growth coupled with a modest increase in inequality contributed to these impressive achievements in poverty reduction. As growth and inequality lie at the heart of the pro-poor growth concept and strategy, inequality will be analysed at some length in this section, which considers the changes in distribution and poverty that accompanied the rise in per capita income. By definition, the change in income or expenditure measured poverty results from changes in the average level and changes in distribution. An improved (worsening) distribution raises (lowers) the poverty reducing effect of growth.

During the 1990s, Viet Nam sustained an annual growth rate of 7.2 percent with the average slightly higher for 1993-1998. As a result, per capita expenditure of Vietnamese households increased, by forty-three percent on average, while income inequality as measured by the Gini Coefficient rose modestly, from .33 to .35.[39] Thus, it would appear that the poverty-reducing effect of a very large increase in per capita expenditure was only slightly moderated by a worsening distribution. While this general conclusion holds, it should be stressed that the Gini Coefficient is not the relevant statistic to reveal changes in the elasticity of poverty with respect to growth, which is determined by the distribution around the poverty line.

39 Using the 'bootstrap' technique, Do Thien Kinh et. al. found that the difference in Gini coefficients was not statistically significant, the "negligible increase' in Gini coefficients (GSO 2000b). However, row 6 and 7 of Table 3.1 show that the shares of two bottom quintiles (covering 92.5 percent of the 1998 poor) and three bottom quintiles (covering 95% of 1993 poor) all fell while that of the richest group increased substantially, by more than three percentage points.

Table 3.1 provides two measures of income growth of households. Row 4 measures the growth of mean income of each quintile, and row 5 estimates the mean of growth rates of households in each quintile.[40] While economists frequently use the former, the latter is a better measure of pro-poor growth (Ravallion and Chen 2001, p. 5). The two measures provide slightly different results. Row 4 indicates that the per capita expenditure of the bottom two quintiles grew slower than that of other quintiles. In contrast, row 5 shows that the growth rates were the highest in the bottom two quintiles, suggesting that the low income groups in the initial period benefited more from the high economic growth.[41] Ravallion and Chen's measure suffers from some caveats, however. First, while it is appropriate for the chronic poor and those poor whose incomes rise, it ignores the downward movements of non-poor households. The VLSS2 shows that 9.6 percent of households moved down two quintiles during the period 1993-1998 (Haughton et. al 2001b, p. 122), and a large proportion of these 'sinking stones' fell into poverty. Also, the two bottom quintiles in row 4 do not include so-called shooting stars,[42] that were poor in the initial period, but managed to rise two quintiles, and move out of poverty in the subsequent period (about eight percent of all households).

Table 3.1: Expenditure per Capita by Quintile, 1993 and 1998
(thousands of VN Dong, per capita, 1993 prices)

QUINTILE	LOW	LOW-MID	MID	MID-UPPER	UPPER	OVERALL
Expenditure per Capita, January 1998 Prices						
1993	854	1233	1582	2098	3911	1936
1998	1099	1632	2125	2929	6032	2764
Annual percent change in income	5.2	5.7	6.0	7.0	9.0	7.4
Annual percent change in income (panel data only)	5.3	5.7	6.1	6.9	8.5	7.2
Mean of Annual Growth Rate*	12.0	8.6	7.9	6.0	4.0	7.5
Share of Total Expenditure						
1993	8.8	12.7	16.3	21.7	40.4	100.0
1998	8.0	11.8	15.4	21.2	43.7	100.0

Source: GSO 2000b and *our own estimates based on VLSS1 and VLSS2.

40 Row 4 was calculated using data from VLSS1 and VLSS2 as two cross-sections while row 6 was based on the panel of 4,302 households only, which is quite representative for VLSS1, but to a lesser extent for VLSS2.

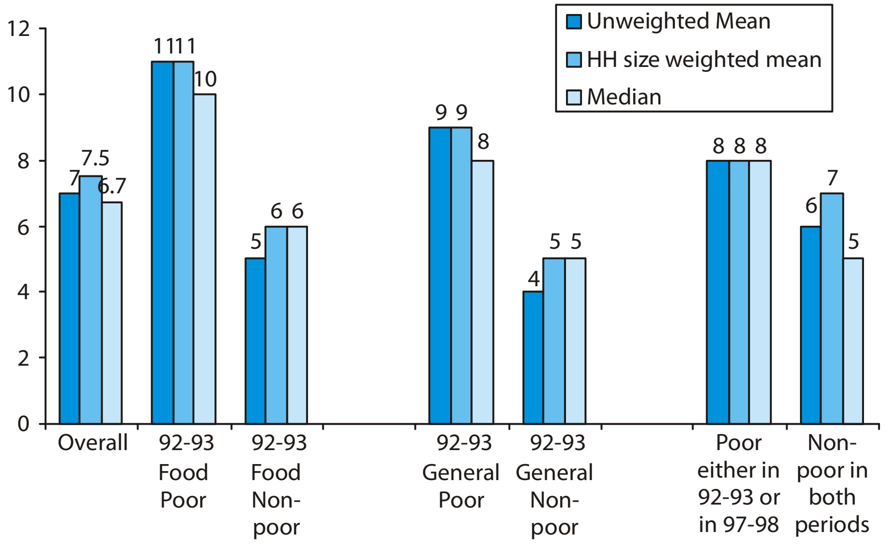
41 These two measures indicate the possibility of rapid poverty reduction for a modest rise in income inequality. Analysis of the data sets also found that the poor are disproportionately represented among those who experienced increase in per capita expenditure.

42 This is a rather unfortunate metaphor for households whose income increased. A 'shooting star' is, by definition, an object that falls into the Earth's atmosphere and is destroyed within minutes, either by burning or by impacting the ground. One hopes that the metaphor is inaccurate.

To avoid the exclusion of some households, the calculation can be reformulated to include those households that were non-poor in the initial period, but became poor in the terminal period.[43] The results of this calculation are found in Figure 3.2, which shows that whatever measure is used, the poor achieved a higher growth rate of per capita expenditure than the non-poor.[44] However, if those who lived under the poverty line in either period are included, the difference in growth rates between poor and non-poor is the smaller than if all non-poor in the initial period are excluded.[45]

As mentioned, row 4 of Table 3.1 indicates that the bottom three quintiles experienced slower rate of growth of average incomes than the rest of the population. This resulted in a decline in their share of total expenditure, thus widening income inequality. This is confirmed by marginal increase in Gini coefficients, be it based on food expenditure, non-food expenditure,[46] or total expenditure. However, inequality among the poor dropped quite substantially.

Figure 3.2: The Mean of Growth Rates: Poor vs. Non-Poor



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43 This approach is in line with that of Kakwani (1997), who provides a symmetric treatment to the initial and terminal periods.

44 The poor had lower expenditure base than non-poor and that the increase took place across the board. However, calculation based on the same data sets shows that the poorer tended to experience higher per capita expenditure increase (in absolute terms) than the richer, suggesting room for equal distribution growth.

45 Improvements in well-being of the poor were confirmed by four Participatory Poverty Assessments (PPAs) carried out in 1999 (See Turk 1999, pp. 23-26).

46 Non-food expenditure moves more closely in line with income and therefore the corresponding non-food expenditure based Gini may be used as a proxy for income-based Gini.

Table 3.2. Expenditure-based Gini Coefficients

	Food	Non-food	Overall	Among Poor
1992-1993	.26	.47	.34	.16
1997-1998	.26	.48	.35	.13

Source: Based on VLSS1 and VLSS2.

Though useful, Gini index is not directly decomposable in order to analyse sources of the change in inequality. The Theil index can be used to decompose changes in inequality into within and between groups. This analysis shows that ninety-six percent of the increase in inequality in Viet Nam during 1993-1998 period can be attributed to an increase in inequality *between* rural and urban areas, and only four percent was due to an increase in inequality *within* rural or urban areas (World Bank 1999a, p. 67). When the regional dimension is included, eighty-three percent of the increase in inequality can be attributed to the increase between regions, and the remaining seventeen percent to increased inequality within regions. The evidence therefore seems to suggest that it is the widening rural-urban gap and regional disparities in economic growth that are the major causes of the increase in inequality in Viet Nam (World Bank 1999a, p. 67).

The policy importance of these decompositions is not obvious. The inference that rising urban incomes are the culprit, and that restraining the growth of urban incomes is the solution to rising inequality is superficial and analytically naïve. At the beginning of its transition to a market economy, Viet Nam's population was about eighty percent rural. If there is an 'iron law' of the development process, it is that urbanisation accompanies rising incomes. This urbanisation is achieved by the emerging urban-based industries paying wages that will induce people to migrate. Thus, it would be quite astonishing if rapid economic growth were not accompanied by a rise in urban compared to rural incomes.

A second reason to be sceptical of the 'rural-urban gap' explanation of inequality is the essential difference between what is being measured for urban and rural households. Urban dwellers face a different set of prices and living costs than do rural households. The prices of food and housing are typically higher, especially in Ho Chi Minh and Ha Noi, and charges, formal and 'informal' for health and education may be higher. Perhaps even more important, urbanites incur costs not faced by rural households. Most important of these is transport to work, but there are other subsistence needs, produced within the household in rural areas, are monetised in cities. Taken together, these differences in price and costs imply that the difference in living standards between urban and rural areas is considerably less than the so-called urban-rural income gap (Jamal and Weeks 1993, Chap. 3).

More interesting than the rural-urban decomposition is the relative contribution of growth and distribution to poverty reduction in Viet Nam in the period 1993-1998. Using Ravallion's method, of the 20.8 percentage point fall in the headcount index (1993-

1998), growth accounted for 30.7 and distribution for minus 7.6 points, with the unexplained residual, the so-called interaction effect, minus 2.3 (World Bank 1999a, p.137). To check the robustness of this finding, one can do a similar decomposition exercise using the Kakwani formula (Kakwani 1997).[47] This calculation is more theoretically grounded, and avoids the problem of interpreting the interaction effect, since the change in the poverty incidence is completely explained by the growth and redistribution components. This exercise finds that contribution of growth and redistribution to be 32.5 and minus 11.7 respectively. Thus, more than a third of potential poverty reduction was cancelled by the increase in inequality; or, put another way, had growth been distribution-neutral, poverty would have fallen by two-thirds, rather than by two-fifths. Both decomposition exercises yield the conclusions that (i) the effect of growth on poverty during the period 1993-1998 is very strong, (ii) the redistribution effect counteracted rather than reinforcing the poverty reducing impact of growth.[48] The results show that increases in inequality, apparently small when measured by standard statistics (e.g., the Gini Coefficient) can have dramatic impact on poverty reduction.

For policy analysis, it is important to understand the reasons for poverty reduction and an increase in income inequality in Viet Nam. In doing this, we assess whether the pattern of growth and poverty reduction can continue into the first decade of the twenty-first century. Most studies agree on the explanations for poverty reduction in Viet Nam during 1993-1998. In 1993, a large proportion of the population found itself just below the poverty line, so the elasticity of poverty reduction with respect to growth was relatively high (Haughton *et. al.* 2001, p. 16). At the same time, this high elasticity implied that the poverty reduction was quite fragile; a mild contraction of the economy could push many households back into poverty (see Figure 3.3). Over ninety percent of poverty reduction occurred due to the rise in earnings across all sectors, and only ten percent was due to a shift from low-income sectors (e.g., agriculture) to high-income sectors (Bales et. al, 2001).

Household earned income depended primarily on income earned per unit of time, and only secondarily on the number of hours worked (for employees), or the number of working household members (Hoang Van Kinh et. al. 2001). The labour force participation rate rose slightly, from 85.7 in 1993 to 86.4 percent in 1998, and unemployment rate dropped from 3.4 to 1.6 percent (Loan et. al, 2001). Other favourable factors, notably improved agricultural terms of trade, also contributed to the fall in poverty. Indeed,

47 Kakwani's decomposition formula is as follows: $\theta_{ij}=G_{ij}+I_{ij}$, where θ_{ij} – change in poverty measure θ between two points in time i and j, and this measure is fully characterised by the poverty line z, the mean income m, and the Lorenz curve (which is a general measure of relative income inequality) $\theta=\theta(z,\mu,L(p))$; G_{ij}, I_{ij} – the growth and redistribution component of change in poverty respectively: $G_{ij} = 0.5*[\theta(z,\mu_j,L_i(p)) - \theta(z,\mu_i,L_i(p)) + \theta(z,\mu_j,L_j(p)) - \theta(z,\mu_i,L_i(p))]$; $I_{ij} = 0.5**[\theta(z,\mu_i,L_j(p)) - \theta(z,\mu_i,L_i(p)) + \theta(z,\mu_j,L_j(p)) - \theta(z,\mu_j,L_i(p))]$. The Kakwani's formula thus treats the initial and terminal dates i and j equally.

48 In this respect, Malaysia 1973-1989 may serve as an example which Viet Nam should follow, as redistribution component contributed to 3.9 percentage point decrease in total 19.1 percentage point drop in headcount index (Ahuja et. al. 1997).

between 1993 and 1998, the price of rice rose by 62 percent, while the price of non-food items increased by only twenty-three percent (Haughton *et. al.* 2001).

While these explanations are useful for understanding performance of Viet Nam in poverty reduction in the past, they provide limited guide to whether poverty reduction can be sustained in the future. In particular, it is not clear whether earnings, particularly income per hour, will continue to rise across the board. The deterioration of agricultural terms of trade resulting from by the recent drop of world prices of key agricultural commodities had a strong negative impact on earnings of rural households, including many rural poor. Therefore, we require a more analytical approach to the past pattern of poverty reduction, and for this purpose we use the analytical framework presented in Chapter 1.

That framework makes the distinction between regime change and regulatory change in transitional economies. The former is the shift from controlled economy, in which prices have no allocative function, to an economy governed by regulated markets.[49] This distinction implies two concepts of poverty, 'basic poverty' and 'market-generated'. Basic poverty results from the country's very low level of development, which would exist whatever the nature of the political and economic regime. In addition, centrally planned economies had their own particular form of regime-generated poverty, caused by inefficient resource use. Market economies also generate their own variety of poverty, due to unemployment and landlessness. Major regime changes, symbolised by price liberalisation in Viet Nam in the late 1980s and the early 1990s, the approval the legal framework for the private corporate sector, and the passing of radical Land Law in 1993 unleashed a process of market-creation. As to be expected, it took some time for these radical changes in the incentives system to affect the behaviour of agents. When behaviour changed, the result was an across-the-board increase in earnings and returns to productive factors, as noted in other studies.

As the once-and-for-all effects of regime change diminish over time, one would expect basic poverty to decline towards a steady-state level, determined by the level of per capita income at any moment, and the social mechanisms that determine the exclusion of households from the benefits of growth. Market phenomena such as unemployment, landlessness, and possibly widespread dropouts from post-primary education emerge and their negative impacts intensify. There is some concern that Viet Nam has already reached the level of inequality of China, which began the shift from a controlled to a market economy about seven to eight years sooner than Viet Nam.[50] For example, Haughton *et. al.* (2001, p. 30) comment that 'there is a risk that Vietnamese experience will mirror that of China, where economic reforms and rapid growth led to a rapid fall in poverty in the 1980s, followed by a period when poverty hardly fell any further'. There is

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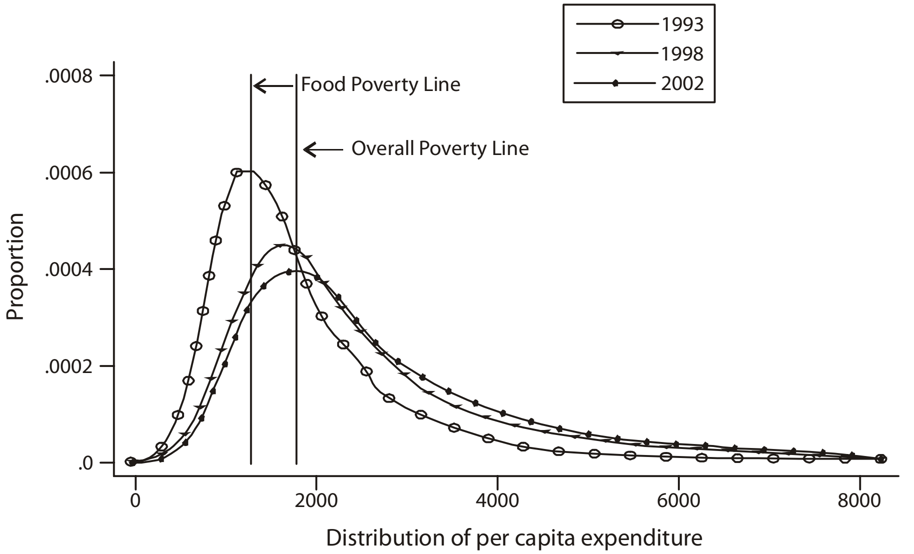
49 Again, we stress the obvious point that all markets are publicly regulated in some manner and to some degree.

50 According to Yao (1999), the Gini coefficient for income rose in China from .29 in 1981 to .39 in 1995.

Figure 3.3: Distribution of Real Per Capita Expenditure in 1993, 1998 and 2002



Source: World Bank 2003, p. 18

reason to expect that without appropriate policies and timely actions to arrest the growth of inequality, the increase in market-generated poverty will outweigh the growth-induced decline in basic poverty (see Figure 1.1 in Chapter 1), and, as a consequence, the achievements of regime change will disappear and be reversed.

Although the scale in Figure 1.1 in Chapter 1 is hypothetical, it provides a useful framework for understanding the poverty reduction process in the 1990s, and for projecting it into the first decade of the twenty-first century. Despite impressive achievements in poverty reduction, Viet Nam remains one of the poorest countries in the world, with a large population still classified as poor. The relatively easy phase of reducing basic poverty is over, and the task of avoiding the growth of market-generated poverty and poverty reversal is challenging. This calls for formulating and implementing a pro-poor growth strategy. In the first step, understanding characteristics of the current poor is crucial, as it sheds light on the policies required for making the economic growth more pro-poor. On the basis of a number of poverty-related studies, the Comprehensive Poverty Reduction and Growth Strategy paper (CPRGS) identified the following characteristics of the poor (CPRGS 2001, pp. 21-25).

First, almost eighty per cent of the poor worked in agriculture. After controlling for gender, age, education, ethnicity of household head, location (urban vs. rural), region, household size and the number of children, it was found that farm-based households had higher probability of being poor than non-farm, by eight percentage points, which is statistically significant (Do Thien Kinh et. al. 2001).

Second, the poor typically had low educational attainment. Statistics show that about ninety percent have lower secondary level or below (CPRGS 2001, p. 22). This is generally interpreted to mean that a low level of education of poor households reduces the return on their resource endowments, and prevents them from finding better jobs in high-paying sectors. On the basis of this assumption, one study, based on both VLSS1 and VLSS2 data, concluded that a rise in schooling of the household head by one year would reduce probability of being poor from twenty to eighteen percent, i.e. by two percentage points (Do Thien Kinh et. al. 2001). This finding in itself is of limited policy interest. The decline in the probability of being poor refers, of course, to the head count measure based on an absolute poverty line. The question for policy is whether the income increase implied would exceed the private cost of acquiring an additional year of schooling; whether a rational household would undertake the expenditure required for more schooling. Without an answer to that question, the finding is useless for policy.

A similar exercise by the same authors found that a rise of the number of illiterate workers in family by one person would raise the probability of being poor by ten percentage points in 1993 and five points in 1998, from a base of twenty percent. Again, the result provides little guide to policy. Since illiteracy is a basic characteristic of the poor, the result states the tautology that if a poor person is added to a household, the household has a higher probability of being poor.

These results confirm the well recognized vicious cycle of poverty: lack of education limits access to markets and information, which results in a lack of resources to send children to school at higher education levels. Figure 3.4 shows net enrolment rates by expenditure quintile, and suggests that in addition to loss of employment and land, many poor households sacrifice education of their children at the upper secondary level and above, in order that they work and generate income for the household.

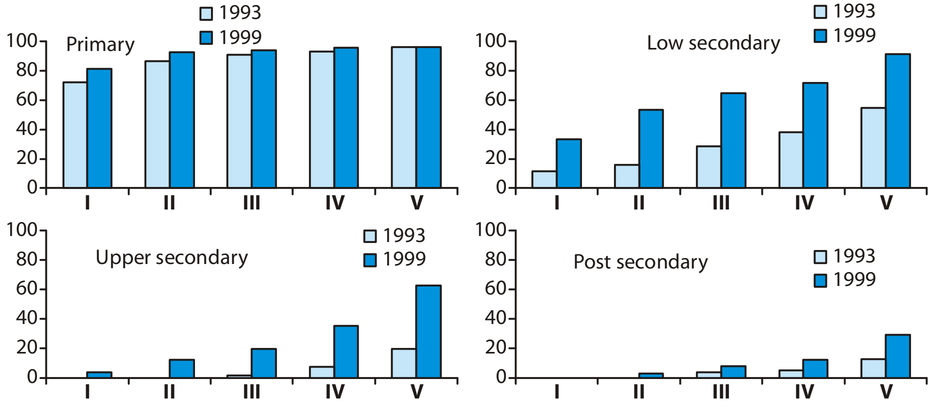
The approach in which lack of education is viewed as the cause of poverty must be questioned. First, causality may run the other way, or the two may be simultaneously generated by other, unspecified variables, such as ethnic discrimination. Second, there is the problem of fallacy of composition. It is not clear whether the hypothesis postulates that the poor are poor because they have an absolutely low level of education, or because they have relatively less than the non-poor. If it is the former, the direction of causality must be established and not assumed. If it is the latter, the fallacy of composition applies. Were the poor by some means able to raise their general level of education, one presumes that the non-poor would do so as well, in order to maintain their relative position. Since the latter have more means to achieve an increase in education than the former, the resulting poverty reduction would be small if not nil. Indeed, the results of Do Thien Kinh *et. al*., that a further year of education reduces the probability of being in poverty by a mere two percentage points, suggests that the fallacy may apply.

As a corollary of this point, it should be noted that the level of education of the poor in Viet Nam is considerably higher than for the poor in other countries with a similar level of per capita income. This fact suggests that across countries, more education does not appear to be the variable explaining the incidence of income-measured poverty. All residents of a country should have the right to education, regardless of income level, and illiteracy is a social scourge that any responsible government should banish. However, it does not follow from these basic rights that increasing levels of education and reducing poverty will diminish poverty. The result may be that the poor are better educated and more literate.

A third and more interesting finding reported in the CPRGS is that poor households typically have small landholdings or are landless, and this tends to perpetuate itself, especially the case in the Mekong River Delta. Lack of access to land helps explain that this region experienced the slowest rate of poverty reduction in spite of a rice export boom and favourable agricultural terms of trade throughout 1993-1998.

A CRP-ActionAid's study of a rice growing area in Angiang province found that the impact on poverty of changes in the rice price was asymmetric. Adverse price changes increased poverty incidence quite substantially, as many near-poor households fell into poverty. A price rise had a little impact on the poor, because they lacked resources to take advantage of them, most notably land. The same study found that poor households had limited access to sources of credit (CRP/ActionAid 2000). Although the access of the poor to credit improved in response to the 'Project on Providing Credit to the Poor', under the 'National Program on Poverty Reduction', a considerable number of the poor, remained without access to credit. There is clear evidence of credit rationing to the disadvantage of households with limited land and a low level of educational (Do Qui Toan *et. al*. 2001). It also appears that the majority of poor and very poor households in a rice growing area in the Mekong River Delta resorted to credit in informal markets, with high lending interest rates of five to thirty percent per month. In formal markets the typical rates were 1.2 to 1.5 percent (CRP/ActionAid 2000). The same study found that sixty-five percent of poor households interviewed put improved access to credit as their greatest need.

Figure 3.4. Net enrolment rates by quintile and education level, 1993 and 1998 (%)



Source: Nga Nguyet Nguyen 2002. p. 3.

Because of their low cash incomes, many households used loans for purposes other than for which they formally contracted them, often consumption expenditures. The study found that this undermined the creditworthiness of the poor. As a result, access to future loans was reduced, reinforcing household poverty. Limited access to land and credit was exacerbated by the lack of information, especially the information on laws, policies and markets, making it even harder for the poor to escape from their poverty.

Fourth, poor households tend to be large with a high dependency ratio. Households with many children and few labourers were disproportionately poor. The average household size in the poorest quintile in 1998 was 5.6 as opposed to 4.1 in the richest (Do Thien Kinh *et. al*. 2001). In 1998, the average number of children per mother in the poorest quintile was 3.5 compared to 2.1 in the richest. Large household size is associated with a high dependency level. The ratio for the poorest quintile was .95 compared to .37 for the richest (CPRGS 2001, p. 23). This, in turn, correlated with a higher level of poverty.[51] The poor were disproportionately likely to be from an ethnic minority, with the exception of Chinese-Vietnamese. Other minorities had a probability of being poor of between thirty-two and thirty-seven percent, as opposed to twenty percent for the Kinh majority and the Chinese minority.

Fifth, most of the poor lived in rural, isolated or disaster prone areas, where physical and social infrastructure is relatively undeveloped. Because their income level is very low and unstable, they had low savings capacity and were unlikely to cope with loss of harvest, job loss, natural disasters, loss of health, and other potential disasters. This is well documented in four Participatory Poverty Assessments carried out in 1999 by Action Aid Viet Nam, Oxfam GB, Save the Children Fund (UK) and the Viet Nam-Sweden Mountain Rural Development Program (Turk 1999, pp. 30-35).

A further comment is necessary on the evidence that most of the poor live in rural areas. The typical conclusion drawn from such evidence is that poverty reduction requires an emphasis on agricultural growth. For a number of reasons this is a superficial inference. If one found that most poor households derived their incomes from street trading, one would not automatically conclude that the policy response should be to build market stalls and provide training in accountancy. More effective might be to foster employment growth in other sectors, where incomes would be higher. Similarly, poverty in rural areas may be most effectively reduced by growth in non-agricultural employment, or by a policy that links manufacturing to agriculture. For example, rural poverty reduction in South Korea was largely achieved through the transfer of households and their labour to non-agricultural employment. To reinforcing this point, at the beginning of the transition to market regulation Viet Nam was overwhelmingly rural, with only twenty percent of households in urban areas. All international experience indicates that development,

51 Do Thien Kinh et. al. found that if the number of children in family rises by one person, probability of the household being poor would rise by seven percentage points in 1993 and by 12 percentage points in 1998, from 20% in the base case.

whatever strategy it follows, results in the relative, then absolute decline of the rural population and the share of the labour force in agriculture. Thus, while growth should be balanced between agriculture and non-agriculture, the expansion of the former should be accompanied by rising productivity, which historically has resulted in lower labour absorption.

3.3: Growth, Inequality and Poverty, 1998-2002

As the raw data of VHLSS02 officially released at the time of completion of this report, this section is based on statistic tables provided by GSO and reported in World Bank's *Viet Nam Development Report* on poverty (World Bank 2003), and on reports of regional poverty assessments conducted in the middle of 2003. For some of these findings, we must draw on additional sources.

Figure 3.5 shows that poverty continued to decline during 1998-2002 period Food poverty dropped by 4.1 percentage points for the whole period or 1.03 percentage points per year. These figures were 9.9 percentage points and 1.98 percentage points respectively for 1993-1998. General poverty dropped by 8.5 percentage points for the whole period or 2.13 percentage points per year, versus 20.7 and 4.14 percentage points respectively for 1993-1998 period. The slowdown in poverty reduction is still evident even if the higher base of poverty rate in 1993-1998 is taken into account.[52]

As for the previous period (1993-1998), poverty reduction occurred across all regions. As before, we list the regions in descending order of the fall in poverty, here for 1998-2002 (World Bank 2003, p. 10):

1. North Uplands, 20 (64 to 44%);

2. Mekong River Delta, 14 (37 to 23%)

3. South Central Coast, 10 (35 to 25%); and

4. Red River Delta, 7 (29 to 22%);

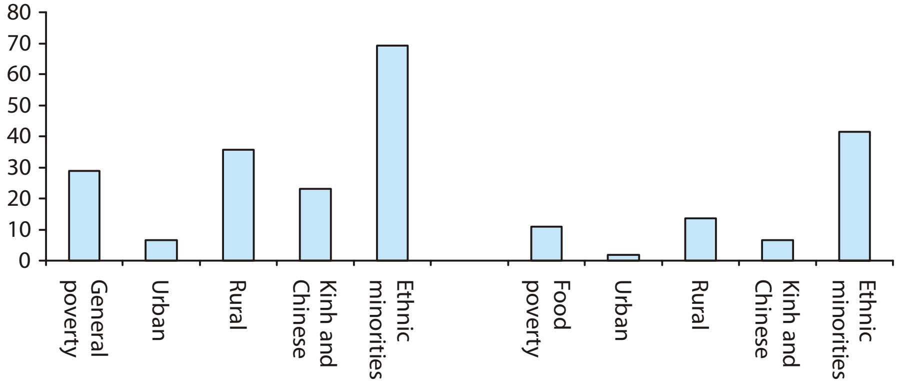
5. North Central Coast , 4 (48 to 44%);

6. South East, 1 (12 to 11%);

7. Central Highlands, 1 (53 to 52%);

[52] For example, ten percentage points drop from, say 40%, (i.e. 10/40=.25) would be larger than ten percentage points drop from 50% (10/50=.2). Even if differences in base year rates (58.1% in 1993 and 37.4% in 1998) and the duration of the periods (five years for 1993-1998 and four years for 1999-2002) are taken into account, the slowdown in poverty reduction is still obvious. This fact is also widely acknowledged in Viet Nam.

Figure 3.5. Poverty Incidence in 2002



The poverty decline for ethnic groups showed a pattern similar to 1993-1998, falling from 31 to 23 percent for the Kinh majority and those of Chinese ethnicity, and by much less for ethnic minorities, 75 to 69 percent (World Bank 2003, p. 9). As a result, the concentration in the four major regions declined, but still accounted for seventy-six percent of Viet Nam's poverty: Northern Uplands (22 percent); and the North Central Coast (20 percent); Mekong Delta (17 percent) and Red River Delta (17 percent). Characteristics of the poor very much remain the same as in the period 1993-1998 (for details, see World Bank 2003, pp. 21-22), so does the distribution of real per capita expenditure (see Figure 3.3).

There are a number of explanations that can be offered for the reduced poverty reduction at the national and regional levels. At the national level the slowdown in poverty reduction is explained by a slower economic growth, with an annual average rates of 5.3 (see GSO 2000a, and World Bank 2002), as opposed to 7.2 percent for 1993-1998. Given the low base of the Vietnamese economy, economic growth continues to be the main driver of poverty reduction, and even under an assumption of constant elasticity of poverty reduction with regard to growth, which we will show to be unrealistic, it is obvious that poverty reduction is significantly slower than during 1993-1998.

Second, inequality rose steadily and at apparently faster rate with Gini coefficient of .37 in 2002, as opposed to .35 in 1998 and .34 in 1993. Other indicators also confirm the rise in inequality. For example, the ratio of consumption by the richest quintile over that of the poorest quintile increased from 4.97 in 1993 to 5.49 in 1998 and 6.03 in 2002 (World Bank 2003, p. 13). The rise in income and expenditure inequality is probably underestimated, as the richer quintiles tend to underreport their consumption to a greater degree than the poorer quintiles do, and the magnitude of this difference tends to grow over time, together with the rise in the average per capita income.

Third, although the gap in education levels as measured by a conventional indicator of net enrolment rates appears to be slowly decreasing, with the poor being increasingly covered by the formal educational system (World Bank 2003, p. 62), the quality of education varies enormously between the better-off and the poorer areas. This education quality gap also tends to grow over time with the increase in the average per capita income. This problem is recognised, and the education sector has suffered heavy public criticism. The educational gap adjusted for quality difference may to explain a part of income and expenditure disparities. Nga (2002), who used VLSS1 and VLSS2,[53] found that in the formal private sector, which has expanded rapidly and whose labour conditions are less regulated than in the formal sector, the annual return to education grew rapidly for upper secondary school and university education.[54] At the same time, the return to primary education dropped slightly, from 15.3 in 1993 to 14.4 percent in 1998, as did the return to lower secondary education, from an already low three percent in 1993 to 1.8 in 1998. These numbers, for all their methodological problems, support the view that the income gap between the rich and the poor widened.[55] (see also Psacharopoulos 1993, for a cross-country review of rates of return to education). The statistics on education imply that as Viet Nam continues to move towards more market-based economy, the return to education may grow further, increasing income disparities in society.

At the regional level, the numbers on rates of poverty and poverty reduction show significant geographical differences in terms of poverty reduction, thus indicating the need to look beyond averages. Ranking of regions in terms of poverty reduction changed substantially as compared to the 1993-1998 period. The regional poverty figures show that the North Uplands and the Mekong River Delta did far better than other regions during the 1999-2002 period.

The Mekong River region actually reversed its status from the worst performer and achieved the second highest drop (as measured in percentage points) in poverty. This is an outstanding performance, given the region's large population size. Regional poverty assessment for Mekong River Delta provides a number of reasons including (i) improved infrastructure; (ii) education; (iii) government policies; (iv) job expansion; (v) price stability and improved agricultural terms of trade; and (vi) more favourable climate with no major

53 This study actually did not take into account unobservable quality difference in education provided, so the resulting estimates should be biased. However, the direction of biases is unknown.

54 The calculated returns rose from near zero to slightly over four percent for the former, and from minus six to over twenty-three percent for the latter (Nga 2002). These numbers should be viewed skeptically given the methodology used. Derived from Table 20, p. 24 in Nga 2002, which in turn is derived from estimation of the well-known (extended) Mincerian earning equation for wage workers. Wages in private sector are widely perceived to be more market-based than in public sector. The return to a level of education is defined as incremental earnings at that level (as compared to the preceding level, after controlling for experience, gender, location as classified by region and by urban vs. rural, and time of entry into the labour market) divided by investment cost for that level, which in turn is equal to the sum of direct education cost and opportunity cost (forgone earnings).

55 See Psacharopoulos (1993), for a cross-country review of rates of return to education.

natural disasters since the 1997 Typhoon Linda and 2000 floods. (UNDP&AuSAID, p. 9). Although these reasons appear to be valid, they are not strong enough to explain why the region's ranking in terms of poverty reduction has improved considerably. For example, improved infrastructure is also seen in many parts of the country, in particular the Red River Delta region, so are other policies and factors that prevail throughout the country.[56] This may indicate a promising area for further research, which may bring about important policy implications.

The 2003 regional poverty assessment reconfirmed the seriousness of the landlessness problem in the Mekong River Delta, which is one of the main obstacles to poverty reduction in the region. Heavy reliance on agriculture makes the region extremely vulnerable to effects of natural disasters, pests and disease and market price fluctuations for both inputs and outputs. Borrowers investing in agricultural activities are at risk of falling into cycles of indebtedness and loss of land because of these vulnerabilities. This type of market-generated poverty is strongly felt in this region. It is explicitly noted that 'recently increased living standards resulting from stable prices and fewer natural disasters are not necessarily sustainable as it is not possible to control market prices or natural disasters in the future' (UNDP&AuSAID 2003, p. 17).

Within the North Mountainous Area, the North East by far outperformed the North West in terms of poverty reduction. The latter even experienced an increase in food poverty, from 22 percent in 1998 to as high as 46 percent in 2002. This is probably why GSO has recently decided to break down the North Uplands into these two sub-regions, which may lead to differentiated policy interventions. The disparities between the North East and the North West may be largely explained by differences in access to infrastructure and markets. A main reason for poverty reduction is better market supply (of agricultural inputs) and better marketing opportunities (demand for maize, beans, flax, and livestock in the lowlands and China; transport and improved marketing infrastructure) (DFID&UNDP 2003, p. viii), and growth in yields and increases in real prices of agricultural commodities are two main factors contributing to income growth in rural North Uplands (IFPRI 2003, p. 3-35). It is evident that people in the North East are better positioned than those in the North West to capture these production and market opportunities.

With regard to the Central Highlands, a disappointing rate of poverty reduction there is largely explained by the sharp reversal of favourable conditions prevalent in the past years. Unlike during 1993-1998, the terms of trade of key agricultural products deteriorated during 1999-2002, because of the weakness of world agricultural markets.[57] A recent

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56 The only factor which is specific for the Mekong River Delta is the last one, i.e. no big natural disasters such as 1997 Typhoon Linda and 2000 floods happened. However, for comparative analysis of poverty reduction, it should be shown that other regions experienced more natural disasters than the Mekong River region did during this period in order to come up with convincing explanation for the outstanding poverty reduction performance of the Mekong River Delta.

57 These include rice, coffee, sugar, black pepper, and cashew nuts.

Oxfam/MARD study of coffee growers in Daklak province in Central Highland found that many non-poor households, particularly so-called monoculture households (including ethnic minorities) suffered greatly from the collapse of coffee prices, falling into poverty and debt. This was also confirmed by the most recent regional poverty assessment for this region (ADB 2003, p. 17). Due to falling incomes, these households were forced to switch from rice to cassava for their food staple (ICARD/Oxfam GB. 2002, pp. 35-37). On the basis of a time series of prices of major agricultural commodities, Classens and Ducan concluded that households have a long memory of price shocks, so that a relatively long time is required for producers to recover. In other words, for monoculture households in Central Highland, these shocks are not transitory, and have caused severe difficulties. Therefore, a major contributor to poverty reduction during 1993-1998 in the Central Highlands, the agricultural terms of trade, was likely to be a negative impact during 1999-2002.

Regional disparities in growth rates tended to widen, while private sector resources did not flow into poor provinces. This is suggested by the disproportionately small number of registrations of new enterprises in these provinces.[58] Based on historical data, Beard and Agrawal made projections of poverty dynamics for the period 2001-2010 with alternative scenarios of regional development. They have found that equal development (all regions growing at the same rate) would result in much lower poverty rates than unequal growth across provinces.[59] Another striking finding in their study is that from 2006 onward, a more equal growth scenario (i.e., distribution-neutral) would produce faster poverty reduction than a scenario of higher growth.[60] As shown in Chapter I, equal distribution growth (or growth with redistribution) would result in even faster poverty reduction, given that a large proportion of the poor is located around the poverty line (Figure 3.3).

On the positive side, regional development has been recognised and recently put by the CPRGS at top priority among topics to be addressed in a World Bank-led training for East Asian PRSP teams. One of the major mechanisms to reduce regional disparities in poverty reduction is migration. Evidence shows that urban-rural gap continues to widen, leading to a larger and accelerated flow of migrants into big cities in recent years. However, as Box 3.2 shows, there still exist barriers to geographic mobility of labour and, therefore, to equalisation of wage rates and living standards across geographical regions in Viet Nam.

58 There is also anecdotic evidence of widening income disparities and inequality: prices of real estate in many cities have rocketed in recent years as opposed to very low inflation and depressed prices of agricultural products providing a clear indication of widening income gap between the richest and the poor.

59 More uneven regional pattern of growth than the past, with 5 per cent growth rate overall, but the South East and Red River Delta provinces grew at the same rate, and the Central Coast at half the rate of the South East and the Red River Delta, and the remaining regions grow at one fifth of the leading two. This could be interpreted as a 'growth pole' scenario, whereby the majority of future growth is concentrated in two or three key regions.

60 Based upon the Socio-Economic Development Strategy (SEDS) target of doubling real GDP by 2010 (requiring a real GDP growth rate of 7.5 per cent till 2005 and seven per cent till 2010);

Table 3.3 indicates that the textile and clothing sector, usually considered to be a low skill industry, may have minimum educational requirements that are not met by many people in poorer provinces. The last column of the table shows that eighty-six percent of total unskilled workers achieved lower secondary educational level or higher. Thirty-eight reached upper secondary school level, well above the attainment of poor households (Figure 3.4).[61] Although migrants are over-represented in the group of workers with lower secondary and particularly primary level, this does not eliminate the possibility that education serves as a barrier to job entry.

There is a substantial under-representation of migrant workers in state sector,[62] and to a lesser extent, in firms with foreign investment (Table 3.4). Domestic private firms absorbed a disproportionately large proportion of migrant workers; such firms *de facto* carried burden of job creation for people from the poorer provinces.[63] Additional research is needed to better understand the reasons behind this pattern.

Access to information on job opportunities may also be a factor that impedes the participation of people in poorer provinces in the growth process. Figure 3.6 shows that friends and relatives were the major source of information about job opportunities for people who had employment, and the difference between migrant and non-migrant workers is significant. The proportion of workers who 'found a job myself' is also high, by far exceeding other sources of information. These results may imply a job bias against provinces and regions that are under-represented in the existing workforce when new job opportunities arise. This may lead to the persistence of severe unemployment in certain areas that have weak links with the fast growing parts of the country.

Evidence shows that people were active in search of employment, evidenced by high proportion that found jobs by their own efforts. However, data indicate that migrants face greater difficulty than non-migrants. In addition, data reveals that job centres, state and non-state, have much work to do if they are to play an important role in the labour market, and if the government is to distribute job opportunities equitably among provinces and geographical regions.

We have so far analysed factors that impede people in gaining access to jobs in the major economic centres. Table 3.5 provides information on wage differentials between migrant and non-migrant workers. It shows a relatively large wage difference in favour of non-migrants. By controlling for education, experience, skills, location Huong found that in

61 Three regions North Uplands, Central Highlands and Mekong River Delta are those that have the lowest net enrolment rates at the lower and upper secondary education level (Nga 2002, p. 8).

62 CPRGS Consultation in Vinh Long province 2001, p. 2 (www.vdic.org.vn) has found that ***SOEs*** were seen by poor people as urban-based, requiring highly skilled labour, and accessible mainly to those with "friends on the inside". They therefore do not hope to get a job in SOEs.

63 The last two columns Table 3.4 imply that share of migrant workers in total workforce of private firms is 34.5%, which is quite similar to estimate of 29% for manufacturing made by Steer and Taussig 2002 (p.20).

both domestic private and foreign invested firms, there exist wage differentials between migrant and non-migrant workers, and between male and female workers.[64] The difference is substantial, with wages of migrant workers, estimated at eighty-seven and eighty-eight percent that of non-migrant workers in domestic private sector and foreign invested sector, respectively (Huong 2002).[65]

Box 3.2. Do the Poor Participate in the Export-Led Growth Process?

Do people in general and, particularly, the poor in poorer provinces, adequately participate in the export-led growth process through wage employment in labour-intensive export-oriented manufacturing industries? This question arises from recent evidence of widening regional disparities in growth rates and poverty reduction, particularly between the so-called growth poles and the remaining parts of the country. Migration is an important mechanism that allows a more balanced regional development, and thus is the main focus of this note.

In 2001 and 2002 the Institute of Economics supervised a survey of 150 textiles and garments firms located in the greater Ho Chi Minh City area, Dong Nai and Binh Duong in the South, and the greater Ha Noi area including the city itself, Hai Phong, Nam Dinh, Thai Binh and Phu Tho in the North, which are the eight provinces highest in terms of employment in the textile and garment industry. These provinces account for forty-six percent of revenue and fifty-four percent of jobs in the industry. The sampling frame was constructed from GSO/UNIDO Industrial Census 1998. Firms were selected randomly with the probability of being selected proportional to size, measured by the number of workers in the firm. The sample was also stratified by ownership (central SOE, local SOE, foreign invested firms, domestic private firms) and sector (textile vs. garment) to capture differences in incentives and performance between these types of firms. Two separate questionnaires (for management and workers) were simultaneously applied. A standard weighting technique was applied to make the sample representative of the population of firms located in the selected provinces.

One of the questions asked is where he or she lived three years previously. If the province where the worker had lived was different from the one where the factory was located, this worker was considered to be migrant. 1200 interviewed workers come from 42 provinces throughout Viet Nam. Migrants represented eleven percent of total surveyed workers. Of these, thirty-six percent come from the South, twenty-eight percent from the Centre, and thirty-six percent from the North. Data indicate no sign of south-to-north migration. These figures may suggest that rapid export-led economic growth in the South East of the country had spill-over effects through the whole country. However, the proportion of migrants in the total workforce seems small relative to that in the informal low-paid non-tradable sector. This may indicate that people from poorer provinces of Viet Nam benefit little in terms of employment from the export-led growth process.

(Adapted From Nguyen Thang 2002)

64 The difference is statistically significant at the one percent level and not sensitive to whether selection bias is corrected through the Heckman procedure or not.

65 State owned enterprises employ too few migrant workers to allow a similar estimation.

Table 3.3: Unskilled Workers by Educational Attainment (in percent)

	MIGRANT UNSKILLED WORKERS								
Education	Northern Upland	Red River Delta	North Central	Central Coast	Central Highlands	Southeast	Mekong Delta	Unskilled migrants	All unskilled workers
Primary	0.0	26.3	0.0	31.6	100.0	28.6	20.0	25.0	14.4
Lower Secondary	50.0	47.4	60.0	52.6	0.0	57.1	60.0	52.9	47.2
Upper Secondary	50.0	26.3	40.0	15.8	0.0	14.3	20.0	22.1	38.3
Total	100	100	100	100	100	100	100	100	100

Table 3.4: Ownership, Employment and Migrants (number of enterprises)

	FDI	Private	SOE	Total	Percentage
Central Coast	6	28		34	26.0
Central Highland	1			1	0.8
Mekong River Delta	3	25		28	21.4
North Central	6			6	4.6
Northern Uplands		1	1	2	1.5
Red River Delta	15	23	5	43	32.8
Southeast	15	2		17	13.0
Total	46	79	6	131	100.0
Share of migrants (%)	35	60	5	100	
Share of employment (%)	27.1	19.0	53.9	100.0	

In summary, evidence suggests that there exist impediments to mobility of labour and, thereby, to participation of people in periphery and poorer provinces in the export-led growth process. For those migrants who find work in this sector, there exists a wage gap that cannot be explained by market-based factors such as education, training, skills, experience, location etc.

Table 3.5: Hourly Wage Earnings: Migrant Workers vs.
Non-Migrant Workers (thousand VND per hour)[66]

Group	No. of Obs.	***Mean***
Non-Migrant Workers	1069	5.21
Migrant Workers	131	4.70
Combined	1200	5.17
Difference		0.51

3.4: Conclusion

Analysis of data from the VLSS shows that Viet Nam made impressive achievements in poverty reduction during 1993-1998. Poverty fell due to an across-the-board rise in per capita expenditure, the proxy of income in the surveys. Within the analytical framework in Chapter 1, the major reason for these achievements is the process typical to transitional economy in a booming period. These easy gains are unlikely to be sustained in the coming years. Indeed, there is a growing body of evidence indicating that poverty reduction has slowed down, and inequality is on the rise. Our analytical framework predicts these tendencies. The reduction in basic poverty appears to have weakened, outweighed by an increase in market-generated poverty. The causal mechanisms are the growing differentials among various income groups in access to employment and to land, capital and education. Our analysis of the data implies a pressing need for pro-poor policies that would achieve a more equal distribution of the benefits of growth.

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66 Wages are real wages, i.e. adjusted by regional deflator provided by GSO (World Bank, 1999).

Annex to Chapter 3: The Comprehensive Poverty Reduction and Growth Strategy (CPRGS)

1. National Planning Instruments

The purpose of this report is to contribute to the policy making process in Viet Nam. Central to this purpose is linking to the country documents that define the government's development strategy. This annex shows the relationship among the major policy documents. It then focuses on the national poverty reduction strategy paper (PRSP), and considers its approach to pro-poor growth.

The Vietnamese Interim Poverty Reduction Strategy Paper (I-PRSP) and Comprehensive Poverty Reduction Strategy Paper (the national name for the PRSP) built on the country's socio-economic development strategies, five-year plans and targeted poverty programmes. The CPRGS is derivative from the Ten Year Socio-Economic Development Strategy and the associated Five-Year Plan, since these were approved by both the Communist Party and the national legislature. The sectoral parts of the CPRGS derive from the sectoral ten-year strategies for 2001–10 (see Figure 3A.1), and documents from line ministries. The development of poverty strategies began well before the government decided to prepare an I-PRSP at the request of the Bretton-Wood institutions.

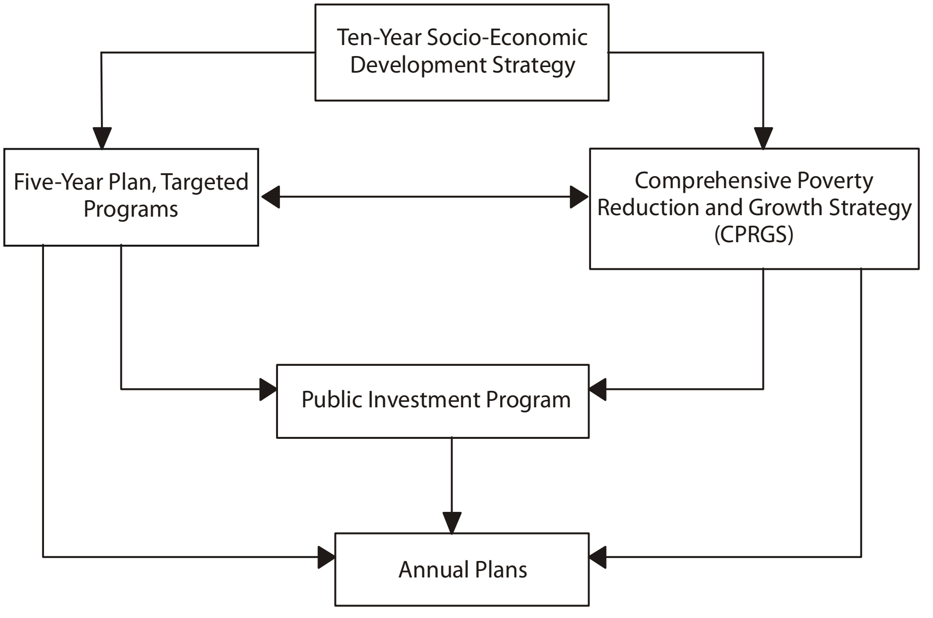
2. Pro-Poor Growth Policies and Poverty Analysis

One criticism of the CPRGS is that it represents a 'cut-and-paste' from other documents, and that while it was government owned, it was of no practical significance except as a document required for multilateral funding. The status of the CPRGS is further called into question by the fact that the development plans mentioned in the quotation above were endorsed by various party congresses, giving them the standing of national policy, while the CPRGS was not. It would appear, from a strictly legal point of view, that in cases in which the CPRGS and other documents conflict, the latter take precedence.

As a practical matter, the government is free to introduce shorter term programmes that include policies not found in the long term planning documents. Thus, the important question is whether the government is committed to the poverty reduction policies found in the CPRGS. Since with few exceptions, the policies in the CPRGS are taken from or adapted from other documents, the answer to this question would seem to be positive. Thus, this report concurs with the JSA conclusion that 'the government has a strong commitment, endorsed at the highest level of policymaking, to poverty reduction and social equity' (IMF & IDA 2002, p. 3).

Though the government is committed to poverty reduction, this is not manifest in the macro framework or discussion of structural changes ('reforms') found in the CPRGS. As the JSA assessment points out, 'the link between the proposed reforms and poverty reduction is not well-articulated' (IMF & IDA 2002, p. 6). As stressed in the UNCT comments on the CPRGS, integrating explicitly pro-poor growth measures into the macro framework,

Figure 3A.1: The CPRGS and other Planning Instruments



Source: Socialist Republic of Vietnam (2002a, p. 3)

'mainstreaming' poverty reduction, as it were, remains an uncompleted task.[67] UNDP's efforts to foster a more pro-poor growth strategy took many forms, and the argument in favour of this approach is well stated in the UNCT comments on the CPRGS (UNCT 2002, p. 3). UNDP and the UNCT were among the few international partners placing a strong emphasis on the need for policies to address the widening income inequalities in Viet Nam.

The poverty diagnosis in the CPRGS draws on the VLSS, the PPAs, and information collected by MOLISA. The emphasis is overwhelmingly on income poverty, with other dimensions playing a peripheral role. Even for income poverty there was some confusion, with MOLISA preferring its own measures to those using the VLSS-based international poverty line (from GSO). The MOLISA measure implies a much lower headcount measure of the poor (see Box 2). However, at the time the CPRGS was approved, the government announced its intention of using the GSO-VHLSS measure for monitoring.

67 'The UNCT strongly recommends that the CPRSGS show how the proposed economic growth strategies will address long term causes of poverty and inequality, and how the economic policies proposed under this strategy will be translated into actual poverty reduction' (UNCT 2002, p. 1).

3. Millennium Development Goals

With strong support from UNDP, the government incorporated the MDGs into the PRSP. As much or more than any other country, the government has made the MDGs nationally owned, in the form of the Vietnamese Development Goals (VDGs, UNDP 2001).

The MDG/VDGs should play an important role in the monitoring of poverty reduction, as decided in the Hai Phong workshop in October 2002. Issues discussed included a plan of the General Statistical Office (GSO) on to submit reporting guidelines to Prime Minister, and to consult with ministries and data users on objectives and contents of poverty surveys. This reporting would include progress in achieving MDG/VDGs, as well as sectoral targets in the CPRGS. The findings would be disseminated in annual reports for 2003 and 2004. As noted below, the integration of the MDGs into the PRSP process in Viet Nam, and the role of the UNDP in facilitating this, represent good practice that could be applied elsewhere.

While the MDG/VDGs are integrated into the CPRGS, 'a more in-depth and precise costing analysis at the sectoral level [should] be undertaken', and concrete technical steps are required to make them operational for monitoring (UNCT 2002, pp. 3, 9).

Chapter 4
Fiscal Policy for Pro-poor Growth

4.1. Overview of Fiscal Performance

In this chapter we review fiscal policy issues in Viet Nam from a macroeconomic perspective. Section one presents an overall macro-fiscal analysis. Until the late 1980s, three quarters of Viet Nam's government revenues consisted of transfers from State enterprises, a revenue structure typical of centrally planned systems. The transfers from state enterprises to the budget and *vice versa* were negotiated between government officials and individual enterprises (IMF 1998). During 1989-1991 a number of laws were enacted to replace the centrally planned system with a taxation mechanism consistent with a market economy, as part of the *Doi Moi* reforms. Revenues in 1992 were slightly higher than the average for 1988-1991, and the structure of the tax system changed dramatically. Budgetary transfers to State enterprises fell drastically, and tax and non-tax transfers rose slightly. This revenue performance is perhaps the most impressive evidence of the effective management by the government of the transition from central planning to market regulation, even more impressive than the rapid growth of the economy or export performance. It contrasts positively with the experience of transition countries in Eastern Europe and Central Asia, where state revenues tended to collapse in the early stage of regime change.

The specific purpose of our investigation of fiscal performance is to determine the potential for the public sector to foster pro-poor growth, through recurrent social expenditure and public investment. We begin our analysis with Table 4.1, which presents government fiscal operations for 1998-2002. Over these years, the government generated a substantial current fiscal surplus (current revenues less current expenditures). This surplus fluctuated between four and six per cent of GDP, generating impressive savings for public investment. However, there is cause for concern because oil revenues, vulnerable to price fluctuations, constituted a higher proportion of total revenues than in past years.

In 2000, current outlays rose, resulting from both wage and non-wage expenditures. The share of government *consumption* in GDP fell from 8.3 per cent in 1994 to 6.4 per cent in 2000 (IMF 2002b). Moreover, annual growth of private consumption outstripped that of government consumption after 1998. This implies that the orthodox negative warning that public consumption might 'crowd-out' private consumption was not manifested.

Unlike for some other countries in the region, notably Indonesia, interest payments as a proportion of GDP do not represent a pressing problem. Though these more than doubled during 1998-2002, they rose to only 1.2 percent of GDP (compared less than one per cent in 1998). This corresponds to a rise in foreign financing of government expenditure, from 0.6 percent of GDP in 1998 to 1.6 percent in 2002. This external finance went to capital expenditures, which rose steadily over the period, from 7.2 percent of GDP in 1998 to 10.2 percent in 2002. Indeed, a characteristic of public expenditure in Viet Nam since *Doi Moi* has been the absolute and relative growth of public investment.

The growth in public investment resulted in an increase in the overall fiscal deficit. This deficit rose from 1.6 percent of GDP in 1998 to 5.1 percent in 2000, and a projected 6.5 percent in 2002. In 2002 the projected fiscal deficit would have been even higher were one to include the financial burden imposed by the costs of restructuring of the publicly-owned banking system. These costs arise from the need to cover non-performing assets, and the policy decision to raise reserves to meet international guidelines. In 2002 these costs were projected to be as much as 2.2 percent of GDP, which would raise the fiscal deficit to 8.7 percent of GDP. Projections of Viet Nam's fiscal balances were critically affected by assumptions about these restructuring costs. The IMF viewed these costs as temporary, estimating that the overall deficit will rise during 2002-2004 and decline thereafter.

In this context, it should be noted that Viet Nam has increasingly relied on foreign loans and assistance to amortise its fiscal deficit, pointed out above. While financing for capital costs in 2002 were partially financed through domestic borrowing, 0.9 percent of GDP remains uncovered, and hence open to foreign borrowing. On the basis of our discussions with government officials, we conclude that the possibility of foreign commercial borrowing to cover this expenditure commitment was under active discussion. The government should consider this form of finance with great care, because it creates a vulnerability to external instability that has cause great difficulties for other countries in the region.

4.2. Public Sector Revenue Trends and Tax Incidence

Viet Nam enjoyed a strong revenue performance throughout the 1990s. During 1992-96, total revenue as a percentage of GDP rose sharply, to peak at twenty-four per cent. Government enterprises continued to deliver the bulk of fiscal revenues over these years. With the expansion of international trade, taxes on imports and exports contributed an increasing proportion of tax revenues, accounting for nearly a quarter of revenues in 1994. The subsequent fall in the revenue share was due to a decline in net transfers on state enterprises, with this partly balanced by increases in taxation from joint venture and private sector firms through consumption taxes and revenues from the non-agricultural sector. Much of the fall in non-tax revenue from state enterprises was due to deliberate and specific policy decisions, such as a reduction capital user fees and accelerated depreciation.

As pointed out above, the increase in the ratio of revenue to GDP in the early 1990s was a major achievement, especially for a transitional economy with a very low per capita income. Nevertheless, IMF reports during these years called for authorities to implement 'efficiency enhancing reforms' in the tax system: 'the next steps of tax reform thus need to increase the efficiency of the tax system by lowering rates and rate dispersion, broadening the tax base, enhancing consistency' (IMF 1998, p. 24). These so-called efficiency improvements were to be secured, apart from improvements in administration, by 'simplification' of the tax system, which would lower personal income tax rates and levies on international trade. The putative efficiency enhancing effects follow from neo-classical economic theory. High taxes on international trade and personal incomes, combined with multiple tax bands are 'distortionary' in that they alter the market based decisions of economic agents (Atkinson and Stiglitz 1987).

Some of these proposed changes in tax structure were accepted by the government, and legislated during 1994-1996. The National Assembly in 1997 endorsed a value added tax, to be implemented from 1999. Also enacted were excise duties levied equally on domestic and foreign goods. A new 'Enterprise Income Tax Law' was passed in 1997, which provided benefits to foreign firms, and a uniform corporate tax rate of thirty-two per cent. The corporate tax law provided for several exemptions and higher rates in certain sectors, notably oil and gas exploration.

Table 4.3 shows tax-to-GDP ratios for various revenue categories during 1995-2001. These figures have been reclassified from Table 4.1, and the two tables are not strictly comparable. We can identify some clear tendencies during the second half of the decade. Revenue-to-GDP ratios, and tax-to-GDP ratios fell, though the ratio of non-tax income to GDP remained steady. The most precipitous fall in was in taxes on international trade. The switch to VAT from the enterprise turnover tax in 1999 does not appear to have had a negative impact on revenue performance. On the other hand, the fall in revenues from taxes on international trade was not replaced by increases in tax revenues from domestic goods and services.

The fall in the tax GDP ratio after 1995 was in part due to international trade taxes, following the implementation of IMF recommendations for reduction of tariffs in 1996 and 1999. Even though foreign trade-to-GDP ratios rose during 1995-2000, the share of tariff revenues declined from 24.9 per cent of total revenue to seventeen per cent in 2000. The IMF (2002) attributes these declines to Viet Nam's accession to AFTA. An alternative explanation is that the commitment to introduce a revenue-neutral VAT, with a simultaneous policy action to lower the share of taxes from international trade, resulted in a decline in the tax revenue/GDP ratio. In any case, the implementation of IMF tax prescriptions was compatible with the observed drop in the revenue-to-GDP ratio.

While donors and lenders have supported improving tax administration in Viet Nam, there has been less donor interest in tax incidence analysis. The only study on tax incidence by income category was for agricultural areas (Bao, Houghton and Quan, 1991). The study showed that agricultural taxation was quite low, accounting for only four percent of total household expenditure in the Mekong delta, the North, and North Central regions, and less than three per cent elsewhere. As one moves from the poorest to the richest quintiles, tax burdens rise, then fall (Table 4.4).

The authors of this report find this outcome puzzling, though is consistent with a simple hypothesis: most agricultural taxes derive from the sale of farm products. If the poorest households lack sufficient land to support themselves, only part of their incomes will come from the sale of the produce of their farms. Additional income will be derived from wage labour on other farms and various non-agricultural activities. Households in the middle-income range will tend to have sufficient land to support themselves, and be less likely to seek other sources of income. And wealthy households would have the income and assets to diversify into non-agricultural opportunities. As a result, the share of household expenditure taken as agricultural taxation would tend to have the pattern shown in Table 4.4. If this hypothesis is correct, no conclusion can be reached about the progressivity of agricultural taxes.

Several documents (PER 2000, for example) assert that the incidence of local taxes and fees is quite regressive, because of the imposition of a bewildering array of *ad hoc* charges on local populations. While it is a value judgement as to whether these charges are arbitrary, there is evidence on their magnitude for the poor. Table 4.5 shows that taxes represented over forty per cent of the revenues collected from agricultural households. The irrigation fee, the largest in terms of incidence, appears progressive with respect to the bottom quintile, but regressive for all other quintiles. The land protection fee is regressive. The electrification fund levee is heavily progressive, and most of others regressive. In the aggregate contributions are regressive principally because of the *corvee* labour fund. On balance the incidence of fees and contributions appears regressive. There is potential for pro-poor policy reform through changing the fee structure for the irrigation fund and land protection charge, *corvee* labour, contribution to school funds, the road construction fund, and the electrification fund. However, such changes are likely to have a marginal impact on the tax burden of the poor.

The incidence taxes on domestically consumed goods and services, appears proportional with respect to income. In the case of gasoline tax, the incidence is highly progressive, since the consumption of gasoline by those who can afford private transport is much higher than those who cannot. However, this data must be treated with caution since it predates the imposition of VAT. The assumption is that the entire burden of the VAT is passed on to the consumer may be faulty for several reasons. If it is assumed that the entire burden of gasoline taxation on public transportation is borne by the consumer of public transport, without accounting for any absorption by the supplier of transportation, then this would overestimate the tax burden on consumers. This result would be quite contrary to that found in the case of private gasoline excise incidence in the previous table. One can conclude that the evidence in Table 4.5 somewhat overstates the burden of indirect taxation on the poor.

Given this conclusion, it is still the case that the indirect tax burden in Viet Nam seems strikingly proportional, extracting four per cent tax from rich and poor alike. On the other hand, it is clear that there is scope to widen the tax base on the richer quintiles. The incidence of indirect taxation when measured in terms of the taxable base is considerably lower on the highest incomes than that for poorer quintiles. The overall incidence of taxation is presented in Table 4.8. From this table it would appear that taxation is Viet Nam is broadly progressive, except in the case of the second poorest quintile with respect to agricultural taxation.

4.3. Public Expenditure Trends

To analyse the impact of public expenditure on the Viet Nam economy, one must inspect its fiscal impact. One can examine the impact of fiscal spending in terms of economic purpose, consumption, investment, and transfers. For this one needs an economic classification of government expenditure. Alternatively, one can approach the impact of fiscal spending by function; i.e. expenditure on general government services, social services and economic services. For this one needs a functional classification of government expenditure, ideally, divided, if possible, into recurrent and capital expenditure.

Until the 1990s, Viet Nam's fiscal budget was secret. Thus, it is only possible to calculate a fiscal impact analysis of public expenditures from 1995 onwards. Further, the lack of a reliable time series means that analytical and policy conclusions must be drawn using a number of non-comparable statistics on functional expenditure. The IMF provides economic classification data from 1995 (IMF, 2002-b), on the economic impact of public spending for Viet Nam. As discussed above, there were two discernable tendencies of importance, the rising burden of interest payments and the increasing commitment of resources to structural changes in state enterprise. The other main issue that emerges from the economic classification of expenditure in Viet Nam are non-wage operating expenditure allocations ('operations and maintenance', O&M expenditure).

The Public Expenditure Review of 2000 contented that 'in Viet Nam the O&M [expenditure] has not been adequately funded in some sectors'. This was particularly true for the infrastructure, agriculture and industry sector, though O&M funding appears adequate for education and health. Making available more resources for non-wage recurrent expenditure is constrained by a government policy under which the rate of growth of recurrent expenditures may not exceed the rate of growth of investment expenditure. Given this policy rule, it is likely that fiscal trends would squeeze non-wage recurrent expenditure. Rising interest payments and social safety net expenditures would further increase the ratio of recurrent to capital expenditure. Any real increases in public sector wages, would, irrespective of improvements in the revenue-to-GDP ratio, require compensating decreases in non-wage recurrent expenditure growth.

One possible solution to the above problem would be to reclassify some major non-wage recurrent expenditures as capital expenditures. In Viet Nam, general repairs are commonly classified as recurrent expenditure, rather than as capital. On the other hand specific sectoral recurrent expenditures, such as expenditure on road repairs, are treated as capital expenditure. Hence, it is difficult to assess the extent to which such a reclassification would enhance the scope for increasing expenditure on operations and maintenance.

A result of the above policy is that public investment growth in Viet Nam has been rapid, rising from 5.5 per cent of GDP in 1995 to 10.2 in 2000. However, a major portion of such expenditure in recent years covers the cost of state enterprise restructuring. In the absence of data on the nature and magnitude of gross public investment, it is difficult to comment in detail on the pro-poor nature of public investment in Viet Nam, though some conclusions based on the above trends are discussed in the concluding section.

Turning to the functional classification of Viet Nam public expenditures, we use several data sources. The most detailed information is from two estimates, from the PER (2000) for 1997 and 1998. We also have current expenditure data from the Ministry of Finance for the period 1999-2001 and budgetary forecasts for 2002. Finally, we can use the IMF categorisation of current expenditure in the functional classification from 1995. It is probable that these three sets of data are not statistically comparable. Hence the trends identified below, and the policy issues discussed in the concluding section must be considered tentative.

Table 4.9 reproduces some of the data on public expenditure presented in PER (2000). Based on this table, above we conclude that the government allocated considerable investment to economic sectors and to education. However, there are extremely low O&M allocations to the major economic services. Given the large proportion of poor people deriving their incomes from the agricultural sector, and the importance of health and education, this structure of allocation can be said to be progressive, though the effectiveness of the expenditures and their sustainability is in doubt given low O&M allocations.

Over twenty-five per cent of the total expenditures fall into the 'other' category, making judgments difficult about the distributive impact of government spending. No detail is available for expenditure on social subsidies, for example. However, to the extent that subsidies represent cash transfers to poorer provinces, their impact is pro-poor. They constitute an effective form of revenue equalization which permits poorer provinces to undertake expenditures on poverty alleviation that otherwise would not be done. Given that provinces are overwhelmingly responsible for expenditure on social services this is *ceteris paribus* progressive.

The PER also provides a division of expenditure on 'social subsidies for 1997' (Per, 2000; page 78). These expenditures constitute important sources of social protection for the poor. In addition, the Viet Nam social insurance and health insurance schemes work as off-budget funds similar to those in operation in developed welfare states, though their operation tends to be limited to the formal wage economy. The PER data suggests that all safety net programmes are focused on poverty alleviation. A review of the literature in the PER and elsewhere on these funds indicates that while there are important issues to be addressed with respect to how these funds are classified, managed and used, there appears to be no intention to reduce or replace these funds as a fiscal vehicle for allocating resources to poverty alleviation. On the contrary, there are powerful arguments for widening the scope of these funds to cover more poor people and to operate within the informal and rural economies.

The IMF data enables one to inspect expenditure allocations more completely than the PER estimates (Table 4.10). Allocations for the 1995-2001 period were relatively stable. It is clear that in Viet Nam the bulk of current expenditure allocations are for social services and security expenditures. The data confirms the importance accorded to education and social security. It also reveals that security expenditures constitute a sizeable, though constant, portion of current expenditure.

Government data provide the most recent estimates for current expenditure allocations (see Table 4.11). To assess the relative importance of different expenditure allocations, all allocations are presented in terms of the share in total expenditure. The data confirms the trends discussed above, and reveals that allocations for social services rose in 2001 and 2002. On the other hand, allocations for administration expenditures fell. As with all government data, a substantial proportion of total expenditures is not allocated to a specific expenditure head. One can deduce that these non-allocated expenditures are for the military and other security spending.

4.4. Public Sector Investment

The World Bank argues that Viet Nam needs to streamline and set priorities for its public investments, in order to secure the returns in forthcoming years that it did in the past (World Bank 2002, VDR). This recommendation derives from the observation that previous projects involved rehabilitation and reconstruction, while most current and future projects initiate new activities. The report summarises the fiscal challenge as follows:

With a worsening external environment and limited potential for revenue growth, achieving targets for growth and poverty reduction will require considerable emphasis on directing public investments to priority areas with the highest social and economic returns. It will also require greater attention to adequate financing of operation and maintenance costs that will be required to translate these new investments into a sustainable flow of goods and services in the priority areas" (WB 2002, page 71, VDR).

VDR (2002) concludes that Viet Nam's sectoral spending is broadly similar to the average for other developing countries (see p. 73) It argues for better integration of recurrent and capital spending; i.e. for instituting a regular calculation of recurrent costs of capital expenditure into the budgetary and capital investment planning process.

In view of the above, it is important to examine capital expenditure in some detail. As explained above, the data by economic classification that would normally be used for this purpose is limited. In the absence of this, one can use the 2001-2005 Public Investment Programme (PIP 2002). The PIP for 2002 provides additional information to assess the validity of the points made in the Viet Nam Development Report 2002, and to further inspect present and future public investment trends.[68] While PIPs can be 'shopping lists' if their link with the budget is tenuous, in Viet Nam the Ministry of Planning and Investment has responsibility for PIP formulation as well as for capital investment allocation. This institutional arrangement, combined with the high priority assigned to public investment by government, makes the PIP document more credible than in many other countries.

During 1995-2000 the overwhelming focus of public sector investment in Viet Nam was on industry and construction, followed by transport, communications, agriculture, and science and technology. Allocations to social services were extremely low (PIP 2002, page 11). The document identifies the lack of mobilisation of private sector resources for investment as the major drawback during the 1996-2000 period (PIP 2002, page 16). Poor investment management, inadequate planning, and low effectiveness of capital use were also identified as major bottlenecks (PIP 2002, pp. 16-17). The PIP for 2001-2005 requires increasing the share of domestic resources, almost doubling private investment, to raise the investment/GDP ratio in Viet Nam (PIP 2002. p. 19). The programme is explicitly linked to the poverty reduction growth strategy, CPRGS, and repeats the target of reducing the number of poor households to ten per cent by 2005.

Table 4.12 (from PIP, pp. 24-25) provides a detailed division of capital expenditure requirements for 2001-2005 by functional classification, and identifies sources of financing for each sector's programme. Since such financing includes recurrent requirements, we also have implicit sectoral estimates for O&M expenditure. These figures must be seen as incomplete with respect to recurrent costs, especially since wage and non-O&M non-wage recurrent expenditures would be excluded. Even so, it is clear that the emphasis on economic services in the 1996-2000 PIP continues in the subsequent one, if one takes the public sector as a whole. However, the *budgetary* allocations for social services in PIP 2001-2005 (items 4-7) are greater than the allocations to these sectors given in the PIP.[69] The implied government strategy is to devote budgetary resources to social services, while increasing investment in state enterprises, and investment credit for economic services. Given that significant complementary foreign concessional resources can be mobilised for social sector investment, provided the government demonstrates its budgetary commitment to social sector spending, this seems a rational strategy.

68 This document provides an assessment of the allocation of capital expenditures in the previous PIP (1996-2001) and a plan for capital investments for the 2001-2005 period.

69 The only economic service that receives large budget allocations are transport and communication, because the railways and posts in Viet Nam are run as government departments. Hence, their operations are entirely on-budget.

The PIP explicitly allocates resources to poverty reduction (Table 4.13), and the funding for anti-poverty programmes come from the budget. The likelihood of obtaining funding from donors is high, since these areas represent high priority for most aid agencies. The financing strategy is sophisticated, with the budget providing approximately a third of the funding, and anticipated foreign assistance making up the rest. The government's financial commitment for large scale anti-poverty programmes is impressive by global standards. The typical counterpart funds donors expect from governments are around 20-25 percent.

The PIP incorporates some calculation of O&M in its investment planning process. It also appears to be grounded in an investment strategy that is more developed than that advocated in the VDR, which separates budgetary and state enterprise allocations. The PIP takes a more integrated view of resource requirements in each sector. It also presents a relatively transparent financing plan for capital investment, distinguishing between budget resources, non-budget public resources, and resources to be generated from outside the public sector.[70] There are substantial allocations for sectors with high returns in terms of social welfare and poverty alleviation. At the same time, the integrated approach to public sector resource planning ensures that that key economic services and infrastructure will be funded on a sustainable basis. National poverty alleviation programmes secure funding with from donors, if properly assessed and monitored to ensure there are not losses through mismanagement and leakages into other expenditure lines.

Though the PIP is impressive, one can note certain gaps associated with it. In particular, it includes a number of large infrastructure projects (so-called mega projects) that have two problems: 1) the government has yet to carry out systematic studies of the impact on poverty of these projects, which given the size of the projects, makes these studies essential to the country's poverty reduction strategy; and 2) coordination of the projects, especially among those providing similar services, is not clear. The latter problem will take on increased importance as the process of decentralisation advances. There seems to be no formal mechanism by which the plans of the various provinces will be harmonised and rationalised.

4.5. Macro-fiscal Policy

From a macroeconomic perspective, Viet Nam has maintained a stable fiscal path. No major events are anticipated that might drastically affect this stability. The healthy current surplus gives the government the flexibility to manage fiscal shocks. Given the healthy fiscal surplus, fluctuations in oil prices are unlikely to have an adverse stabilisation impact.

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70 The PIP (2002) and VDR(2002) both devote considerable attention to regional spending allocations which are not treated in this chapter.

Rising government current expenditure does not appear to have crowding-out affects, for private consumption grew faster than public consumption in the 1990s. Further, the surplus of current revenues over expenditures implies that investment is not being crowded-out, except in the definitional sense that a dollar of increased consumption could *ceteris paribus* have been used for investment. Since at least some of the rise in government consumption went to increased O&M expenditure, the quality of public investment should be enhanced.

The rise in interest payments should not be worrying in the aggregate. However, the long-term implications of this increase require analysis. The 2002 fiscal deficit and projections for the future are higher than it would otherwise have been due to the cost of restructuring state enterprises and the banking system. There is no evidence that this reduced allocations for poverty alleviation; nor is there direct evidence that the fiscal deficit has negative implications for income distribution. However, if the restructuring costs grow, and if the restructuring fails to achieve its aims, then there could be major implications for funding poverty reduction.

Perhaps the most serious danger in the restructuring process is the possibility that the re-capitalisation of state banks might slip out of control, as occurred in Indonesia. This possibility becomes a substantial probability if the government sets no *ex ante* limit to the level of re-capitalisation, and seeks to achieve the so-called international norms for reserves. The combination of a 'blank-check' recapitalisation process and commitment to 'international norms' can lead to impending disaster if the economy enters a downturn and non-performing loans increase, requiring unanticipated recapitalisation. If this happens the Bretton Woods institutions may pressure the government to cut public spending, with potentially adverse effects on reducing poverty and inequality, as has occurred in Indonesia.

Two further policy issues emerge from the discussion above. Viet Nams' macro-fiscal scenario is stable and is likely to be so in the medium term. Hence, arguments for enhanced delivery of pro-poor public services and for equity enhancing public expenditures should not be inhibited by constrained by fears of their adverse effects on macroeconomic stability. Specifically, ongoing and future pro-poor fiscal initiatives should not be sacrificed to perceived or actual lack of success resulting from the restructuring state enterprises and state banks. Any rise in the fiscal deficit due to the costs of restructuring is programmed to be *temporary*. Further, the welfare of the poor should take at least equal priority to the welfare of state enterprises and the banking system.

4.6. A Universal Pension

As shown above, the Vietnamese government enjoys a fiscal position that allows it scope to expand existing poverty reduction programmes and to initiate new pro-poor programmes. In this section we suggest that the government consider moving beyond target programmes to 'universal' ones for which there would be no income qualification.

Current poverty reduction programmes, such as the support to disadvantaged regions, incorporate the principle of universalism, rather than targeting a sub-set of households. There are several which the government might consider, and here we propose a **universal old-age pension**.

There are several advantages of universal programmes as complements to targeted ones. First, and perhaps most important, they are *inclusionary* rather than *exclusionary*; that is, they do not require the state to divide the population between beneficiaries and non-beneficiaries. As a result, benefiting from the programme does not place the stigma of 'poverty' upon the recipient. Avoiding this stigma implies that the programme does not represent 'charity' for the 'needy'; rather, it is an entitlement derivative from the obligation of society to promote the welfare and dignity of its citizens.[71] This, what might be called the 'social democratic principle' is particularly important in circumstances in which programmes based on exclusion might intensify ethnic, regional, and political tensions.

Second, *if they are feasible to implement*, universal programmes carry much lower administrative requirements and costs, and involve much less state intrusion into the private life of citizens than exclusionary programmes. The administrative demands of targeted programmes can be high if a goal is eliminate 'leakages' to the non-poor. They require a bureaucracy assigned the task of differentiating the poor from the non-poor. This differentiation is difficult in developed countries, and associated with 'means testing' methods that are personally intrusive and frequently demeaning. In Viet Nam, where the vast majority of the labour force workers in small-scale urban and rural activities, direct income measures of poverty are almost impossible to make on a basis that is consistent across the country. While the targeted programmes presently implemented by the government reach some of the poor, there is considerable scope for arbitrariness and nepotism at the local level. Therefore, if a universal programme can be designed to be within fiscal constrains, it dramatically reduces the scope from official rent-seeking, excessive bureaucracy, and state intrusion into private life.

Third, and specific to the Vietnamese context, a universal programme funded at the central government level would avoid the variation in support levels by districts that characterise the present targeted programmes. Under present arrangements, local budgets and the number of households that require assistance determine the level of support to the poor. As a consequence, support levels vary dramatically across districts.

Finally, there is the well-known 'borderline' problem that arises from the relatively continuous nature of income distributions. Societies are not, in practice divided between two clearly demarcated categories, 'the poor' and the 'non-poor'. The categories are essentially conceptual or analytical shorthand, in that they aid the analysis of a complex

[71] The word 'citizen' is used for want of a better one. Citizenship in the legal sense need not be a requirement for a universal programme; indeed, in many countries it is not.

real world problem. Measurement, using any exclusionary criteria such as an income line, imparts a precision to the concepts which does not exist in reality. This spurious precision results because the criteria of measurement, if they are cardinal,[72] exclude important aspects poverty. For example, a household with an income per member below the poverty line may have more able bodied workers than one with a higher income per member, and, as a consequence, may be better able to protect itself from illness and accident. In addition, there is the 'pure' borderline problem: delivering a benefit to those below an arbitrary income line will make some households close to the line better off than the 'non-poor' just above the line. These problems do not invalidate the basic concepts of the poor and the non-poor; rather, they indicate the practical complexity and arbitrary nature of targeting.

The specific advantages of an old age pension are several. In most low-income countries it would not be possible to administer a pension. In Viet Nam the administrative system reaches down to the commune level for the vast majority of the population, where records are adequate to verify ages. Distribution of the pension could be implemented through existing institutions, with low administrative costs. Further, a universal pension could be gender-neutral, by being distributed to all that qualify, rather than through heads of households. In addition, since saving by the elderly is typically low, the expenditure effect of the pension would be close to one hundred percent, with multiplier effects in communities. Finally, and most obviously, a pension for the elderly would go far to eliminate one of the most pernicious and tragic forms of poverty: destitution among those who have exhausted their working years. So-called 'linkages' to the non-poor, if they be judged as a drawback, would be outweighed by the social and economic benefits.

Given these advantages, it remains to inspect whether a pension would be within the fiscal constraint that was set at a non-trivial level. Table 4.14 provides an estimate of the fiscal cost. Using prices of 1993, the table estimates the cost of a pension for 1998.[73] The basic calculation assumes that the pension could be distributed though existing institutions, with no net administrative costs. The qualifying age for the pension is set at sixty-five for both men and women. To avoid bureaucracy, the pension would be paid with no requirement that recipients demonstrate they have 'retired'.[74] The upper part of the table provides the basic statistics for the calculation.

The level of the pension derives from two ratios: the ratio of the poverty line to average per capita consumption, and the ratio of the proposed pension to the 1998 VLSS poverty line. The former is a parameter for 1998, and the latter a policy choice. In the case of a

72 'Cardinal' measurements have the characteristic that the numbers are proportional to each other; that is, two is twice as large as one, four twice as large as two, etc. 'Ordinal' measures, which result from the combining of criteria of different types (such as the Human Development Index), only order or rank a population.

73 These years are chosen because they are those of two living standards surveys.

74 Since most Vietnamese work to some degree as self-employed, this term is not applicable.

pension set to equal the poverty line, the budgetary cost in 1998 would have been 2.2 percent of GDP, implying an increase in total social expenditure of about one-third, a fifteen percent increase on all current expenditure, and a ten percent increase in the total government budget. It is obvious that lower values for the ratio of the pension to the poverty line imply lower expenditure.

Equally obvious is that as the economy grows, the pension cost declines. If the poverty line remains at the dong equivalent of the international standard used in the VLSS, any per capita growth reduces the pension cost if the share of the population sixty-five and over does not increase. For example, if between 1998 and 2003, per capita income grew at about four percent, if consumption per capita grew at the same rate, it follows that the ratio of the poverty line to average consumption fell from .64 to .52, and the total cost of a pension equal to the poverty line would fall below two percent of GDP. By any realistic estimate of administrative costs, a poverty line pension would be well within the government's fiscal constraint. The aging of the population would obvious increase the cost, but this is unlikely to result in a major fiscal outlay for two decades. In the meantime, the economy would have expanded, increasing public revenue more than enough to cover the relative increase in claimants.

Indeed, so modest is the pension cost, that bolder programmes could be costed, such as universal child support payments. This report strongly recommends that the Vietnamese government, consistent with its official commitment to socialist principles of equity, and in the context of the society's veneration of the elderly, consider introducing a pension for the elderly.

The proposal that the government introduce universal programmes does not represent a criticism of existing targeted programmes, which have been a notable success. Especially important are those investment projects targeted to disadvantaged areas, where poverty is particularly severe. The proposal for universal programmes has the same purpose as the regionally targeted ones: to reduce the growth of inequality, regional in the one case, inter-household in the other.

4.7: Policy Recommendations Summarised

On the basis of the foregoing analysis of the fiscal situation at present and its likely evolution in the foreseeable future, we make the following policy recommendations.

1. The government should change the rule that restricts the rate of growth of current expenditures to that of capital expenditures.
2. The magnitude defence and security-related expenditures need review. There is a *prima facie* case for improving the pro-poor content of fiscal policy by switching expenditures away from this area. As a start, the government could report defence expenditures transparently, facilitating a debate over their appropriate level.

3. Concerns about social subsidies and capital spending are overstated. Social subsidies seem pro-poor in content and impact. These expenditures should be expanded.
4. The Public Investment Programme for 2001-2005 is sensitive to poverty concerns and quite sophisticated in the fiscal plan for mobilising and allocating resources. This could be complemented by more intensive assessment of the benefit incidence of capital spending.
5. A clear distinction should be made between capital formation and financial investments in the public sector, particularly given the ongoing restructuring of state enterprises and the banking system. Cutting the former to sustain the latter would have adverse consequences for the poor, especially in rural areas.
6. As a bold move towards social protection, the government should consider introduction of a universal pension for the elderly.

Table 4.1: Summary of General government fiscal operations 1998-2002 (% GDP)

Category	1998	1999	2000	(estimate) 2001	(budget) 2002
1.Revenue and grants	20.2	19.8	21.1	21.8	20.8
Oil revenue	4.1	4.7	6.7	7.0	6.5
1.1 Revenue	19.6	19.2	20.6	21.3	20.4
1.1.1 Tax revenue	15.4	15.2	15.2	16.1	15.8
1.1.2 Non tax revenue	4.2	4.0	5.4	5.3	4.6
1.2 Grants	0.6	0.6	0.5	0.4	0.4
2. Total expenditure	21.9	22.4	26.2	26.4	27.3
2.1 Current expenditure	14.7	13.9	16.3	17.0	16.5
2.1.1 Current non-interest expenditure	14.1	13.3	15.5	16.1	15.2
2.1.1.1 Wages and salaries[a]	2.7	2.8	3.4	3.8	3.6
2.1.1.2 Other [b]	11.4	10.5	12.1	12.2	11.5
2.1.2 Interest payments	0.6	0.6	0.8	0.9	1.3
Current costs of reform	0.0	0.0	0.2	0.0	0.6
2.2 Capital expenditures	7.2	8.5	9.9	9.4	10.3
2.2.1 Onlending	1.5	1.8	2.3	1.2	2.6
2.3 Contingency	0.0	0.0	0.0	0.0	0.5
2.4 Capital costs of reform	0.7	0.0	0.0	0.0	2.2
3. Fiscal balance excluding onlending & capital costs of banking sector	-0.1	-0.8	-2.8	-3.5	-3.9
4. Fiscal balance including onlending and capital banking sector	-2.3	-2.6	25.1	-4.6	-8.7
5. Domestic financing of deficit	-0.4	-0.4	1.7	2.4	2.4
6. Foreign financing of deficit	0.6	1.2	1.1	1.1	1.6

Source: IMF (2002) and Ministry of Finance. State Budget Department.

Notes:

a Excluding wages & salaries in defence sector.

b Including wages & sslaries in defence sector.

Table 4.2: Viet Nam: Revenue Structure 1988-95 (per cent of GDP)

Category	1988	1989	1990	1991	1992	1993	1994	1995
1.Total domestic revenue	13.1	16.0	16.1	14.4	18.3	21.6	24.0	23.2
1.1 Tax revenue	3.4	4.5	4.4	11.6	13.2	17.4	19.0	19.0
1.1.1 State enterprises	0	0	0	7.6	8.2	9.3	9.1	8.5
1.1.2 Nonagric private sector	1.4	1.8	1.7	1.4	1.8	2.5	2.7	2.9
1.1.3 Agricultural tax	1.0	1.3	0.8	1.0	1.2	1.0	0.7	0.7
1.1.4 Taxes on international trade	1.0	1.5	1.9	1.6	2.0	4.3	5.9	6.0
1.2. Non-tax revenue	9.7	11.5	11.7	2.8	5.1	4.2	5.0	4.2
1.2.1 State enterprises	8.4	9.2	9.5	1.3	2.5	2.5	2.9	1.3
1.2.2 Other non-tax revenue	1.3	2.3	2.2	1.5	2.5	1.8	2.1	2.9
2. Net transfer from SOEs	-0.1	4.4	6.9	7.9	9.9	11.2	11.6	9.3
2.1 Tax & non-tax revenue	8.4	9.2	9.5	8.9	10.8	11.8	12.1	9.8
2.2 Budgetary transfers	8.5	4.8	2.6	1.0	0.9	0.6	0.5	0.5

Source: Calculated from data presented in IMF (1998).

Table 4.3: Viet Nam Government Revenues 1995-2001 (percent GDP)

Category	1995	1996	1997	1998	1999	2000	2001[a]
1.Total revenue and grants	23.3	22.9	20.8	20.2	19.8	21.1	18.9
1.1 Tax revenue	17.5	18.5	15.8	15.4	15.2	14.9	14.4
1.1.1 Corporate income tax[b]	3.3	3.7	3.7	3.6	3.7	4.6	4.5
1.1.2 Personal income tax	0.2	0.5	0.5	0.5	0.5	0.4	0.4
1.1.3 VAT[c]	3.4	4.1	3.8	3.3	4.3	4.0	3.8
1.1.4 Excises	1.1	1.7	1.5	1.5	1.1	1.2	1.2
1.1.5 agricultural tax	0.7	0.7	0.5	0.5	0.5	0.4	0.3
1.1.6 Taxes on international trade	5.8	6.0	4.3	4.5	3.8	3.1	3.3
1.1.7 Other taxes	2.1	0.5	0.4	0.4	0.,3	0.3	0.1
2. Non-tax revenue	5.1	3.9	4.2	4.2	4.0	5.7	4.0
2.1 Fees and charges	na	na	1.2	1.1	0.9	1.2	1.0
2.2 Income from natural resources	1.0	1.1	1.1	0.9	1.1	1.6	1.3
2.3 Capital revenues	na	na	0.3	0.2	0.2	0.2	0.1
3. Grants	0.7	0.6	0.8	0.6	0.6	0.4	0.4

Source: IMF 2002b.

Notes:

Sub-categories exclude minor taxes and charges; hence subtotals may not add to totals.

a Budget estimate.

b Profit tax prior to 1999.

c Turnover tax prior to 1999.

na not available.

Table 4.4: Taxes per agricultural household by expenditure quintile, 1998 (000 dong p.a.)

Category	Low	Low-mid	Middle	Mid-upper	Upper	All
Expenditure/household	7474	9796	11745	14694	22844	11670
Agricultural taxes as % of expenditure	3.9	4.3	4.1	3.5	2.5	3.7
% of households active in agriculture	79.3	39.7	72.2	59.3	23.5	58.7

Source: Bao, Houghton and Quan (2001), also for Tables 4.5, 4.6 and 4.7.

Table 4.5: Agricultural taxes per household 1998 (000 dong p.a.)

Category	Lowest	Lower-mid	Middle	Mid-upper	Upper	All
Taxes + fees +contributions	292	423	479	510	574	432
Agricultural land tax	134	188	211	231	260	194
Other taxes	4	4	9	35	50	15
Fees:						
Irrigation fee	55	92	108	99	100	89
Plant protection fee	2	4	3	3	3	3
Land protection fee	10	9	7	7	7	8
Security fee	5	6	7	7	7	6
Other fees	6	7	8	4	2	6
Contributions						
Corvee labour fund	25	29	27	27	21	27
Defence labour fund	2	2	3	3	4	2
Medical fund	1	1	1	1	0	1
School fund	12	14	13	15	21	14
Community development fund	6	9	14	10	19	10
Road construction fund	12	15	18	14	17	15
Electrification fund	14	23	34	33	52	27
Natural disaster fund	2	2	2	2	2	2
Other funds	5	5	5	4	4	5

Table 4.6: Excise taxes by expenditure per quintile , 1998 (000 dong p.a.)

Category	Low	Low-mid	Mid	Mid-upper	Upper	All
1. Tax paid on excisable goods	12	19	26	41	99	39
A. Tax as % of total expenditure	1..0	1.1	1.2	1.3	1.6	1.4
Cigarettes						
1.1 Excise paid	5.8	9.0	14.0	19.3	38.6	17.3
A.1 Tax as % of total expenditure	0.49	0.52	0.63	0.63	0.62	0.60
Alcohol						
1.2 Excise paid	5.7	8.3	9.7	13.0	30.1	13.3
A.2 Tax as % of total expenditure	0.49	0.48	0.43	0.42	0.48	0.46
Gasoline						
1.3 Excise paid	0.3	1.3	2.6	8.3	30.7	8.7
A.3 Tax as % of total expenditure	0.03	0.08	0.12	0.27	0.49	0.30

Table 4.7: All indirect taxes by expenditure by quintile 1998 (000s dong p.a.)

Category	Low	Low-mid	Mid	Mid-upper	Upper	All
Expenditure/household	6608	8844	10379	13255	25587	13596
Estimated indirect tax/household	273	390	400	549	1027	554
Tax as % of total expenditure	4.1	4.4	3.9	4.1	4.0	4.1
Taxable spending	4175	6147	7917	11114	24380	11454
Tax as % of taxable spending	6.5	6.3	5.1	4.9	4.2	4.8

Table 4.8: All taxes by expenditure per capita quintile, 1998 (thds of dong p.a.)

Category	Low	Low-mid	Mid	Mid-upper	Upper	All
Expenditure/household	6608	8844	10379	13255	25587	13596
Estimated indirect tax/household	273	390	400	549	1027	554
Agricultural taxes and fees/household	232	337	346	302	135	254
Business taxes/household	13	42	46	146	1270	352
All taxes as percentage of expenditure	7.8	8.7	7.6	7.5	9.5	8.5

Source: Bao, Houghton and Quan (2001)

Table 4.9: Functional expenditure classification, 1997 & 1998 (percentages)

Functional category	Capex 1997	Capex 1998	Curex 1997	Curex 1998	W&S 1997	W&S 1998	O&M 1997	O&M 1998
Agric &forestry	12.4	14.9	2.1	2.1	0.8	0.8	4.2	4.2
Fishery	0.3	1.9	0.1	0.1	0.04	0.03	0.2	0.1
Transport	28.1	29.7	1.9	2.2	0.6	0.5	4.6	5.5
Industry	10.9	11.6	0.4	0.1	0.01	0.01	0.8	0.1
Energy	2.3	1.7	0.1	0.06	0	0	0	0.07
Water	3.2	2.6	0.0	0.01	0	0	0	0.02
Education	10.1	15.2	16	17.9	23.3	26.3	13.7	15.8
Health	4.2	5.7	7	7.5	5.1	5	13.9	15.2
Social subsidies	0.9	0.9	18.9	16.6	18.9	24.4	3.6	0.4
Culture, etc.	7.4	7.7	3.8	3.9	2	1.9	8.5	8.8
Public admin	na	an	14.7	13.1	8.5	8.3	33.5	29.8
Interest	na	na	4.0	4.0	na	na	na	na
Other	25.8	12.4	31	32.5	37.9	32.8	5.5	7.7

Source: PER (2000) Tables 3-1-A and 3-1-B.
Legend: Capex, Capital Expenditure; Curex, Current expenditure; W&S, Salaries and wages; and O&M, Operations and Maintenance (non W&S, non-interest, expenditure)

Table 4.10: Viet Nam government expenditures 1995-2001 (percent GDP)

Category	1995	1996	1997	1998	1999	2000	2001*
1. Total expenditure	24.1	23.6	24.8	21.9	22.4	25.5	25.4
1.1 Total current expenditure	18.6	17.4	16.3	14.7	13.9	15.3	15.4
1.1.1General admin services	2.5	2.3	2.3	1.9	1.7	1.5	1.3
1.1.2 Economic services	1.7	1.5	1.4	1.3	1.2	1.3	1.3
1.1.3 Social services	8.0	7.5	7.5	6.8	6.4	7.5	6.9
1.1.3.1 Education	2.1	2.0	2.3	2.1	2.0	2.5	2.4
1.1.3.2 Health	1.0	1.0	1.0	0.8	0.8	0.9	0.8
1.1.3.3 Social subsidies	3.2	3.0	2.9	2.4	2.3	2.6	2.3
1.1.4 Other non-interest expend**	5.1	5.0	4.5	4.1	3.9	4.3	4.9
1.1.5 Interest payments	1.3	1.0	0.6	0.6	0.6	0.7	0.9
1.1.5.1 Foreign	0.6	0.4	0.3	0.2	na	na	na
1.1.5.2 Domestic	0.7	0.6	0.3	0.4	na	na	na
1.2 Capital expenditure	5.5	6.3	8.4	7.2	8.5	10.2	9.5
1.2.1 onlending	0.2	0.5	2.2	1.5	1.8	2.4	2.3
1.3 contingency	na	na	na	na	na	na	na

Source: IMF (2002b)
*Budget estimates excluding current and capital cost of SOE and banking sector reforms
** includes defence and some other security expenditures

Table 4.11: Functional classification of expenditure (% shares of total expenditure)

Items	1999	2000	Estimate 2001	Planned 2002
Total expend (bn dong)	84,817	103,151	115,110	120,484
Current	64.9	67.9	66.9	65.3
Administration	8.0	7.8	6.9	5.9
Economic	5.6	5.6	6.8	5.7
Social	30.1	29.7	31	31.9
Education	9.4	9.6	10.6	11.2
Training	2.7	2.6	3	3.3
Health	3.6	3.3	3.5	3.7
Social subsidies	10.6	10.4	10.5	10.1
Interest payment	2.7	3.4	3.7	5.1
Others	18.4	21.3	18.3	16.5
Capital expenditure	35.0	29.7	31.6	32.3

Source: calculated from data provided by Ministry of Finance, Government of Viet Nam

Table 4.12: Public Investment Programme. 2001-2005 (VND trillion at 2000 prices)

Category	2001	2002	2003	2004	2005	Total
1.Agriculture forestry and fishery	15.60	16.6	17.6	18.3	19.5	87.6
-State budget	8.9	9.0	9.4	9.5	9.8	46.6
-State credits	2.9	3	3.1	3.2	3.2	15.4
-SOE investment	3	3.8	4.2	4.6	5.4	21
-O&M expenditure	0.8	0.8	0.9	1	1.1	4.6
2. Industry and construction	31.6	36.1	40	43.4	46.4	197.50
-State budget	3.3	3.5	3.6	3.7	3.8	17.9
-State credits	11.5	13.2	14	15.3	16	70
-SOE investment	16.7	19.2	22.2	24.2	26.4	108.7
-O&M expenditure	0.1	0.2	0.2	0.2	0.2	0.9
3. Transport, posts. & telecom	19.5	21.1	22.2	23.4	24.5	111.0
-State budget	10.2	10.6	11.2	11.4	11.6	55
-State credits	2.9	3	3.2	3.2	3.3	15.6
-SOE investment	3.5	4.4	4.9	5.5	6.1	24.4
-O&M expenditure	2.9	3.1	3.2	3.3	3.5	16.00
4. Science, technology & education	5.3	5.8	6.1	6.4	6.6	30.2
-State budget	3.3	3.6	3.7	3.9	4.0	18.5
-State credits	0.3	0.3	0.3	0.4	0.4	1.7
-SOE investment	0.08	0.08	0.08	0.08	0.08	0.4
-O&M expenditure	1.6	1.8	2.0	2.0	2.1	9.5
5. Health and social welfare	2.76	2.96	3.26	3.56	3.86	16.4
-State budget	2.2	2.3	2.4	2.6	2.7	12.2
-State credits	0.2	0.2	0.3	0.3	0.4	1.4
-SOE investment	0.06	0.06	0.06	0.06	0.06	0.3
-O&M expenditure	0.3	0.4	0.5	0.6	0.7	2.5
6. Culture and sports	2	2.7	1.6	1.4	1.4	9
-State budget	1.5	2.2	1.1	0.9	0.8	6.5
-State credits	0.2	0.2	0.2	0.2	0.3	1.1
-SOE investment	na	na	na	na	na	na
-O&M expenditure	0.3	0.3	0.3	0.3	0.3	1.5
7. Urban infrastructure, Water supply & other social services	8.4	8.9	9	9	9.2	44.5
-State budget	4.3	4.3	4.3	4.1	4.1	21.1
-State credits	2.3	2.5	2.4	2.4	2.4	12
-SOE investment	1	1.3	1.5	1.7	1.9	7.4
-O&M expenditure	0.8	0.8	0.8	0.8	0.8	4
Econ services/total (%)						30.2
Social services/total (%)						58.3
Social services/PIP resources (%)						20.1
Social services for PIP/state budget (%)						31.1

Source: PIP 2002

Table 4.13: Capital Funding for poverty alleviation 2001-2005 (bn dong, 2000 prices)

Category	Capital (cumulative)
Poverty reduction and job creation programme	22581
1.State budget	3361
1.1 Capital expenditure	3180
1.2 Recurrent expenditure	541
2. State credits	10,000
3. Other resources	9,221
Socio-economic programme for undeveloped areas	7570
1.State budget	6570
1.1 Capital expenditure	6490
1.2 Recurrent expenditure	80
2. State credits	500
3. Other resources	500
Population and family planning programme	2483
1.State budget	2483
1.1 Capital expenditure	230
1.2 Recurrent expenditure	2253
Targeted programme on prevention of diseases and HIV/AIDS	4500
1.State budget	2685
1.1 Capital expenditure	218
1.2 Recurrent expenditure	2467
3. Other resources	1815
Targeted programme on clean water, rural sanitation and environment	7100
1.State budget	1350
1.1 Capital expenditure	1250
1.2 Recurrent expenditure	100
3. Other resources	5750
National targeted programme on education and training	6000
1.State budget (recurrent expenditure only)	4060
3. Other resources	1940
5 Million hectares forest project	8500
1.State budget	2234
1.1 Capital expenditure	2034
1.2 Recurrent expenditure	200
2. State credits	2250
3. Other resources	4016

Table 4.14: Estimated Budgetary Cost of a Universal Pension, (in 1998, prices of 1993)

Item		Measure	Value			
Share of population 65&over		percentage	4.9			
Private consumption		bn 1993 dong	194841			
GDP		bn 1993 dong	274811			
Private consumption/GDP		percentage	70.9			
Gov't expend/GDP: Social services		percentage	6.8			
All current		percentage	14.7			
Total		percentage	21.9			
Cons per capita	(VLSS)	dong, thds	2784			
Int'l poverty line*		dong, thds	1790			
Estimated pension cost:						
Pension/poverty line		ratio	1.00	.90	.80	.70
Pov line/average consumption		ratio	.64	.64	.64	.64
Pension per person		1993 dong, thds	1790	1611	1432	1253
Pension exp/GDP		percentage	2.2	2.0	1.8	1.6
[Assuming 10% admin cost]		[percentage]	[2.4]	[2.2]	[2.0]	[1.8]
Increase in expend: Social services		percentage	33.0	29.7	26.4	23.1
All current		percentage	15.3	13.8	12.2	10.7
Total		percentage	10.3	9.2	8.2	7.2

Notes and Sources:

1. Private consumption & GDP: IMF 1999, p. 4 & 6, with the ratio of private consumption to GDP assumed to be unaffected by deflating; and 1993 used as base year instead of 1994.
2. Poverty line: that used in the VLSS 1998.
3. Government expenditure: from Chapter 4, Table 4.1.
4. Population statistics: *World Development Indicators 2001*.
5. The last three rows assume no net administrative cost.

* Using the MOLISA food poverty line would reduce the pension and cost calculations by twenty-eight percent (that is, the food poverty line in 1998 was .719 of the international standard poverty line.

Chapter 5
Monetary and Financial Policies

5.1. Monetary Expansion and Financial Deepening

After the late 1980s the *doi moi* policy shift and rapid growth brought about a basic transformation of the monetary and financial institutions of the country. These institutional changes generated profound transformation in the structure of the economy. In this chapter changes affecting the financial sector are considered, and their implications for achieving growth that is more pro-poor.

From 1989 to 2001, gross domestic capital formation (gross investment) and gross domestic savings grew much faster than nominal GDP, increasing from 11.6 and 3.5 percent of GDP in 1989, to 30.9 and 28.3 percent in 2001 (see Table 5.1). The increase in investment was the basis of the growing capacity of the economy; and the rising savings rate allowed financing of the increased capacity to be domestic in great part. For a low-income country the investment rate and savings rate were quite high, although not as high as in China. Whatever one might think of the pace, sequencing and composition of government policy towards the financial sector over the years following *doi moi*, these were associated with an impressive saving and investment performance.

There has been increasing monetisation and financial deepening in the economy, especially in the second half of the nineties and the early twenty-first century (Table 5.2). The money supply and domestic credit increased rapidly in the late 1980s, in response to *doi moi*, which brought the ratio of the M2 measure and GDP ratio above twenty percent. Subsequently, this ratio rose above fifty percent, and may have reached sixty percent in 2002 or 2003. However, the ratio is low compared to other South East and East Asian economies. The rate of growth suggests that this ratio will hit three digits in the 2010s.

The growth in monetary and credit variables had both domestic and foreign components. Domestic deposits as a percent of GDP grew from single digits in the 1980s and mid-1990s to 25.8 percent in 2001, while domestic credit rose to thirty-five percent in 2000 and close to forty in 2001. Table 5.2 shows that foreign currency deposits grew from less than one percent of GDP in 1986 to slightly over eighteen in 2001. Associated with the increase in the former, net foreign assets grew from less than ten percent of GDP throughout most of the nineties to over twenty, reaching 24.3 percent in 2001. The last two sets of statistics show the increased dollarisation of the economy in the late 1990s.

Most shops and businesses accepted dollars as a medium of exchange, and so the above statistics most likely underestimate their use in the economy.

The growth in monetary and financial variables hides many complexities and potential problems, discussed in this chapter. We can note that since the late 1980s, the growth in credit of the private sector outpaced that of state enterprises, although state enterprises started from a much higher base. Credit to private sector was almost nil in 1986. From three percent of domestic credit in 1986, the private sector's share increased to more than one third of domestic credit in 1993, above fifty percent in 1999, and sixty percent in 2002. Thus, the share of credit to state enterprises fell below half, indicating the shift in economic structure towards private production and distribution.

5.2. The External Account

Table 5.4 provides a quantitative summary of the balance of payments. Most notable are the large increases in exports and imports after the late 1980s, through the 1990s and beyond, a result of changes in Viet Nam's trade policy. Merchandise imports increased from US$1.6 billion (between six to eight percent of GDP) in the mid-1980s, to ten billion in 1996 (40.7 percent of GDP), and 14.5 billion (forty-four) in 2001. Merchandise exports increased even faster. From US$700 million (three percent of GDP) in the mid-1980s, they grew to nine billion (34.2 percent of GDP) in 1997, outpacing imports in 2000 and 2001. The trade balance had been quite volatile in the 1980a, with large deficits, which declined in the early 1990s. From 1993 to 1996 trade deficits surpassed eleven percent of GDP in 1995 and 1996. These deficits, likely to be unsustainable, were followed by a fall in the ratio and a move to a trade surplus, of more than 1 percent of GDP in 2000 and 2001. The government anticipated a return to trade deficits in 2002 and 2003, due to large public sector infrastructure projects that would require substantial imports of capital equipment and materials. The current account balance followed the trade balance movements with large deficits in the 1980s, again during 1993 to 1997, then current account surpluses for 1999-2001. Moderately low current account deficits were expected in 2002 and 2003. In part, the deficits were covered by remittances, equal to about four to five percent of GDP (Table 5.3).

The capital account has shown much less volatility than the current account, reflecting the impact of capital controls, and success in attracting foreign direct investments. As can be seen in Table 5.3, the capital account balance tended to be positive during 1988 to 2001, with negative balances not above 1.5 percent of GDP. The clearest pattern is the sharp rise in foreign direct investments during the 1989 to 1997, leading to large capital account surpluses (fortunately offsetting the large current account deficits) during 1994 to 1997, reaching 9.7 percent of GDP in 1996. After the East Asian crisis, foreign direct investments to Viet Nam declined to four percent to five percent of GDP, a rate that is better than most of its neighbouring more advanced East Asian economies. But because of debt payments in 2000 and 2001 (which brought external indebtedness down, see next section), the capital account turned low (and slightly negative in 2000) but at a time when the current account surpluses more than made up for the smaller capital account balances. Overall, balance of payments turned from negative values (net outflows) during the period of 1988 to 1995 to positive values (net inflows) from 1996 onwards, allowing international reserves to grow respectably. By 2001, international reserves stood at US$3.7 billion, about three months of imports.

To the discussion above, should be added the 'errors and omissions' category, which after 1996 showed moderate, unaccounted negative outflows of two to three percent of GDP. This may indicate that the capital controls have not been totally effective, avoided by various avenues. It might also be explained by the liberalization of the current account, which increased the proportion of foreign exchange earnings which could be retained.

External indebtedness had a major impact on the balance of payments (Table 5.4). One sees an increase in public external indebtedness in the second half of the 1980s. This generated high ratios of foreign debt to GDP during 1989 to 1992, reaching 330 percent in 1990. This indebtedness, unsustainable in the long run, partly arose due to debts incurred from the Council for Mutual Economic Assistance countries (CMEA), the former Soviet Union and its Eastern European allies. The increase also resulted from the rise of dollar-denominated debts, discussed below. The artificial exchange rate of the rouble exaggerated the size of the CMEA debts (largely to the Soviet Union and later Russia). Based on the World Bank's definition of 'severely indebted', which involves a debt-to-GDP ratio of more than 80 percent and debt-to-exports ratio of more than 220 percent, Viet Nam suffered severe indebtedness from 1989 to 1999, but from 1990 to 1997, the foreign debt to GDP ratio fell consistently. The rescheduling of Russian debts in September 2000, and a re-pricing of these to more relevant dollar equivalents reduced the stock of Vietnamese external debt by almost half. Using the technical definition above, Viet Nam escaped severely indebted status in 2000, when its debt-to-GDP ratio fell to forty-one percent, and debt-to-exports ratio below ninety percent.

Short-term debts reached more than 100 percent of merchandise exports and more than 20 percent of GDP during 1989 to 1992 (Table 5.3). This category of debt increased nominally from 1993 to 1996, to comprise from fifty percent to ninety percent of merchandise exports. This debt level led to a mild debt crisis, as will be discussed below. After 1997, short-term debts actually fell, drastically in 2000, to around eight percent of GDP, and sustainable percentages of merchandise exports. These percentages fell further in 2000, to three percent of GDP, and 6.4 percent of merchandise exports.

The changes in external debt levels and debt service suggest that there has been a tendency for outside observers to exaggerate the debt problem of Viet Nam.[75] Certainly, the statistics for the 1990s showed no sign of a debt crisis (Table 5.4). Debt service was high in 1986 and 1987, but this was quickly controlled in succeeding years, with a temporary increase in 1989). Debt service, as a percent of merchandise exports, fell to

75 This was the view of both the World Bank and the IMF offices in Ha Noi in late 2003.

single digits in most of the 1990s, and rose to around twelve of merchandise exports in 1998 and 1999. With the rescheduling of the Russian debts to the distant future, debt service to exports ratio dropped back to a comfortable nine percent in 2000.

After the restructuring of the Russian debts, the external debt structure and composition became healthy enough to protect Viet Nam from potentially damaging capital outflows and sharp currency depreciation. The government has been astute in ensuring lower interest rates for external debt through the years (see Table 5.4), especially when world interest rates fell. Further, the maturity and grace period of the loans lengthened through the years, with grant elements increasing. Table 5.4 shows the medium and long term composition, which comprise the bulk of the external debt. There was a sharp increase in non-concessional loans, at world market interest rates plus a premium, during 1996 to 1998. But this was quickly corrected in 1999 after the East Asian crisis. Since 1999, the government's strategy, to concentrate on concessional loans, cautiously paced borrowings, continued capital controls, and promotion of strategic entry foreign direct investments, made Viet Nam's external capital accounts quite healthy.

5.3. Financial Liberalisation

The multilateral institutions, especially the International Monetary Fund (IMF), the World Bank (WB) and the Asian Development Bank (ADB), played major roles in the financial reforms of Viet Nam. The IMF has been particularly interested in the macro aspects of monetary aggregates as well as banking and non-banking financial reforms. One can see in Table 2 that the monetary and credit growth was rapid in the second half of the 1980s and early 1990s. This moderated in the mid-1990s till 1997 because of inflation in the mid-1990s, which reached 10.2 percent and 5.7 percent, respectively, in 1995 and 1996. The decline in monetary expansion was associated with falls in inflation, although there was a spike in 1998 due to the Asian financial crisis, which led to a significant *dong* depreciation that affected domestic prices. Despite increased monetary expansion in 1999 and 2000, inflation remained low, turning negative in 2000. These statistics indicate that the correlation between increases in the monetary supply and inflation was loose, perhaps reflecting excess demand for money due to financial deepening.

As part of the Comprehensive Poverty Reduction and Growth Strategy (CPRGS, the Vietnamese PRSP), and the associated conditionalities of the Poverty Reduction Growth Facility (PRGF) of the IMF, and the Poverty Reduction Support Credit (PRSC) of the World Bank, Viet Nam capped monetary and credit growth from 2001 onwards. This explains the sudden fall in credit growth in 2001. The 21.4 percent increase in domestic credit to the economy (see Table 5.2) achieved in 2001 surpassed by a very small margin the programmed growth agreed with the IMF. This was replicated in 2002 with a 20.5 percent programmed growth in domestic credit, which the economy again slightly surpassed.

The inflation rate rose to four percent in 2002 (see Table 5.5), and perhaps higher in 2003. The inflation rate in 2002, below five percent, can be seen as a healthy change from the previous deflationary pressures. The figures for January and February of 2003 showed a slight drop to 3.7 and 3.8 percent. Programmed credit and broad money growth rates for 2003 have been further lowered to 19.5 percent, reflecting discussions between the IMF and the government. In the event credit expanded in the first half of 2003 at an annual rate in excess of thirty percent. More important than the rate of expansion is what the IMF calls 'the quality' of credit, which refers to whether it had a sound financial basis.

The multilaterals pushed for state-enterprises to be privatised ('equitised'), for unviable ones to be closed down, and for the remaining ones to undergo structural reforms to be subject to 'market discipline'. Thus, loans by state commercial banks (SOCBs) to state-owned enterprises (SOEs) were seen as targeted policy lending, which should be reduced. Thus programmed targets associated with credit growth have particularly stipulated that credit growth to SOEs should be restricted to slightly more than half of the programmed growth of domestic credit of the economy. For end-December 2001, Viet Nam surpassed this programmed credit growth for SOEs by 0.9 percent. It again missed it marginally in March 2002. For the whole of 2002, growth in credit to SOEs was capped at 12 percent, compared to 20.5 percent for domestic credit to the entire economy, and, again, this was marginally exceeded. The multilateral institutions worried more about the over-run of credit to SOEs, than exceeding the overall domestic credit cap. This has been viewed as a lack of government commitment to the structural reforms on SOEs.

The main aspects of the commitments of the Vietnamese government to financial liberalisation involved shifting to so-called market processes in the banking and financial sectors, and more foreign participation. This included:

1. Liberalizing interest rates on both foreign currency and *dong* deposits and lending;
2. Making SOCB and private banks lending more commercially-based by phasing out directed lending, except for a few cases in which explicit Ministry of Finance guarantees are provided; and
3. Liberalisation of foreign participation in the banking and non-banking financial sectors, and liberalization of the current account.

Liberalization of interest rates began in 1996 by allowing rates on *dong* deposits to fluctuate freely. The government liberalised interest rates for foreign currency deposits in 1999, for foreign currency loans in 2001, and for loans in domestic currency in 2002. Table 5 shows that despite interest rate ceilings in the early 1990s, *dong* deposit rates were quite high, and much higher than the dollar interest rate. It is interesting to note that when interest rates on *dong* deposits were liberalized in 1996, they remained relatively stable several years. Also, while deposit rates increased in 2001 and 2002 from 2000, the margins between lending and deposit rates (row 7 in Table 5.5) substantially decreased. This may indicate improvement in financial intermediation, but the small margins are remarkable given the need for loan loss provisioning required by the banks. The World Bank (2003) notes the tendency of Vietnamese banks' tendency not to compete on interest rates but on volumes of deposit mobilization and loan disbursal. Overall, the statistics suggest that regulation caused little substantial suppression of interest rates.

Along with interest rate deregulation, the multilaterals have pushed for a greater 'market orientation' for the banking sector. As part of the state-guided strategy before *doi moi*, public sector banks disbursed much of the credit before the 1990s under the instructions of the state planning agency. However, the Vietnamese Government places importance on directing credit to promote key projects sectors in infrastructure, public services, basic and priority industries, with many of latter being state-owned. The government insists on providing funds for targeted sectors in the economy, including micro-finance for the poor, low-income households and micro-enterprises. The compromise with the multilateral institutions was that all banks, especially the SOCBs, the source of most of the credit of the SOEs, will phase out targeted credit and focus on commercial lending. This compromise accounts for the limit on credit growth to state-owned enterprises in the programmed targets of the IMF.

The government intends to continue to target lending via two mechanisms. The first is the Development Assistance Fund (DAF), which provides financing for domestic enterprises in infrastructure, public services, and export and heavy industry. The second is the conversion of the current state-owned the Bank of the Poor, to the Social Policy Bank, which will provide micro-financing to agricultural households and low-income groups, mostly in the rural areas. The agreed compromise is to separate the entities dealing with commercial lending, except the Social Policy Bank and Bank of the Poor, and those that carry out targeted lending.

The Development Assistance Fund (DAF) was established in 2000. Its purpose was to: 1) provide subsidized state loans for medium to long-term investments in priority projects; 2) engage in interest-rate support and investment credit guarantees; 3) provide short-term export promotion credit beginning in 2002. In principle, lending can go either to state-owned or private enterprises, based on commercial and policy criteria. Some of the policy criteria include whether the investment is in underdeveloped areas, preferential sectors, and projects related to health, education, culture and sport. The DAF has branches in all sixty-one provinces, with a registered capital of five billion *dong* (US$326.8 million). Before 2002, the Office of the Prime Minister determined allocation of funds. Funds came from the Social Insurance Fund, the Sinking Fund, the Viet Nam Postal Service Savings Company (VPSC),[76] the government budget, loan repayments, and official development assistance (ODA). After 2002, DAF would have to mobilize its own resources. It could continue to draw funds from the sources mentioned above, through negotiation. If funds come from the government budget, this usually involves issuance of investment bonds.

[76] VPSC was established in 1999. In 2002, it already had 539 to 600 branches all over the country, and has been a good and fast-growing venue to mobilize rural savings. There are around half a million deposit accounts with outstanding deposits at D3.8 billion (around $250,000). Though not very large in terms of total value, the use of these deposits as sources of credit for DAF worries the multilateral agencies, since it monetizes DAF's credits and makes it operate like a bank.

Table 6 shows us that ODA was a significant source of funding for the DAF. Annual loan disbursement, new credit from DAF, has increasingly relied on domestic resources. Table 6 also shows that outstanding credit from the DAF in 2001 to 2002, and loan disbursements in 2002 and 2003, grew much faster than total domestic credit to the economy, implying that the DAF comprised an increasing share of domestic credit, reaching 24 percent in 2002, equal to 3.3 percent of GDP. The DAF is the largest financial intermediary in Viet Nam for channelling domestic and foreign funds to investment activities. The government plans to double its five trillion *dong* of capital to ten trillion ($653.6 million). The major role of the DAF worries the multilateral institutions, since it contradicts a shift of the financial sector to commercial and market-based lending.

Recently the government undertook a review of the DAF, which reflected concerns about the economic viability of its loans. We strongly endorse the consensus view that the DAF requires a thorough reorganisation of its operations. In this context, one should distinguish between economic viability and 'market-based' criteria for lending by public institutions. The former is a necessity whatever might be the development goals of the government. If the latter refers to what is colloquially called a 'level playing field' in lending, this is an impractical goal in Viet Nam, and may be undesirable. Given that public enterprises play a major role in the economy, a 'level playing field' is impossible. No government can be expected to treat public sector enterprises in the same manner it treats private ones. If such were the policy, there would be little justification for public ownership. A 'level playing field' in credit allocation may be undesirable, since it implies abandoning a major instrument of industrial policy.

However, the distinction between commercial lending and policy lending is quite important. To separate these, the Social Policy Bank (SPB) was established, with a chartered capital of five trillion *dong* ($326.8 million) and branches in all provinces. All policy lending in the banking sector would be transferred to this bank. The SPB enjoys special privileges, including liquidity and solvency guarantees by the government, and is exempt from deposit insurance and tax regimes. The target borrowers are small rural households, low-income students, micro-enterprises, and small and medium enterprises (SMEs), mostly in the rural areas. There is a plan for SPB and BARD to create a mutual fund for production and consumption loan guarantees in case of natural disasters that may result in non-payment of loans. The SPB would have accounts separate from the other SOCBs, consistent with the separation of commercial and policy lending.

5.4. Financial Services and Balance of Payments

The government had been very careful in opening the financial sector to foreign investors, with the State Bank of Viet Nam (SBV) shown caution in allowing new banks to open. The United States Bilateral Trade Agreement (USBTA), ratified in December 2001, had important implications for the opening up of the financial services, along with liberalization in trade and other sectors, to prepare for Viet Nam's accession to the World Trade Organization. The key commitments for financial services liberalization, based on targets made from March 2002, are as follows:

> In the banking sector: (i) permit majority US ownership of banks after three years; (ii) grant national treatment in the possible equitisation (privatisation) of SOCBs; and (iii) phase in national treatment of deposit-taking activities after eight years.
>
> In the insurance sector: (i) permit majority US ownership of firms after three years; (ii) eliminate restrictions on the operations of joint ventures after three years (and wholly US-owned companies after six years); and (iii) permit wholly US-owned firms after five years. (IMF 2002, p. 10)

The IMF sought to convince the government to allow a foreign joint venture for one of the major state-owned banks, even before the WTO would become operational. The government response was to declare its willingness to allow foreign capital only in relatively minor state-owned banks.

The IMF and World Bank have also argued for allowing foreign-owned banks to expand their activities from dollar transactions to take *dong* deposits. The Bretton Woods Institutions claim that the banking sector is inappropriately restricted, with SOCBs giving preferential credit to SOEs, and increasingly serving the larger firms in the private sector. Existing joint-stock banks mainly serve the private domestic sector of the economy, and foreign banks the multinational firms. Moves towards universal commercial banking functions for banks that qualify, the BWI argue, will reduce the market segmentation of the banking sector.

In a move related to financial reform, the government liberalised the current account in 2002. The foreign exchange surrender requirement, applying principally to exporters, was reduced from forty percent to thirty percent in May 2002, and will be phased out during this decade. For the capital account, the tax on profit remittances of foreign investors would be eliminated at the end of 2002. This policy is to harmonize tax treatment between foreign and domestic enterprises as part of removing restrictions on current international transfers and payments under the obligations of Article VII of the IMF Review for the PRGF (which the government interpreted to imply liberalization only in the current account). The short-term capital account remained controlled, with this justified by the government on the argument that it reflected proper sequencing of financial liberalization. Permitting short-term foreign private debts, which could prove volatile, would not be undertaken until there was strong and sound monitoring, supervision and transparency in the financial sector. Portfolio flows have not been liberalized on the same argument, since the Vietnamese stock market is small and limited to only nineteen companies listed. The removal of taxes on repatriation of profits is unlikely to be adverse for the external account, since entry of FDI into the economy has been quite controlled and directed.

Opening up the Vietnamese economy in the late 1980s and permitting foreign currency deposits (FCDs) have resulted in the use of the dollar as medium of exchange and store of value, creating a major dollarisation of the economy. This was reflected in the rise of such deposits, from almost nil in 1986 to high levels during 1989 to 1992 (see Table 5.2).

An indicative measure of the dollarisation of the economy is the share of FCD to the broad money supply, M2, and its share in total deposits. One can see in Table 5.2 that these percentages went above twenty-five, then fifty percent in 1989 and 1991. The percentages fell sharply from 1993 to 1996, as large interest rate differentials between domestic and foreign interest rates shifted money holdings to *dong* (see row 5 of Table 5.5). But with the mini-crisis in the Vietnamese financial sector in 1996-97, discussed below, and the onslaught of the East Asian crisis in 1997-98, FCDs again increased as a share of M2 and of total deposits. One can also see in Table 5.5 that the difference between the *dong* savings and dollar interest rates turned negative in 1997, thus making it more attractive to hold dollars than *dong*. This shift continued during 1999 to 2000, when FCDs made up almost a third of M2 and about forty percent of total deposits.

The weakening dollar and low foreign interest rates contributed to slowing the pace of dollarisation in 2002. Table 5.5 shows the positive differential between *dong* and dollar savings rates. None the less, the FCDs represented a potentially volatile component of the monetary system. Dollar loans based on these deposits could lead to the same currency mismatches that occurred during 1996-7 and the Asian crisis. Non-hedged short-term dollar borrowings, coupled with sudden sharp depreciations of the currency, could lead to non-performing loans and a financial crisis with banks becoming illiquid or insolvent. The State Bank of Viet Nam (SBV) and the multilateral agencies have agreed to close monitoring and supervision of the movements of the FCDs. This monitoring is especially important after the SBV in 2002, following the IMF program, reduced the reserve requirement ratio for FCDs to eight percent. It should be noted that this is still higher than the reserve requirement ratio for *dong* deposits of five percent.

Despite the government's success in managing the economy over the 1990s and early 2000s, the country's financial sector requires restructuring. The shift to commercial lending from a directed state-guided credit system requires more market-focused legal, accounting, monitoring and supervisory systems. Currently these changes are underway by the State Bank of Viet Nam and the Ministry of Finance in close coordination with the IMF and the World Bank. Financial liberalization and partial deregulation of the capital account, without adequate regulatory and supervisory framework and capacity, led to a mini-crisis in 1996-7 and further manifestation of vulnerability during the East Asian crisis. These experiences call for strengthening banks and for better monitoring and supervision of the banking sector;

The problem of non-performing loans, with the greater amount incurred by state-owned enterprises, has to be resolved. These should be taken off the books of the banks holding them, implying some recapitalisation of those banks. The government and the multilateral development banks differ on the seriousness of the non-performing loan problem. In this context, the Vietnamese government has agreed, as part of the IMF World Bank programs for the CPRGS, to address the issue.

As part of *doi moi*, the State Bank of Viet Nam was partitioned in 1988 into a central bank (retaining the name SBV), and various state-owned banks. Decrees on banking in 1990 authorized the SBV to assume traditional central bank functions of conducting monetary policy and supervision of the financial sector. Restrictions and barriers to entry for new domestic and foreign banks were liberalized, but the SBV retained some responsibility to control entry and expansion in the banking sector. Table 5.7 gives the number of financial institutions established from 1994 to 2001, and shares in the deposits and credit of the banking sector. Table 5.8 presents IMF estimates of various market shares of SOCBs, credit outstanding, credit outstanding of the state-owned enterprises (SOEs), new credit, new SOE credit, and overdue loans in 2001. Table 5.7 shows that there were substantial increases in joint stock banks, foreign banks and credit funds and credit cooperatives in the 1990s. The joint-stock banks, which are privately owned with some having SOCB equities, decreased in number in the later half of the 1990s, due to the mini-crisis described below. Foreign banks increased their number and share of credit during the late 1990s. The rise in the number of credit funds and credit cooperatives was quite spectacular, and points to the proliferation of micro-finance over and beyond the Social Policy Bank, discussed above.

Table 5.7 and, more importantly, Table 5.8 show that in terms of credit and deposits SOCBs dominate the banking sector.[77] They are almost exclusively the source of credit for SOEs. They also hold the bulk of overdue loans. The Industrial and Commercial (IndCom) Bank holds 40 percent of overdue loans even though it comprises only 20 percent of total bank credit.

The mini-crisis of 1996-97 resulted from high domestic interest rates vis-à-vis foreign interest rates (see Table 5.5). This problem was compounded by liberalization of foreign short-term borrowings, especially through letters of credit. Table 5.5 shows the extremely high and positive interest rate differentials between *dong* and dollar deposits during 1992 to 1996. At the same time, there was little depreciation of the *dong*, as the exchange rate was held steady, which reduced the risk of holding *dong*. These conditions brought a shift from holdings of dollars to *dong*. Though there were capital controls on foreign borrowings, domestic enterprises were allowed to accumulate trade credits. These were guaranteed by commercial banks through deferred letters of credit. Because of poor supervision, many SOCBs and joint-stock banks gave guarantees to dollar borrowing that was not hedged against exchange rate changes.

Table 5.3 shows that the 'other short-term capital' category increased substantially from 1993 to 1996. From negative values prior to this period, it rose to US$117 million in 1993 and 311 million in 1995. In 1996, other net investment inflows amounted to US$514 million, which was 2.1 percent of GDP. The stock of letters of credit was estimated at US$1.5 billion in early 1997. Simultaneous with these short-term inflows, the current account deficit widened to reach 7.2 percent of GDP in 1994, nine percent in 1995 and 8.2 percent in 1996. The high current account deficits resulted primarily from trade

[77] Note that Tables 5.5 and 5.6 differ in the share of SOCBs' and other banks' share in bank credit. The IMF estimates the SOCBs' share in bank credit much higher than SBV, from which Table 5.5 is based.

deficits. These deficits arosefroma variety of reasons whose relatively importance cannot be judged rigorously: imports for investment projects, trade liberalization, interest payments on the short-term trade credits, and perhaps currency overvaluation.[78]

The sequence of events reads like a mild version of the 1997 Asian crisis. It appears that the dollar borrowings were channelled into the long-term speculative real estate market (at high lending rates), causing currency and term mismatches in the loans. The speculative bubble in the property market burst in early 1997, *before* the Asian crisis, when the firms in question could not serve their debts. About forty percent of the letters of credit guaranteed by commercial banks became non-performing. As a result, the SOCBs, particularly the Vietnamese Commercial (VietCom) Bank, and many joint stock banks defaulted. Creditors demanded that banks to honour their guarantees, so that the SBV was forced to use substantial foreign reserves to rescue these commercial banks. As a consequence, Viet Nam's sovereign credit in 1997 rating fell from Ba3 to C. Because of this, the sudden rise in the demand for dollars brought about a ten percent depreciation in the *dong* in 1997, and another thirteen percent in 1998.

This brief period of instability demonstrated to the government the potential dangers of capital account liberalisation. Because of the experience, the SBV put strict limits on letters of credit, and on commercial banks' guarantees of such credits. Specifically, a deposit equivalent to eighty percent of the value of each letter of credit was required, as opposed to zero to thirty percent previously. Thus, in the second half of 1998, use of letter of credit fell substantially. The main lesson learned was that opening the financial sector to volatile short-term debts without proper supervision, control and regulation would be a very harmful undertaking. The after-effects of the mini-crisis and the rise of non-performing loans brought to the fore the need to strengthen weak banks. The immediate needs were to resolve the problems of non-performing loans, improve the capital adequacy ratios of the banks, and enhance the risk assessment capacities of the banks.

The first banks targeted for restructuring were those joint-stock banks hit by the mini-crisis and burdened with large non-performing loans. The restructuring began in 1998, immediately after the Asian crisis. In 2001 the restructuring extended to the large SOCBs (see Table 5.8). Restructuring the joint-stock banks proved relatively easy. Those with capital-to-adequacy ratios below eight percent were forced to increase their chartered capital, restructure their ownership, and reduce overdue debts. Those unable to comply had to merge with stronger banks or go into forced bankruptcy. From fifty in 1998, joint-stock banks fell reduced to thirty-six by the end of 2002 (the licenses of fourteen were revoked). The SBV continues to monitor the capital adequacy and loan portfolios of the remaining joint-stock banks.

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78 In the absence of formal modeling, it is not possible to judge the degree of overvaluation, or if the currency was overvalued. Without exception, judgments as to the appropriateness of the exchange rate have been based on inter-year numerical comparisons with arbitrary time periods.

The multilateral institutions claim that the SOCBs remained in a dangerous position after the mini-crisis, due to their continued holdings of non-performing loans of uncompetitive SOEs. The first SOCBs targeted for restructuring was the VietCom Bank, which was hard-hit by the crisis of 1996-98. By end of 2001, four other SOCBs had been targeted. Judgements about the financial health of the SOCBs depend on one's assessment of the size of the non-performing loans. Using Vietnamese accounting standards (VAS), these were more than twelve percent of total loans in 1997-98 (Thanh *et al* 2002), and fell to about ten percent (US$1.3 billion) by the end of 2000. However, according to the calculations of the multilateral development banks, using international accounting standards (IAS) may increase these percentages substantially. The Government's strategy to resolve the bad loan problem, in line with the strategy of the multilateral institutions, involved the following:

1. To establish autonomous asset management companies (AMC) and loan workout units (LWUs), with a AMC and a LWU for each major SOCB. The AMCs are supposed to dispose of bad loans with collateral, while the LWUs collect and resolve uncollateralised loans. The Government also planned an independent AMC to settle debts owed among SOEs.

2. The targeting of cumulative non-performing loans to be resolved as part of the structural performance criteria of the PRGF agreement with the IMF. The March 2002 target 1.4 trillion *dong* of non-performing loans was exceeded, and a cumulative D2.5 trillion (US$166 million) was resolved by September 2002. Most of these bad loans resolved were collateralised debts with recovery rates of around 50 percent. It would be more difficult now to resolve the remaining non-performing loans, most of which were not collateralised.

3. The IMF program for the PGRF facility also required 'timely' monitoring and reporting of the debts and budgetary support for the two hundred largest SOEs. The government complied, but targeted ceilings for SOEs debts were slightly exceeded (see above). As of March 2002 the two hundred SOEs held D43.6 trillion (US$2.9 billion) debts, out of which D40.8 trillion (93.6 percent) were bank debts.

Implicit in resolving the non-performing loans, including micro-finance loans to rural households, is the sensitive decision whether to embrace property rights in the Western sense. Land in Viet Nam is in great part socially owned, in that use and usufruct rights cannot be easily marketed, and where creditors' rights to seize debtors' properties and assets are correspondingly limited. The multilateral development banks want the government to adopt laws on bankruptcy and creditors' rights that include cadastral surveys, the institutionalisation of land titles and alienability of land-use or usufruct rights. This would allow creditors to lay claim to debtors' property, especially properties of SOEs. In a quite rational approach, the government treats this issue considerable caution. While a narrow definition of property rights might be consistent with one particular method of dealing with aspects of the non-performing loan problem, it runs counter to twentieth century Vietnamese history, in which the struggle for land and against landlessness was central to national identity.

The IMF program for the PRGF also stipulates that the initial round of recapitalisation of SOCBs in August 2002 would be implemented after other restructuring, such as the resolution of non-performing loans, the establishment of credit risk management, and internal audit committees. Further recapitalisation will be contingent on creation a special credit file examination by the SBV on credit risk management, and on conforming to international rules of loan classification and provisioning. Furthermore, the multilateral institutions seek appropriate public funding mechanisms for the recapitalisation funds that will take into consideration fiscal constraints. On the other hand, the SBV schedules key restructuring steps to continue until 2005. Perhaps most important, it would postpone until 2008 or 2010 the adjustment of the SOCBs' capital adequacy ratio from five to ten percent (the standard set by the Bank of International Settlements).

The shift to commercial lending of course requires shift in banking practices. Most justified would be the need for better and more sophisticated monitoring, supervision, regulation and assessment of bank operations and records. Again the IMF and the World Bank are in the forefront of these banking reforms, as they incorporate it to the conditionalities associated with the PRSC and PRGF facilities. Also at issue between the government and the World Bank is the application of the Basel Core Principles (see Box 5.1).

As a result of the World Bank assessment, the prescribed changes were incorporated into the conditionalities associated with the IMF's PRGF and the World Bank's PRSC facilities. Starting with 2000, external audits by international accounting firms for the four large SOCBs would be carried out using international accounting standards (IAS), partly to assess the true size of non-performing loans. External audits for financial statements of 2001 were made and identifying donor funds for the external audit of the financial statements of 2002 is under way. The banks in Viet Nam, especially the SOCBs and SBV, would change loan classification to be closer to international practices starting December 2001, as part of the structural performance criterion for the IMF PRGF facility. Using IAS, banks would classify an entire loan balance as overdue if any interest or principal payment became overdue. The target completion date for this shift was the end of 2002. This loan classification has been the main reason for the change from the Vietnamese accounting standards (VAS) to IAS. In the VAS, only those portions of loans due and suffering from principal or interest non-payments would be classified as non-performing.

In 2002, credit risk management and internal audit committees would be created for SOCBs. After this, credit risk management would be improved with the designing and implementation of credit manuals based on IAS, focusing on the resolution of non-performing loans. The SOCBs would pass a credit file examination by the SBV in order to receive further recapitalisation in 2003. As mentioned in a previous section, periodic targets for resolution of non-performing loans, especially those not collateralised, would continue, and recapitalisation of the SOCBs would be contingent on resolution of these and compliance with the other changes in rules and practices.

To address the problem of property and creditors' rights discussed previously, the Credit Bureau and Registry of Collateral would be strengthened, including identification and

Box 5.1: Limited Basel Core Principles Assessment

The relevant details of the agreement by the State Bank of Viet Nam to apply the Basel Core Principles are as follows:

Principle 1. The State Bank of Viet Nam should define the objectives and responsibilities of each agency involved in supervision. This includes putting in place arrangements to share information between supervisors and establishing independence with respect to other State bodies.

Principle 3. The licensing process leaves room for excessive subjectivity. It should include: an assessment of the ownership structure, directors and senior management; clear operation and internal controls plans; and projected financial conditions (including capital base).

Principle 6. A minimum capital adequacy ratio (8 percent) is in place, but compliance is hindered by the use of local accounting standards. This is particularly evident regarding loan classification and provisioning, which have a decisive impact on the computation of the ratio.

Principle 7. The task of SBV inspectors is very much oriented towards checking compliance with laws and regulations. It does not involve sufficient judgment in the evaluation of bank's policies and procedures related to the making of loans and investments.

Principle 8. The SBV evaluate asset quality based on a matrix of overdue periods, rather than on the risk profile of borrowers. Evaluation is made more difficult by a legal environment that hinders the enforcement of creditor rights, thus reducing the value of collateral.

Principle 14. The general principles of corporate governance, laid down in the Law of Credit Institutions, are not followed. The duties and powers of the internal control unit are focused on compliance rather than risk.

Principle 16. The SBV inspectors do not perform forward-looking risk assessments. On-site inspections manuals exist but need to be implemented. Off-site supervision is not forward looking either and is not in a position to assess risk-based profiles of credit institutions.

Principle 21. Accounting practices and policies are rather ad-hoc. Differences with International Accounting Standards include loan classification, loan loss provisioning, and accrual versus accounting of interests and expenses.

Principle 22. The SBV has given its inspectors a wide range of sanction powers. But no meaningful track record exists to confirm the effective use of these powers.

Source: World Bank 2002, p. 33.

definition of what could be used as collateral, with processes to legalise this. Similarly, moves to strengthen the Registry Centre under the Ministry of Justice were planned in order to settle disputes of creditors on claims involving transactions secured with movable assets. Part of the changes to strengthen the Registry Centre would establish an electronic filing system capable of tracking, recording and providing information on a timely basis. The SBV issued a directive in October 2002 to legalise the use of the Registry Centre.

A Credit Information Centre was established in 2003 as a legal entity owned by credit institutions with a fee structure that would make it self-sustaining. This Centre would provide to information on borrowers to creditor, to reduce risk of future lending. To make this work effectively, legislation would be required to stipulate the rights and duties of affected entities and provide them the protection from misuse of the information gathered, with appropriate sanctions and punishments for breaches of the law. The SBV identified other areas for restructuring: asset and liability management, business planning, management information systems (MIS), personnel training, and 'modernization' of all banking services.

There have been rapid increases in the non-banking financial sector of Viet Nam, although coming from a very low base. Eighteen insurance companies, many of which are joint foreign ventures, have come into operation since the Law on Insurance Business took effect in April 2001. The state-owned insurance firm remains dominant, though decreasingly so. Its current coverage is one percent of GDP, but premiums have grown at thirty percent annually, reaching D4.9 trillion (around $321 million) in 2001 (World Bank 2003). The Securities Trading Centre opened in July 2000 in Ho Chi Minh City, though dealing in equities and bonds remains limited. As of the end of 2002, nineteen companies and eighteen bond issues were listed, with a total market capitalisation of only D1.6 trillion ($105 million). The companies listed are joint-stock, previously SOEs. Trading in the Securities Trading Centre was upgraded in December 2001, and a clearing and settlement system would be introduced in 2005 (World Bank 2003).

5.5: Recommendations and Conclusions

To sustain the high growth and impressive performance of Viet Nam, the monetary and financial sectors require strengthening, with effective regulation in order to prevent volatilities and vulnerabilities that may threaten the economy. In light of these requirements and the discussion of this chapter, the following conclusions and recommendations are reached.

1. The past rate of growth of monetary and credit aggregates of up to twenty percent should be adequate in the future to accommodate GDP growth rates of five to eight percent, and allow for necessary financial deepening. The rise of the inflation rate towards five percent should be seen as indicating that the economy recovered from the lower growth during 1998-1999. Reductions in monetary and credit growth to substantially below twenty percent should only be considered if inflation rises into high single-digit figures.

2. In recent years the government has acted prudently to avoid the high external indebtedness of the late 1980s and early 1990s, and to reduce dependence and exposure to short-run commercial loans. Controls on short-term capital flows, including trade credits, which caused a mini-crisis in 1996-98, should still continue. The shift back toward long-term and more concessional loans is an astute policy to reinforce a healthy capital account.

3. The main tensions arising from financial reforms between the government and the multilateral institutions lie in the fear of the multilateral institutions that the government and the SOCBs give preferential credits to SOEs, many of which the multilaterals perceive as unviable or uncompetitive. They view this as increasing the dangers associated with non-performing loans, which may lead to a financial crisis. Thus, the controversy over financial reforms mirrors that associated with the SOE restructuring, which must proceed with some haste in light of the coming accession to the WTO.

4. The Vietnamese Government follows sound economic principles by channelling credit to basic infrastructure, public services and priority areas in the country. Thus the DAF can be justified by economic and social arguments. The DAF would be more beneficial if the criteria for areas given preferential credit were clearly identified by the government. This might be done in the national development plans, jointly by the Ministry of Planning and Investment, the Ministry of Finance, and the Office of the Prime Minister. A clear identification of the priority areas will reduce the tendency to give preferential credit to state enterprises due to political connections or in order to prevent SOE bankruptcy. Further, a review of the DAF, which has been initiated by the government, is necessary, with an eye to major changes in its operations.

5. Once the SOCBs focus on commercial lending, policy lending could be moved to DAF and the Social Policy Bank, as is the current policy. If DAF justifies and identifies the preferential credit to priority areas, then there will be little need for differential limits on credit growth, with credit growth to SOEs lower than the overall growth. Competitive and viable SOEs should be allowed to compete for the commercial loans.

6. The government could take a clear position on its view of the mixed economy it seeks to foster. This implies legislation to identify which property and usufruct rights could be traded. Based on clear and unambiguous legislation, rules on bankruptcy and creditors' rights would follow.

7. The government seems also to be eager to adopt modern accounting and credit management techniques for monitoring and supervision of the financial sector. There is official recognition that the shift to commercial lending requires stronger and more effective supervision and regulation of loan transactions, and improved risk assessment capacities. While necessary, measures to achieve this must be implemented cautiously. As this chapter has shown, the financial sector remains basically sound, amenable to restructuring consistent with macroeconomic stability. However, the rushed adoption of internal financial rules, especially overly strict capital

and loan-loss requirements, may create the possibility of a credit crunch and loss of confidence in the financial sector. Specifically, a reserve ratio of eight percent should not be viewed as a 'magic number' to be achieved in haste, if at all.

8. From a poverty reduction perspective, the basic function of the financial system is to foster rapid, pro-poor growth. To the extent that restructuring of the financial system facilitates such growth, it should be implemented purposefully. It is by this criterion that the government might assess the advisability of the various aspects of the complicated process of financial restructuring. The most important impact that this process will have on fostering pro-poor growth will be the budgetary implications, considerably more important than financial policies to increase the access of the poor to credit. Overall, Viet Nam has the institutions that can widen credit access, though some changes in practice may be required for greater effectiveness.

9. However, if restructuring results in a substantial increase in the need for bank recapitalisation, the budgetary implications could be severe. The government would be well-advised to review the experience of Indonesia, where the recurrent costs of recapitalisation have crowded out both development expenditure and social programmes that affect the poor, as well as eliminating for the foreseeable future any new pro-poor budgetary programmes. In particular, the level and rate of recapitalisation recently recommended in the multilateral document, *Taking Stock*, would seem ambitious to the point of placing severe stress on public finances.

10. Finally, the government should consider with care the degree of independence it might grant to the State Bank. The creation of a central bank fully independent from the executive branch would dramatically reduce the government's policy instruments for short term stabilisation and longer term development strategy.

Table 5.1: Saving and Investment Rates, 1989-2001

Year	Percentage of GDP			GDP Growth Rate
	Gross Fixed Capital Formation	Gross Domestic Capital Formation	Gross Domestic Savings	
1989	10.1	11.6	3.5	4.7
1990	13.1	14.4	2.9	5.1
1991	13.7	15.0	10.1	5.8
1992	17.2	17.6	13.8	8.7
1993	21.8	24.3	16.8	8.1
1994	24.2	24.3	17.1	8.8
1995	24.7	26.4	18.2	9.5
1996	24.8	26.5	17.2	9.3
1997	25.8	27.4	20.1	8.2
1998	26.2	28.7	21.5	5.8
1999	25.7	27.6	24.6	4.8
2000	27.6	29.6	27.1	6.8
2001	28.9	30.9	28.8	6.8
2002				7.0

Source: ADB (2002) Key Indicators of Asia and the Pacific, IMF, *International Financial Statistics (2002), various issues.*

Table 5.2: Monetary and Credit Indicators for Viet Nam, 1986-2002

	1986	1987	1988	1989	1990	1991	1992	1993
Percent of GDP								
Currency in circulation	9.2	7.1	6.6	8.4	8.9	8.4	9.6	10.1
Domestic Deposits	9.0	8.3	8.5	10.6	9.4	7.2	7.6	7.6
Foreign Currency Deposits	0.5	1.0	1.6	7.5	8.8	10.9	7.4	5.3
Money supply (M2)	18.7	16.4	16.7	26.4	27.1	26.5	24.6	23.8
Foreign assets (net)	-3.8	7.3	1.8	3.6	6.3	11.1	9.6	4.4
Domestic credit (incl. Govt)	25.5	18.5	17.1	23.9	23.7	18.4	15.5	19.3
Claims on gov't. sector (net)	3.2	2.8	4.3	9.3	9.6	5.2	1.7	2.8
Domestic credit on non-govt	22.4	15.7	12.7	14.7	14.1	13.2	13.8	16.5
Claims on private sector l/	0.7	2.6	1.7	1.8	1.5	1.3	2.5	5.5
Claims on state enterprises	21.7	13.1	11.1	12.8	12.7	11.9	11.3	11.1
Other items	-3.0	-9.4	-2.3	-1.1	-2.9	-3.0	-0.5	-0.8
Annual Growth Rates								
Currency in circulation		272.7	399.5	129.7	58.8	71.9	64.8	34.4
Domestic Deposits		338.9	449.8	128.1	32.7	40.2	51.1	27.7
Foreign Currency Deposits		866.7	734.5	765.7	75.7	127.0	-1.7	-9.8
Money supply (M2)		320.5	445.4	188.8	53.1	78.7	33.7	22.8
Foreign assets (net)		-1013.0	35.2	253.5	161.6	223.8	24.6	-41.2
Domestic credit (incl. Govt)		247.7	394.9	155.1	48.3	41.7	21.3	58.3
Claims on gov't. sector (net)		321.1	736.3	288.6	55.1	-1.9	-51.6	104.0
Domestic credit on non-govt		237.3	334.5	109.6	44.0	71.3	49.8	52.6
Claims on private sector l/		1800.0	235.5	100.4	21.3	65.5	170.0	177.9
Claims on state enterprises		189.2	354.5	111.0	47.2	72.0	36.3	24.7
Other items		1405.6	28.4	-13.2	306.6	88.4	-75.3	84.8
FCD / M2 (in %)	2.7	6.2	9.4	28.2	32.4	41.2	30.3	22.2
FCD / (Dom. Dep.+FCD) (in %)	5.3	10.9	15.7	41.3	48.3	60.2	49.6	41.0
Share in total domestic credit (excl. credit to government)								
Claims on private sector	3.0	16.8	13.0	12.4	10.5	10.1	18.2	33.2
Claims on state enterprises	97.0	83.2	87.0	87.6	89.5	89.9	81.8	66.8

Table 5.2: Monetary and Credit Indicators for Viet Nam, 1986-2002 (continued)

	1994	1995	1996	1997	1998	1999	2000	2001
Percent of GDP								
Currency in circulation	10.4	8.4	8.3	8.0	7.5	10.4	11.8	13.7
Domestic Deposits	8.3	9.8	10.6	12.0	14.2	16.0	22.7	25.8
Foreign Currency Deposits	5.3	4.8	4.8	6.0	6.7	9.3	15.9	18.3
Money supply (M2)	24.1	23.0	23.8	26.0	28.4	35.7	50.5	57.7
Foreign assets (net)	3.9	4.7	5.2	6.7	8.6	8.9	21.7	24.3
Domestic credit (incl. Govt)	21.3	20.6	20.3	21.3	22.4	28.9	35.1	39.5
Claims on gov't. sector (net)	2.5	2.0	1.6	1.4	2.3	0.7	-0.1	0.4
Domestic credit on non-govt	18.7	18.5	18.7	19.9	20.1	28.2	35.3	39.0
Claims on private sector l/	7.2	8.0	8.9	9.9	9.6	14.6	19.4	22.6
Claims on state enterprises	11.5	10.5	9.9	10.0	10.6	13.6	15.8	16.5
Other items	-1.1	-2.3	-1.8	-2.0	-2.7	-2.1	-6.4	-6.0
Annual Growth Rates								
Currency in circulation	31.0	2.9	18.1	10.9	7.4	54.1	25.7	27.0
Domestic Deposits	39.3	51.4	28.5	30.8	36.0	24.4	56.9	24.4
Foreign Currency Deposits	28.7	16.1	19.0	42.0	28.8	54.5	89.2	26.0
Money supply (M2)	29.0	22.6	22.7	26.1	25.6	39.3	56.2	25.5
Foreign assets (net)	11.4	56.4	31.3	47.4	48.6	13.7	169.6	22.9
Domestic credit (incl. Govt)	40.0	24.0	17.6	20.8	21.3	42.8	34.2	23.2
Claims on gov't. sector (net)	16.6	2.9	-5.5	-0.7	90.4	-65.0	-116.5	-534.3
Domestic credit on non-govt	43.9	26.9	20.1	22.6	16.4	55.2	38.1	21.4
Claims on private sector l/	68.0	41.4	31.7	28.6	11.5	69.2	46.8	27.5
Claims on state enterprises	31.9	17.7	11.3	17.2	21.2	42.5	28.7	14.0
Other items	78.7	175.6	-5.8	27.6	57.2	-13.1	228.9	3.5
FCD / M2 (in %)	22.2	21.0	20.3	22.9	23.5	26.1	31.6	31.7
FCD / (Dom. Dep.+FCD) (in %)	39.1	33.0	31.3	33.1	31.9	36.8	41.2	41.5
Share in total domestic credit (excl. credit to government)								
Claims on private sector	38.7	43.2	47.3	49.6	47.6	51.8	55.1	57.9
Claims on state enterprises	61.3	56.8	52.7	50.4	52.4	48.2	44.9	42.1

Note: *Estimated for first nine months.
Sources: ADB (2002); *International Financial Statistics* (2002), and various other issues; World Bank (2002).

Table 5.3: Balance of Payments Accounts, 1986-2001

	1986	1987	1988	1989	1990	1991	1992	1993
US$ mns								
Merchandise exports, fob	785	861	733	1320	1731	2042	2475	2985
Merchandise imports, fob	-2155	-2191	-1412	-1670	-1772	-2105	-2535	-3532
Trade balance	-1370	-1330	-679	-350	-41	-63	-60	-547
Other goods, services & income	...	...	-68	-237	-356	-160	-71	-484
Credit	...	...	...	...	...	...	...	...
Debit	...	...	...	...	...	...	...	...
Unrequited transfers	-53	-30	...	...	138	90	123	264
Private	...	...	...	...	-	35	59	70
Official	...	...	...	...	138	55	64	194
Current balance	-1423	-1360	-747	-587	-259	-133	-8	-767
Capital account	...	...	401	299	121	-59	271	-180
Direct investment	...	...		100	120	220	260	300
Portfolio investment	...	...	...	...	...	...	...	...
Other Investments (net)			401	199	1	-279	11	-480
Other long-term capital	...	...	360	412	-47	-191	52	-597
Other short-term capital	...	...	41	-213	48	-88	-41	117
Net errors and omissions	...	...	26	66	-4	142	-197	-109
Overall balance	...	...	-320	-222	-142	-50	66	-1056
Percentage of GDP								
Merchandise exports, fob	3.0	2.3	2.9	21.0	26.7	26.7	25.1	22.6
Merchandise imports, fob	-8.2	-6.0	-5.6	-26.5	-27.4	-27.5	-25.7	-26.8
Trade balance	-5.2	-3.6	-2.7	-5.6	-0.6	-0.8	-0.6	-4.1
Other goods, services &income			-0.3	-3.8	-5.5	-2.1	-0.7	-3.7
Credit								
Debit								
Unrequited transfers	-0.2	-0.1			2.1	1.2	1.2	2.0
Private						0.5	0.6	0.5
Official					2.1	0.7	0.6	1.5
Current balance	-5.4	-3.7	-2.9	-9.3	-4.0	-1.7	-0.1	-5.8
Capital account			1.6	4.8	1.9	-0.8	2.7	-1.4
Direct investment			0.0	1.6	1.9	2.9	2.6	2.3
Other Investments (net)	0.0	0.0	1.6	3.2	0.0	-3.7	0.1	-3.6
Other long-term capital			1.4	6.5	-0.7	-2.5	0.5	-4.5
Other short-term capital			0.2	-3.4	0.7	-1.2	-0.4	0.9
Net errors and omissions			0.1	1.0	-0.1	1.9	-2.0	-0.8
Overall balance			-1.3	-3.5	-2.2	-0.7	0.7	-8.0
Int'l Reserves (US$ mn)	15.0	15.0	15.0	...	24.0	27.0	465.0	404.0
Months of merch. Imports	0.1	0.1	0.1		0.2	0.2	2.2	1.4

Table 5.3: Balance of Payments Accounts, 1986-2001 (continued)

	1994	1995	1996	1997	1998	1999	2000	2001
US$ mns								
Merchandise exports, fob	4054	5198	7255	9185	9361	11540	14448	15027
Merchandise imports, fob	-5244	-7543	-10030	-10432	-10350	-10568	-14073	-14546
Trade balance	-1190	-2345	-2775	-1247	-989	972	375	481
Other goods, services & income	-278	-150	-445	-1166	-1207	-976	-1001	-1049
Credit	...	...	2383	2666	2743	2635	3033	3128
Debit	...	...	-2828	-3832	-3950	-3611	-4034	-4177
Unrequited transfers	302	627	1200	885	1122	1181	1732	1250
Private	170	474	...	...	...	...	...	...
Official	132	153	...	...	...	...	...	...
Current balance	-1166	-1868	-2020	-1528	-1074	1177	1106	682
Capital account	897	1807	2909	2125	1646	1058	-316	371
Direct investment	1048	1780	2395	2220	1671	1412	1298	1300
Portfolio investment	...	...	...	...	...	...	...	...
Other Investments (net)	-151	27	514	-95	-25	-354	-1614	-929
Other long-term capital	-275	-284	...	...	...	...	...	...
Other short-term capital	124	311	...	...	...	...	...	...
Net errors and omissions	-140	-115	-611	-269	-535	-925	-680	-847
Overall balance	-409	-176	278	328	37	1310	110	206
Percentage of GDP								
Merchandise exports, fob	24.9	25.1	29.4	34.2	34.4	40.2	46.3	45.7
Merchandise imports, fob	-32.2	-36.4	-40.7	-38.9	-38.0	-36.8	-45.1	-44.2
Trade balance r/	-7.3	-11.3	-11.3	-4.6	-3.6	3.4	1.2	1.5
Other gds, serv &income	-1.7	-0.7	-1.8	-4.3	-4.4	-3.4	-3.2	-3.2
Credit			9.7	9.9	10.1	9.2	9.7	9.5
Debit			-11.5	-14.3	-14.5	-12.6	-12.9	-12.7
Unrequited transfers	1.9	3.0	4.9	3.3	4.1	4.1	5.6	3.8
Private	1.0	2.3						
Official	0.8	0.7						
Current balance	-7.2	-9.0	-8.2	-5.7	-3.9	4.1	3.5	2.1
Capital account	5.5	8.7	11.8	7.9	6.0	3.7	-1.0	1.1
Direct investment	6.4	8.6	9.7	8.3	6.1	4.9	4.2	4.0
Other Investments (net)	-0.9	0.1	2.1	-0.4	-0.1	-1.2	-5.2	-2.8
Other long-term capital	-1.7	-1.4						
Other short-term capital	0.8	1.5						
Net errors and omissions	-0.9	-0.6	-2.5	-1.0	-2.0	-3.2	-2.2	-2.6
Overall balance	-2.5	-0.8	1.1	1.2	0.1	4.6	0.4	0.6
Int'l Reserves (US$ mn)	876	1324	1736	1986	2002	3326	3417	3675
Months of merch. Imports	2.0	2.1	2.1	2.3	2.3	3.8	2.9	3.0

Sources: ADB (2002); *International Financial Statistics* (2002), and various other issues.

Table 5.4: External Indebtedness of Viet Nam, 1986-2001

	1986	1987	1988	1989	1990	1991	1992	1993
US$ mn, year end								
Total debt	11413	14465	15841	20705	23270	23395	24332	24168
Long-term	11043	14013	15296	19185	21378	21361	21649	21599
Public	...	...	...	19185	21378	21361	21649	21599
Private	...	...	...					
Short-term	370	452	545	1412	1780	1932	2585	2469
IMF credit	...	...	...	108	112	102	98	100
Debt service								
Repayments, LT	73	55	17	142	99	104	175	209
Interest LT	176	303	31	58	46	33	36	51
Interest ST	10	13	21	26	23	15	19	26
Total	259	371	69	226	168	152	230	286
Percentages								
Debt/GDP								
Total debt	43.3	39.5	62.3	329.0	359.6	306.1	246.6	183.4
Long-term	41.9	38.2	60.2	304.8	330.3	279.5	219.4	163.9
Public				304.8	330.3	279.5	219.4	163.9
Private				0.0	0.0	0.0	0.0	0.0
Short-term	1.4	1.2	2.1	22.4	27.5	25.3	26.2	18.7
IMF credit				1.7	1.7	1.3	1.0	0.8
Debt/MrchXprts								
Total debt	1453.9	1680.0	2161.1	1568.6	1344.3	1145.7	983.1	809.6
Long-term	1406.8	1627.5	2086.8	1453.4	1235.0	1046.1	874.7	723.6
Public				1453.4	1235.0	1046.1	874.7	723.6
Private				0.0	0.0	0.0	0.0	0.0
Short-term	47.1	52.5	74.4	107.0	102.8	94.6	104.4	82.7
Use of IMF credit				8.2	6.5	5.0	4.0	3.4
DebtServ/MrchXpts								
Repayments, LT	9.3	6.4	2.3	10.8	5.7	5.1	7.1	7.0
Interest LT	22.4	35.2	4.2	4.4	2.7	1.6	1.5	1.7
Interest ST	1.3	1.5	2.9	2.0	1.3	0.7	0.8	0.9
Total	33.0	43.1	9.4	17.1	9.7	7.4	9.3	9.6
Terms, new loans	...	...	...	5.0	5.7	3.0	1.7	2.0
Interest (%)	...	...	...	10.0	9.6	12.4	24.4	30.4
Maturity (years)	...	...	...	4.0	4.2	5.6	8.2	8.2
Grace period (years)	...	...	...	23.3	19.9	39.6	61.7	61.7
Grant element (%)								
Med & LT Loans (%)								
Concessional								
Non-concessional								

Table 5.4: External Indebtedness of Viet Nam, 1986-2001 (continued)

	1994	1995	1996	1997	1998	1999	2000	2001
US$ mn, year end								
Total debt	24800	25427	26257	21780	22502	23260	12787	...
Long-term	21855	21777	21964	18986	19918	20529	11546	...
Public	21855	21777	21964	18986	19918	20529	11546	...
Private								...
Short-term	2663	3272	3754	2342	2193	2376	925	...
IMF credit	282	377	539	452	391	355	316	...
Debt service								
Repayments, LT	210	225	200	535	587	1021	932	804
Interest LT	57	82	98	268	387	326	296	375
Interest ST	32	46	86	47	36	33	51	...
Total	299	353	384	850	1010	1380	1279	
Percentages								
Debt/GDP								
Total debt	152.3	122.6	106.5	81.1	82.7	81.1	41.0	...
Long-term	134.2	105.0	89.1	70.7	73.2	71.6	37.0	...
Public	134.2	105.0	89.1	70.7	73.2	71.6	37.0	...
Private	0.0	0.0	0.0	0.0	0.0	0.0	0.0	...
Short-term	16.4	15.8	15.2	8.7	8.1	8.3	3.0	...
IMF credit	1.7	1.8	2.2	1.7	1.4	1.2	1.0	...
Debt/MrchXprts								
Total debt	611.7	489.2	361.9	237.1	240.4	201.6	88.5	
Long-term	539.1	418.9	302.7	206.7	212.8	177.9	79.9	
Public	539.1	418.9	302.7	206.7	212.8	177.9	79.9	
Private	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Short-term	65.7	62.9	51.7	25.5	23.4	20.6	6.4	
Use of IMF credit	7.0	7.3	7.4	4.9	4.2	3.1	2.2	
DebtServ/MrchXpts								
Repayments, LT	5.2	4.3	2.8	5.8	6.3	8.8	6.5	5.4
Interest LT	1.4	1.6	1.4	2.9	4.1	2.8	2.0	2.5
Interest ST	0.8	0.9	1.2	0.5	0.4	0.3	0.4	
Total	7.4	6.8	5.3	9.3	10.8	12.0	8.9	
Terms, new loans								
Interest (%)	2.7	3.3	2.5	3.2	2.4	2.4	1.4	...
Maturity (years)	26.3	26.3	29.6	27.1	29.1	32.4	35.2	...
Grace period (years)	7.8	7.9	8.6	7.6	8.2	8.4	8.8	...
Grant element (%)	56.9	51.9	59.3	52.6	59.5	60.3	71.9	...
Med & LT Loans (%)								
Concessional	99	93	87	74	59	64	71	
Non-concessional	1	7	13	26	41	36	29	

*Sources:*International Financial Statistics (2002) and various issues; composition of MLT loan figures are from Tranh et al (2002).

Note: Public debt includes those that are publicly guaranteed.;

LT – long term;

ST – short term

Table 5.5: Inflation, Interest Rates and the Return on the Dong, 1992-2002

In Percentages	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Dong Deposit Rate	34.1	20.4	16.8	16.8	9.6	9.6	9.6	5.3	4.5	6.0	6.3
Change in Exch Rate	-8.1	2.6	1.9	-0.3	1.2	10.3	13.0	1.0	3.5	3.9	1.9
Return on dong(1)	42.2	17.8	14.9	17.1	8.4	-0.7	-3.4	4.3	1.0	2.0	4.4
US$ Interest Rate	4.1	3.2	3.5	4.5	4.8	5.0	5.0	4.7	4.4	3.0	2.0
Gap, savings rate(2)	38.2	14.6	11.4	12.6	3.6	-5.7	-8.4	-0.4	-3.4	-1.0	2.4
Dong Lending Rate					20.1	14.4	14.4	12.7	10.6	9.4	8.7
Gap, Lending & deposit rates(3)					10.5	4.8	4.8	7.5	6.1	3.5	2.3
Cons Price Inflation				10.2	5.7	3.2	7.2	4.1	-1.7	-0.4	4.0
GDP Growth Rate				9.5	9.3	8.2	5.8	4.8	6.8	6.8	7.0

Notes:
1. Dong deposit rate minus the change in the exchange rate.
2. The return on dong minus the US$ interest rate.
3. Dong lending rate minus the dong deposit rate.
Sources: Dong deposit rates 1992-2001 are from Tranh *et al*, (2002); others from *International Financial Statistics* (Feb. 2003) and ADB (2002).

Table 5.6: Statistics for the Development Assistance Fund (DAF), 2000-2003

Trillion dong	2000	2001	2002*	2003**
Year-End Credit	28.3	39.7	55.0	
From domestic resources	9.2	15.5	24.4	
From ODA & on-lending	19.1	24.3	30.6	
Annual Disbursement	13.7	14.0	17.6	23.0
From domestic resources	4.6	7.9	12.0	16.0
From ODA & on-lending	9.1	6.1	5.6	7.0
Growth Rate (%)				
Year-End Credit		40.3	38.5	
From domestic resources		68.5	57.4	
From ODA & on-lending		27.2	25.9	
Growth Rate (%)				
Annual Loan Disbursement		2.2	25.6	30.8
From domestic resources		71.7	51.9	33.3
From ODA & on-lending		-33.0	-8.5	25.4
% of Total Credit				
Annual Loan Disbursement	18.2	21.0	24.0	
From domestic resources	5.9	8.2	10.7	
From ODA & on-lending	12.3	12.9	13.4	
As % of GDP				
Annual Loan Disbursement	3.1	2.9	3.3	
From domestic resources	1.0	1.6	2.2	
From ODA & on-lending	2.1	1.3	1.0	

Sources: World Bank (2003), *Viet Nam Economic Times*, Feb. 24, 2003.
Notes: *Estimate; **Planned.

Table 5.7: Number of Banks and Share in Deposits and Loans, By Type, 1994, 1996 & 2001

No. of banks	1994	1996	2001
SOCBs	4	4	6
Joint Stock	46	52	45
Joint Venture	3	4	4
Foreign	9	23	26
Financial Companies	2	2	2
Insurance Companies	2	3	18
Credit Funds & Cooperatives	219	907	n.a.
Share of Banks in:			
Total Deposits			
SOCBs	88	76	74
Joint Stock	8	10	9
Joint Venture	2	3	5
Foreign	2	11	12
Total Loans			
SOCBs	85	74	60
Joint Stock	11	14	12
Joint Venture	2	5	10
Foreign	2	7	18

Source: Tranh *et al* (2002).

Table 5.8: SOCBs Selected Banking Indicators, 2001

	Percent of total in:				
	Bank Credit Outstanding	SOE Credit Outstanding	New Credit	New SOE Credit	Overdue Loans
Four Largest SOCBs					
VN Commercial	71.9	91.4	81.6	118.2	74.7
Industrial & Commercial	8.2	14.4	1.3	9.5	12.8
Agriculture & Rural Devt	20.0	26.8	29.5	45.8	40.1
Investment &	24.5	12.0	30.5	11.7	12.9
Development	19.3	38.2	20.2	51.2	8.9
Other Banks	28.1	8.6	18.4	-18.2	25.3

Source: IMF (2002).

Chapter 6
Trade Policy and Poverty

6.1. Analytical Framework

The purpose of this chapter is to consider the implications of changes in the trade policy of Viet Nam on poverty reduction. Each aspect of policy will be judged by the same criterion applied in the other chapters: whether each policy change would make growth more pro-poor in its impact. Making this judgement immediately encounters a fundamental practical problem. There exists very little evidence on the relationship between trade liberalisation and poverty in Viet Nam. This absence of evidence has prompted some to base strong policy recommendations on abstract theoretical arguments and so-called stylised facts, though the latter rarely have a factual basis derived from the Vietnamese context.

Of all the specialised areas of economics, perhaps none is so ideological as trade theory, which draws general welfare assumptions from special-case assumptions. Therefore, it is necessary at the outset to review common non-factual arguments made for trade liberalisation in Viet Nam, and subject them to pragmatic and non-ideological inspection. One of the most common and general arguments is that whatever its form, trade protection benefits 'special interests', while trade liberalisation serves the 'general interest'. This argument is given the semblance of credibility by a syllogism derived from the superficial character of protection and its removal: protection applies to the few (benefiting those that work in and own the protected industries); removal of the protection benefits the many (all those who purchase the products of the protected industry); therefore, protection serves special interests and its removal serves the general interest.

Even at the general level, the argument is logically false. First, it treats consumption as the primary function of households. This is one-sided. In order to consume, households must involve themselves in production, either as direct producers or as owners of the means by which production is carried out. Thus, price changes and competition affect their livelihoods as well as their consumption. From this perspective, the 'liberalisation benefits households' argument suffers from the fallacy of composition. Consider the simple case in which protection is limited to tariffs, and the same tariff rate applies to all products (the case of different tariff rates is treated below). Were the tariff removed from one product, a small number of workers and owners would suffer a fall in income, and a larger number of workers and owners would benefit. However, if the tariff were removed for all products, winners and losers would cancel out, except for distributional effects.

Second, even for the reduction of protection on a few products, the argument is incomplete, because it assumes that competition will lower prices equal to the tariff, but will not result in unemployment in the sector producing the products. Both of these assumptions are empirical issues in each concrete case. The assumption that tariff reduction will result in lower prices is particularly problematical, since it depends on the degree of domestic competition at both the wholesale and retail levels. If tariff reduction is combined with less public regulation of imports, then a few large importing firms can dominate distribution. Product 'variety' may increase, without price declines. On the employment side, reduced protection may not result in increases in efficiency of domestic firms, but drive them from the market. If both effects develop negatively, the result can be less domestic employment for households at the same or higher prices.

Complementary to 'tariff reduction benefits households' is the 'openness fosters growth' argument, with 'openness' defined by some measure of the degree of trade liberalisation (Dollar 1992).[79] This argument has been put forward as an empirical hypothesis without theoretical support based either on macro or micro behavioural assumptions. If the empirical evidence sustained the hypothesis, the absence of theoretical analysis would cast doubt on causality, and make the relationship dubious for policy purposes. However, Pritchett has demonstrated that the empirical work is fatally flawed (Pritchett 1996). In an insufficiently noted article, he demonstrates that there are several commonly used measures of openness, and that these are not correlated with each other. It follows from this finding that the different calculations of 'openness' measured different aspects of the trade regime, some of which are positively correlated with growth, but others are not. If openness or 'outward-orientation' is measured by the average tariff rate, there appears to be no correlation between this and economic growth rates (UNDP, *et. al*. 2003, pp. 28-29). Thus, if 'open economies grow faster', it is true of some trade policy regimes and not of others. If growth is the goal, 'liberalisation' in general is not the means, but growth-fostering liberalisation. This may vary among countries, and, as noted in a UNDP study, 'the only systematic relationship is that countries dismantle trade barriers as they get richer' (UNDP, *et. al*. 2003, p. 29).[80]

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79 Dollar uses an idiosyncratic calculation of openness based on the Law of One Price. It is worth noting that in another paper, with Kraay, Dollar finds no correlation between a measure of openness and the growth of the incomes of the poor (Dollar & Kraay 2002).

80 The book comments on studies that proport to show a positive relationship between growth and openness as follows:

> …[S]uch studies are flawed. The classification of countries as 'open' or 'closed'…is not based on actual trade policies but largely on indicators related to exchange rate policy and location…[O]ne cannot draw from the empirical analysis an y strong inferences about the effects of openness on growth. (UNDP, *et. al*. 2003, pp. 30)

For similar conclusions, see Rodriguez and Rodrik (2001).

Another common argument for trade liberalisation is that in developing countries it shifts resources to relatively labour-intensive sectors; this results in a increase in the demand for labour relatively to other factor inputs; the relative increase in the demand for labour increases labour incomes; and, since the poor rely on their labour to generate income relatively more than the non-poor, trade liberalisation is poverty reducing compared to trade protection. There are several logical and practical problems with this line of argument. First, it involves the well-known factor price equalisation theorem, which is the reverse of the famous Stolper-Samuelson Theorem that protection raises the real income of the scarce factor. Over forty years ago, Bhagwati demonstrated that this analytical outcome, removing protection fosters labour intensity in labour abundant countries, is a special case even within Heckscher-Ohlin trade theory.[81] To be theoretically unambiguous, it requires the strong assumptions that for each product: a) the production function is the same for all countries; b) there are no 'factor reversals';[82] c) consumer tastes are identical across countries; and d) that the protection in question is 'prohibitive' (that is, it excludes all imports of the product). Each of these assumptions is unlikely for Viet Nam: a) prevailing production functions are unlikely to be to international norms; b) outputs have produced inputs, which is the source of factor reversals; c) consumer tastes differ substantially between Viet Nam and its major trading partners; and for no important product is the instrument of protection prohibitive.

A variant of the factor price equalisation argument in Viet Nam involves a critique of so-called import substitution. The current trade policy has a strong component of fostering domestic substitutes for imports, pursued simultaneously with export promotion (see Laing 19xx, for a theoretical discussion). By focussing on the former, some have concluded that the trade regime has a 'bias' against labour-intensive sectors, though rarely is 'bias' explicitly defined. The most common implicit meaning assigned to bias is derived from Pareto Optimality: market 'imperfections' result in a set of prices that differ from the set that would prevail were the economy at a unique full employment general equilibrium. If the general equilibrium is not unique, then there is more than one benchmark against which the actual price set should be compared. If there is not full employment, then the price set is quantity constrained, and does not represent a set of 'market signals' (that is, producers and consumers are not 'price-takers'). Further, if there is any trading at other than the unique general equilibrium price set, it cannot be demonstrated that the system will converge to general equilibrium (Weeks 1989, Chapters 8 and 11). The consequence

81 In his article Bhagwati also considers the logic if one uses ' factor scarcity' by the definitions of Lancaster and Leontief (Bhagwati 1959, p. 740).

82 'Factor reversals' can be explained as follows: assume each product can be produced by several techniques, which have different capital-labour ratios; each technique has frontier that shows the maximum wage possible for any profit rate (and vice-versa); if the frontiers for different techniques cross more than once, the definition of factor intensity is ambiguous. That is, if the frontiers cross, a technique that is profitable at low wage rates, becomes unprofitable as the wage rises, then profitable again at a still higher wage. In effect, such a technique is both labour intensive and capital intensive by the standard definition (for a relatively simple discussion, see Weeks 1989, Chapter 10). Factor reversals can be logically excluded only in a one commodity economy.

of these restrictions is that the theoretical concept of 'bias' in the price mechanism is of limited policy relevance.

The limited policy relevance of the theoretical benchmark does not imply that all possible price sets are equal, for some sets of relative prices are clearly dysfunctional. Whether the set of prices associated with a particular set of public policy interventions, including trade policy, is functional or dysfunctional, requires a definition of the outcomes that the authorities seek to foster. The Vietnamese authorities have sought to foster a high aggregate rate of growth within an economy undergoing industrialisation. It may be that alternative interventions, producing alternative relative prices, would have achieved a higher rate of growth than the impressive one realised. These alternatives cannot be determined on the basis of abstract reasoning.

In addition to theoretical problems with the 'liberalisation-fosters-labour-intensity' argument, there are serious practical issues of measurement. If data on the capital stock by product and sector typically are not available, as in Viet Nam, it is not possible to measure factor intensity directly (that is, the capital labour ratio).[83] Thus, proxy measures are employed. The most common are the share of value added in gross output, the share of wages in value added, and the average wage. None of these are satisfactory for analytical purposes, much less for policy decisions. The share of value added in gross output will be a reliable indicator of factor intensity only under very restrictive assumptions, namely, that marginal products determine the wage and the profit rate, and both wage and profit rates equalise across sectors.[84] Using labour's share in value added and the average wage suffer from the same restrictions. Because of the unreliability of these measures, they are not used in this study.

One can conclude that it is a difficult empirical question as to whether reducing protection in Viet Nam would reallocate resources towards labour intensive sectors. The empirical evidence is not encouraging, for it indicates that the pattern of trade in manufactures across countries does not closely conform to the Heckerscher-Ohlin prediction (Yates 1989a and 1989b). This empirical result is consistent with Bhagwati's conclusion that the assumptions required to achieve the logical outcome that trade conforms to factor intensities is 'restrictive'; that is, a special case.

Some commentators, especially those with an ideological commitment to 'free trade', describe Vietnamese trade policy as one of 'import substitution'. This term is typically used to mean that the overall effect of trade regulations is to foster production for the

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83 Even if data on the capital stock were available, the capital-labour measure becomes ambiguous if there are more than two factors.

84 Consider for example, two products with the same physical capital-labour ratios (thus, the same factor intensity), the same wage rate, and only unskilled labour, but the profit rate is below average in one and above average in the other. The measure would produce the misleading result that the sector with the lower profit rate was more capital intensive.

internal market, with the side effect of discouraging exports; that is, a policy of fostering production of importables, and discouraging the production of exportables. As the discussion below of current trade policy shows, this is certainly wrong. It is standard in trade analysis to treat an economy as producing three goods: exportables, importables, and non-tradables. So-called import substitution means implementing policies that switch resources from exportables *and* non-tradables to the production of importables, compared to what resources allocation would be under a neutral policy regime. Export promotion involves policies that shift resources from importables and non-tradables to exportables. It is obvious that by use of appropriate policy instruments, a government can foster both exportables and importables by shifting resources from non-tradables to both types of tradables (Liang 1992).

Viet Nam has followed policy regime, which might be called 'fostering tradables'. Import substitution industries have expanded, as pointed out by the World Bank and the IMF; and exports have grown at an extraordinary rate. The review of trade policy in the following section explains in some detail the instruments used to simultaneously foster import substitutes and promote exports.

6.2. Current Trade Policy

Mechanisms of Regulation

The government's management of international trade is largely through the licensing system and various interventions on the export side. In practice, tariffs play a small role in trade management, which explains why the country can have relatively low tariff rates, and a government-managed trade regime. Because the trade regime is not essentially tariff-based, the assessment of its impact on poverty is made more difficult.

Though tariffs play a relatively minor role, it is useful to review their structure. The average trade-weighted tariff in 2002 stood at about fifteen percent, with considerable variation across products. Historically, developing countries, and developed, have protected industry more than in agriculture, and Viet Nam was no exception. The *effective rate of protection* for the agriculture sector is about thirteen percent, and manufacturing about eighty percent. This large difference is typical of a development strategy seeking to foster industrialisation.

Table 1 provides a brief history of trade reform in Viet Nam for the period from 1989, when Viet Nam began to open up the economy. The changes described in the boxes in the upper part reflect moves towards liberalisation, while those in the lower boxes show policy changes reinforcing trade management. The figure indicates that Viet Nam has taken major steps towards liberalisation over the past fifteen years. A recent World Bank report acknowledged that trade reform in Viet Nam is on a 'fast track' (World Bank 2002, p. 14).

The present licensing system includes the following components that have direct bearing on importing enterprises: (i) non-automatic licensing, and (ii) special authority regulation.

Direct quantitative restrictions and foreign exchange controls also affect ability of enterprises to import/export and therefore will also be discussed below.

Table 2 shows changes in the import and export licensing system in Viet Nam 1992 to 1997. Until 1998 only licensed (authorised) trading companies were allowed to engage in foreign trade. In the early 1990s, in order to get an import or export licenses enterprises needed to have a foreign trade contract and a shipping license, and to meet the requirements on minimum working capital ($200,000) and demonstrate 'skill' in trade. In 1996 the requirement on foreign trade contracts and shipment permission were removed, but the minimum working capital requirement remained in place. By late 1998 there were 2400 private sector companies involved in foreign trade compared to over six thousand state companies.

Decree 57/1998/ND-CP of 31 July 1998 marked a substantial change in rules of entry into international trading activities. The decree stipulated that all enterprises were allowed to trade goods registered specified in their business licenses with no need to request licenses, except four groups of products.[85] The degree continued the restriction that enterprises were limited to commerce in commodities or items that were registered in their business license. By this regulation, the import or export business of an enterprise was effectively restricted, and it was difficult for enterprises to increase their range of commodities without modification of the licenses.

The business license requirement was abolished in 2000. Subsequently, any registered enterprise, that was also register for foreign trade, could import and export all commodities that were not in the four groups mentioned above. Of equal importance, there was no discrimination against domestic private and foreign invested firms. As a result, the number of enterprises registered for foreign trading increased quickly, from 2400 in the early 1998 to ten thousand in November 2000, of which 4,500 were state enterprises and 5,500 non-state. In 2001 the total rose to 16,200 (World Bank 2002, p. 14).

A considerable number of items still require approval from relevant ministries; for example, pharmaceuticals, some chemicals, and recording and broadcasting equipment. Trade in these goods is generally limited, and access to these goods is selected in special ways, usually by nomination and approval either of the prime minister, the line ministries, or the Provincial People's Committees. This restriction maintains the advantage of state enterprises in international trade, as these companies have better access to the regulating agencies. By 1998 over twelve percent of imports (in value terms) were subject to this form of regulation (CIE 1999). Like in many other countries, many import restrictions in Viet Nam are based primarily on health and safety considerations. The current list of prohibited items includes military equipment, toxic chemicals, antiquities, narcotics,

[85] These were: commodities traded by quotas; prohibited commodities; those under Government management; and those defined as involving 'specialized management'.

firecrackers, poisonous toys, cigarettes, used consumer goods, right-hand driving automobiles.

The government removed quantitative restrictions (QRs) relatively fast on a multilateral basis (see Table 6.1). Only petroleum products and sugar remain subject to QRs, both imported through state enterprises. Although the authorities have begun to allocate some import quotas in all commodities under QRs to non-state enterprises, the number of these enterprises is still small because the conditions for entry are still strict and subject to change. In addition to the formal licensing procedures, administrative rigidities and delays in the customs administration remain important non-tariff barriers. Firms have to spend considerable time on customs procedures, which is well documented in various studies (IMPR 2002, Hopkins 2002). Rigidities and delays in customs procedures have given rise to widespread use of 'unofficial customs fees', which disproportionately affects private firms.[86]

Imports have also been regulated through regulating the release of foreign exchange by banks for meeting payments. In late 1998, in face of the widening current account deficit following the onset of the East Asian crisis, the MPI in consultation with the Ministry of Trade and other ministries, used this control on imports of some groups of consumer goods. The two major instruments used. For foreign invested firms, foreign exchange release for imports were limited to the amount of foreign exchange each brought into the country during the year (the 'balance' of their foreign exchange). The foreign exchange balancing requirement for these firms was relaxed in May 2000. Although foreign exchange control has been relaxed in recent years due to a favourable balance of payments, there still exists an implicit ceiling on imports of consumer goods (not exceeding 10 percent of total imports). This implies that whenever balance of payments pressure presents itself,, access of firms, particularly domestic private enterprises, to foreign exchange can be tightened.

By the middle of 2002, quantitative restrictions on the exports of most sectors, including export of rice, whose quota was abolished in 2001, were eliminated. The exceptions were textiles and garments, and a list of so-called sensitive items. An increasing proportion of bilateral quotas on textile and garments were allocated through an auction process, the proportion being twenty-five percent in 2001).[87] A schedule to phase out quantitative restrictions was announced as part of the Five-Year Import-Export Program (2001-2005). This would allow the private sector to anticipate and adjust to the new trade regime.

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86 Interviews with managers of footwear exporting companies found that the following 'standard' unofficial fees are required to process incoming shipments: US$20 for clearing a 20 foot container, US$40 for a 40 foot container, US$ 100 late inspection fee' (Boye 2002, p. 27).

87 Export quotas to EU and recently to the US markets clearly favoured the market incumbents who normally received automatic allocation of quantities equivalent to those in previous year. However, the importance of quotas for garment exporting firms declined with the phasing out of the MultiFibre Agreement, which will end in 2005.

Private firms increased their participation and play increasingly important role in the export sector. There are also various measures on export subsidies and tax exceptions which other countries use to redress anti-export bias due to import substitution policies. There are no direct export subsidies in Viet Nam. However, the government has used to various tax exceptions to encourage exporters.

When a country seeks to promote exports side by side with a protection of production for the domestic market, it is important to assure uninterrupted tax-free access to the imported intermediate inputs needed to export production. The duty drawback scheme in Viet Nam seems to operate reasonably well in this regard. However, operation of the scheme still has left much to be desired, particularly for firms that export only part of their output or new exporters. This partly arises from customs officers making decisions in an arbitrary, unpredictable fashion. It is common perception in Viet Nam that these practices foster corruption and favour state enterprises over other firms, particularly the small- and medium scale ones. According to a recent survey of 150 textiles and garment firms over forty percent of the responding firms imported inputs used by these firms are imported through third parties, usually the Vinatex, the general State Textiles and Garment Corporation (IMPR 2002, p.20). By 1998 only two products – crude oil and scrap metal – were subject to export duties.

Viet Nam has a number of domestic taxes that impact on trade: the licence tax, turnover tax, special sale tax, profit tax, agricultural land use tax, tax on land transfers, and a natural resource tax. Exporters are exempted from value added tax (VAT) and special sales tax. Exporters also receive preferential treatment with regards to the profit tax. Viet Nam has a three-band profit tax rate: heavy industries, twenty-five percent; light industries thirty-five percent; and services forty-five percent. Profits from export production are taxed at a concessionary rate, depending on the degree of export orientation of production, and whether they are located in industrial and export processing zones. Firms exporting between fifty and eighty percent of production are taxed at twenty percent for twelve years from the date when the project commences production, and which firms exporting more than eighty percent of production are taxed at a more favourable rate of fifteen percent for fifteen years.

With the exception of the VAT rebate, all other tax concessions are based on criteria that offer a wide range of reasons for preferential treatment and therefore leave space for discretionary decisions through tax authorities. Some firms, particularly state enterprises, can negotiate with the state over the tax they pay in a particular year. New firms, particularly small firms, are likely to be disadvantaged when it comes to settling tax payments because their negotiating power is likely to be small.

In September 1998, the State Bank imposed a foreign exchange surrender requirement for exporters under which all exporting firms had to sell eighty percent of their foreign exchange earnings to banks within fifteen working days of transferring these funds into their accounts. The regulation negatively affected exporters, particularly during 1998-200, when there were large fluctuations in the exchange rate. In August 1999, the surrender requirement limit was reduced to fifty percent. The foreign exchange surrender requirement was abolished in 2003.

In the middle of the 1990s, rice exports were subject to quantitative restrictions, with quotas allocated mostly to major trading firms such as Vinafood 1 (northern-based general state food trading cooperation) and Vinafood 2 (southern-based general state food cooperation). The quota was gradually made non-binding towards the end of 1990s, as a part of the trade liberalisation programme. It was completely abolished in 2001. This was due in part to difficulties in exporting rice caused by much weakened external demand, which provided added incentives for the government to change policy to encourage rice exports.

Accession to the WTO

The Vietnamese government has made the policy decision to seek accession to the World Trade Organisation, and do so as soon as is practical. In preparation for its negotiations to this end, there are several issues that the government might consider. These include: 1) the nature of the WTO trading system, 2) the current status of the organisation, and 3) the impact of accession on the government's policy options.

On the first point, the WTO does not seek to establish an international system of 'free trade' in any meaningful sense of that term. It is not even clear that the effect of WTO rules is to foster a 'freer' world trading system. Rather, the organisation seeks to establish a system of regulated trade in which there is a rules-based mechanism for dispute settlement. WTO rules specify the conditions under which commodities can and cannot be trade among countries, the most obvious of these conditions being that member governments must enforce copyrights and patents associated with traded products (so-call 'intellectual property rights'). If 'protectionism' is defined as the imposition of rules to restrict the import of commodities, then the WTO rules are protectionist in the same sense that some argue that environmental and workers' rights rules are protectionist. The issue for every government considering membership is whether the trade restrictions in the WTO rules are to their advantage; or, if not, whether other aspects of the WTO outweigh the disadvantages. Perhaps the most important advantage of WTO membership for Viet Nam is the possibility that the disputes settlement mechanism will protect it from unilateral actions by trading partners to restrict its exports. To date, the WTO's record on preventing unilateral protectionist measures has been mixed.[88]

88 In a presentation that provides an excellent guide to the policy issues facing the government in its WTO negotiations, Gibbs points to a ruling by the US Department of Commerce that Viet Nam is a 'non-market economy'. This could have severe implications for exports to the United States, and perhaps render the WTO disputes mechanism impotent. Gibbs concludes that the ruling… exposes Vietnamese exports of all products to a greater degree of trade harassment than would otherwise have been the case…

While it could be said that Viet Nam recognized its own NME status by accepting the 'market disruption' provisions in the BTA [Bilateral Trade Agreement with the US], the recent [ruling]… is a serious blow to Viet Nam, and alters the balance in the bilateral agreement. It should be noted that the WTO criteria for "Non-market" status in no way apply to Viet Nam. (Gibbs 2002, p. 4)

On the second point, recent developments have raise doubts about the sustainability of the WTO, most notably the inconclusive end to the trade meeting in 2003. The failure of governments to reach an agreement can be treated by the Vietnamese government as an opportunity to assume a role within the group of activist developing country governments.

Third, analysis of the impact of accession should go beyond the implications for trade. An IMF official in Hanoi described accession to the WTO as a 'Trojan Horse', in the sense that contained within it will be powerful pressures to accelerate a range of policy changes which to date the government has introduced with considerable caution. Perhaps most important will be the import pressure on public enterprises, which will force an acceleration of their modernisation programmes.

6.3. Poverty Reducing Trade Policy

It is one thing to review the Vietnamese trade regime, and quite another to assess its impact on the poor. There is very little empirical work on the relationship between trade and poverty in Viet Nam, and what is available is contradictory. Most conclusions are based on so-called stylised facts (i.e., stylised bias), as discussed above. Simulation exercises, of which there are a few, are of limited usefulness, because, among other drawbacks, they assign unwarranted importance to tariffs (see previous section).[89] The fundamental problem is the lack of appropriate surveys of the labour force, agriculture and industry.

One of the few undisputed findings is that the growth of incomes, and, therefore, poverty reduction, has been greater in the more developed provinces, which produce most of exportable commodities (see Chapter 3). This is consistent with the general observation that the growth of international trade tends to benefit those with the greatest capacity to take advantage of it, and foreign investment tends to flow to where infrastructure and skills are more developed. In themselves, these outcomes offer no guide to trade policy, though they provide weak support for improving infrastructure and skills in the less developed provinces. This inference is weak, because detailed study would be necessary to determine why each province gained or failed to gain from the expansion of trade and general inflow of foreign investment.

Perhaps the most important direct impact of trade liberalisation on the poor would be *via* its consequences for food prices. On the basis of partial equilibrium analysis, most conclude that reducing trade regulations would result in a relative rise in the prices of food commodities, including rice. The effect of the price changes on the livelihood of

89 Two studies carried out simulation exercises assuming tariff reduction across the board. The CIE study concluded that tariff reduction would raise incomes across the distribution for both urban and rural households (CIE 1999a). Because of the restrictive assumptions of this and similar exercises, and the relative unimportance of tariffs, these studies are not treated in this chapter.

households would depend on whether households are net food buyers or net food sellers. In the latter category are the vast majority of urban households and landless rural households. However, the net impact of changes in trade policy is considerably more complicated that the simple dichotomy between net buyers and net sellers suggests. While rice is the single most important component of food consumption for most Vietnamese households, this product represents less than half of the value of food consumption for all but the poorest quintile (further, some products in the national diet are not traded to any extent, so one cannot generalise as to impact of changes in trade policy on the entire food consumption basket).

Even for rice, it is difficult to draw firm conclusions. As one moves up the distribution, the share of rice production that is marketed rises, and the consumption share falls. However, existing statistics do not allow for a sufficiently precise calculation of net purchases by households across the income distribution, so it is not possible to draw conclusions more specific that the obvious: *ceterius paribus*: if liberalisation of trade in rice resulted in a higher price, almost all urban households would be worse off; the landless and land-poor would also be worse off; and net sellers would be better off. It is difficult to generate a 'story' in which a higher rice price improves the welfare of the poor, though it is not possible to assess the importance of the price effect.

It may or may not be that the government of Viet Nam should vigorously pursue trade liberalisation. In the absence of the most basic information, it would be irresponsible to recommend strong action of any type. Were it the case that the country's trade performance had been unsatisfactory, there would be a strong *prima facie* case to experiment with policy changes. However, exports have grown spectacularly, and the external account seems manageable (see Chapter 5). It follows that there is no compelling reason to embark on major trade 'reforms' because of past performance. Unlike many governments, the government of Viet Nam is in the enviable position of being able to design its trade policy on the criteria of poverty reduction. At present, these criteria cannot be applied because of lack of information. A high priority of the government should be to commission research on the impact of its specific policy options on the poor. More disaggregated studies would complement research currently being carried out in the MPI and other agencies. It is highly probable that donors and lenders would provide financial support for such studies. It is quite important that these studies be owned by the government in design, execution and choice of researchers, so that advocacy does not take the guise of 'objective' analysis.

Annex: Trade Policy and Capital Account Liberalisation

In this report, as is typical, the issues of opening the capital account and trade liberalisation have been treated separately. This brief appendix considers how the two policy changes interact. By necessity this must be primarily analytical, drawing on the experience of other countries. In several countries, particularly in Latin America, the combination of those policy changes has resulted in undesirable side effects.

A rapidly growing economy tends to attach large capital flows, and this has been the case for Viet Nam (see Annex 2 to Chapter 2). Trade liberalisation combined with the opening of the capital account results in full convertibility of the currency. If the capital flows are unregulated, and can be freely converted by the private sector into the domestic currency, experience suggests there to be two important consequences. First, the initial result of the inflows and their entry into the domestic money supply will be to lower interest rates. However, large capital flows tend to generate booms in asset prices, such at the property speculation that occurred in Viet Nam in the 1990s. This can put upward pressure on interest rates, which would induce short term 'hot-money' inflows when the capital account is open. If the government simultaneously pursues a 'floating' or 'market determined' exchange rate, the capital inflows are likely to provoke a real appreciation, reducing the competitiveness of the tradable sectors.

The scenario described above is well-known, and follows from the standard neoclassical open IS/LM model. In that model, equilibrium is achieved by an expanding trade deficit as export growth declines and imports increase: that is, output equilibrium is reached the capital account surplus equals the trade deficit. If the liberalisation scenario unfolds as described above, the eventual equilibrium finds the economy in a notably weaker position that the one from which it began: interest rates have risen, increasing the cost of capital to enterprises; the appreciated exchange rate reduces the return to exporters, causing a fall in the rate of growth of exports; and the appreciated exchange rate also induces imports, lowering domestic production compared to a non-liberalised equilibrium at the same level of output. In other words, the major concerns expressed by sceptics of Viet Nam's growth sustainability could result from an excessively rapid liberalisation programme: lower growth of output and exports, lower investment, and an increased trade deficit.

Taylor has summarised the liberalisation scenario as follows:

> …[C]apital account liberalization combined with [trade liberalization] and a boom in external inflows could easily provoke 'excessive' credit expansion. Paradoxically, the credit boom could be associated with relatively high interest rates and a strong domestic currency.[90]

The rather grim liberalisation scenario described here need not occur in Viet Nam. However, it has unfolded with sufficient frequency in developing countries that it must be considered a strong possibility to be guarded against.

90 This argument is presented in a formal model in a paper by Taylor (Taylor 2003).

Table A.1: Time Line of Trade Reform in Viet Nam, 1989-2003

Source: CIE (1999), Institute of Economics (2001), and our updates for 2002 and 2003

1989	Customs tariff introduced for the first time	
1990	· Special sales tax · Export - import companies required in register	· Export of certain commodities limited to relevant exporters
1991	· Imported inputs used to produce exports exempt from duty · Export processing zones regulation introduced · Export duty on rice reduced from 10 to 1 per cent · Private companies allowed to engage in international trade	
1992	· HS system introduced · Trade agreement with EU	
1993	· Export shipment licensing relaxed · Duty rebate system improved · Customs declaration form improved	
1994	· Import permits eliminated for all but 15 products · GATT observer status · Licensing steps reduced · Export shipments relaxed	
1995	· Import permits system relaxed · Joint ASEAN · Import quota goods reduced to seven · Export quotas reduced to one rice	· Export taxes raised on 11 products
1996	· Maximum tariff reduced to 80 per cent · AFTA list promulgated · Managed import goods reduced to six	
1997	· WTO accession process started · Rice quotas allocated by provincial government	· Import of sugar prohibited · Temporary prohibitons imposed on consumer goods
1998	· Management of quota goods shifts to tariffs · Highest tariff reduced to 60 per cent · Private sector exports allowed · Foreign invested enterprises allowed to export goods not in license · CEPT road map released · 3-schedule tariff introduced	· Partial surrender requirements imposed
1999	· Decree 57 liberalising right to import and export · New tariff with smaller range and rates released · Surrender requirements reduced from 80% to 50%	· Decree 254 adds to list of conditional imports
2000	· US_VN bilateral trade agrrement · Import permits system relaxed (from 20 to 12) · Remove QR on 8 out of 19 remaining groups. These 8 are fertiliser, liquid soda, ceramic goods, plastic packaging, DOP plasticiser, ceramic sanitary ware, electric fans and bicycle · Establish Trade promotion centre ·C ontrol on FEx relaxed	
2001	· Permit all legal entities (individual & companies) to export most goods without having obtain a special license · Remove quantitative restrictions multilaterally on all tariff lines of the following 8 groups of products: liquor, clinker, paper, construction glass, some types of steel, vegetable oil. Only petrolium products and sugar are still subject to quota · Reduce the foreign exchange surrender requirement from 50% to 40% (May) · Move 713 tariff lines from TEL to IL	
2002	· Reduce the foreign exchange surrender requirement from 40% to 30 % · Detail a list of goods and tax rates for implementin g CEPT · Issue implementin g decision for US BTA · WTO negotiaation team started working session in Geneva (April)	
2003	· Foreign exchange surrender requirement was abolished · Sixth WTO working party in Geneva (May) · Officially announce tariff rates for implementati on under CEPT (June)	

Table 2: Evolution of External Trade Entry Conditions

Foreign trade contracts						
Shipment licenses						
Working capital requirements						
Skill (in trade) requirements						
Business licenses						
	1992	1993	1994	1995	1996	1997

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