REPORT ON VIETNAM COUNTRY DIALOGUE

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Initiative for Policy Dialogue
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INTRODUCTION:

In March 2002 IPD held a Country Dialogue In Vietnam, in collaboration with the United Nations Development Program (UNDP) and the UNDP Vietnam office. The IPD team included Nobel-Prize winning economist Joseph Stiglitz, K.S. Jomo from University of Malaysia, Gerard Roland from University of California at Berkeley, and Shari Spiegel from IPD at Columbia University.

The Dialogue consisted of a series of policy forums, including individual meetings with Prime M minister Phan Van Khai and Deputy Prime Minister H.E. Nguyen Manh Cam, and a public lecture by Professor Joseph Stiglitz to 700 students and faculty from local universities. The 2002 Country Dialogue followed up on IPD's earlier Vietnam Dialogue, held in June 2001.

At the time of the first IPD Dialogue in 2001, Nong Duc Manh had just been named the General Secretary of the Communist Party. Vietnam was about to embark on a program of trade and investment liberalization with far-reaching policy, regulatory, legal, social and institutional implications.

In December 2001 Vietnam ratified the Bilateral Trade Agreement (BTA) with the US. By our second Dialogue in March 2002 Vietnam was in pursuit of WTO accession. The discussions focused on trade policy, new enterprise development vs. privatization and restructuring of state-owned enterprises (SOEs), rural development, and financial sector and capital market liberalization.

Throughout the forums, the IPD team stressed the need for dialogue and discussion of policy options. Professor Stiglitz presented alternative theories of development and emphasized the importance of distinguishing between means and ends. Policies such as inflation targets, exchange rate stability, privatization, and liberalization should not be viewed as ends in themselves. These are tools to achieve long-term goals of sustainable growth and higher living standards. The wrong mix of policies, and an excessive focus on means, can block the development process.

TRADE:

Most of the advice that had been offered to Vietnam on the BTA had been on how to meet the legal, regulatory and institutional terms and commitments. IPD was asked to focus the Country Dialogue discussion on how Vietnam and its people could use the BTA in particular, and trade integration in general, to its advantage. As Prime Minister Phan Van Khai pointed out, as Vietnam liberalizes its trade policies with the BTA and accession to the WTO it must learn from experiences, including failures, of other countries. The discussions addressed the question of how Vietnam can avoid the turbulence that countries, such as Argentina, have experienced. The Dialogue emphasized the advantages of integration into the global economy, but also stressed that the risks must be recognized and managed. In theory, liberalization should help move resources from low productivity to high productivity sectors. But in many instance it has failed to do so. This is especially true in countries with high unemployment. Often resources have ended up moving not to a higher level of productivity, but to no productivity at all (i.e. more unemployment). Liberalization doesn't help without a framework for reallocation.

Many advisors have recommend eliminating trade barriers as fast as possible, rather than waiting for official WTO accession. IPD pointed out that, instead, Vietnam can learn from the Chinese example. The debate on how fast China should make the transition to WTO standards lasted for seven years. During this time China made the domestic transition it needed to adjust the economy to the new regime. Vietnam should concentrate on the generation of an internationally competitive domestic private sector while negotiations with the WTO advance. The lesson learned is that the process of accession will take time, but the transition period starts today.

One way for Vietnam to protect itself from the risks of liberalization is to develop a strong small and medium-sized enterprise (SME*) private sector. This would help the country withstand the risks of adjustment in a rapidly changing environment.

Another question posed was on the effect on Vietnam of China's accession into WTO. Although it presents added competition, China's accession can be viewed as good news for the developing world. Developing countries have not yet had a strong voice in trade negotiations. China's presence creates the opportunity to redress some of the imbalances in trade negotiations. In addition, Vietnam can consider taking advantage of some of what the WTO provides through, for example, safeguard provisions. These are discussed in more detail in the "The Main Messages from the IPD Country Dialogue, Vietnam, March 2002". The basic idea is that the US and other developed countries use safeguard provisions and developing countries can use them to their advantage as well.

Most of the concern about the risk in the new BTA are not based on the traditional agreement of trade in goods, but based on provisions of trade in services, particularly services in the banking sector, that were important for the US. Countries, such as Malaysia, have shown that a large deficit in the service sector can nullify surpluses in the tradable sector. However, within the framework of the BTA, Vietnam can still pursue a development agenda. For example, in the area of financial services, it can use a policy similar to the Community Reinvestment Act (CRA*) in the US. This Act requires financial institutions in the US to lend to disadvantaged sectors of the economy. Both foreign and domestic banks can be required to reorient their lending to SMEs.

One question that arose throughout the meetings was on where Vietnam’s comparative advantage should lie. Many participants wanted to know which industries government policy should target. The IPD team emphasized that comparative advantage should be viewed dynamically. There is no simple or scientific answer to which industries or products should be targeted. The market economy allows for experimentation and, as long as there is an economic structure in place for new enterprise development, new areas of comparative advantage should develop naturally. Vietnam’s Enterprise Law, which reduces red tape, is a step in the right direction. Government policies can emphasize research, education, and public-private partnerships, but the market will be most efficient at determining areas for future development.

Vietnam's location provides special opportunities. Vietnam's comparative advantages include human capital, low wages, and industriousness. Vietnam is a small country; and should use this to its advantage, since it can enter the world market without destroying or flooding the market.

There was also some discussion on the possibilities of a 'new' industrial policy. The challenge is to develop industrial policy in a creative way given the global context. Northeast Asia (Japan, Korea, Taiwan) used a combination of import substitution and export orientation policies in their development. Import protection was conditional on export promotion, and led to a significant increase in exports. Companies used the temporary protections to develop and become competitive. This was the crux of Northeast Asia's success. However, Vietnam’s international trade commitments limit import protection, and this strategy is no longer feasible.

SMALL AND MEDIUM SIZED ENTERPRISE (SME*) DEVELOPMENT VS. PRIVATIZATION AND ENTERPRISE RESTRUCTURING:

A central theme discussed during the dialogue was new business development vs. privatization (also referred to as "equitization") and the restructuring of state-owned enterprises.

It was agreed that the International Financial Institutions have placed too much emphasis on restructuring state-owned enterprises (SOEs*). Competition is at the heart of market and developing economies and policymakers need to look to the most efficient ways of encouraging competition and job creation.

Experience has shown that, in general, development of new enterprises has been a better allocation of resources than privatization of SOEs. With the development of viable private sector, SOEs will become less and less important to the economy, and easier to restructure. The emphasis should be on creating new enterprises, and on policies to encourage their development.

At the time of the IPD forums, the Central Committee of the Party had just finished a Party Plenum that devoted considerable attention to further development of the private sector. For example, members of the Party are now able to engage in private business. In addition the Enterprise Law has resulted in a record number of new enterprises being registered.

Other countries' experiences provide ample examples of effective and ineffective SME development policies. First, access to credit is essential for enterprise development. As mentioned above, Vietnam can adopt a policy similar to the Community Reinvest Act of the US within the context of the BTA to direct credit to the SME sector. It can also try to mobilize resources of nationals living abroad. In Poland, for example, the diaspora has helped fund development.

Another important factor for new enterprise development is the rule of law. For example, SMEs in Poland and Hungary are more successful than those in Russia, because of Russia's weak rule of law. Property rights must be protected and a functional court system is important. It is fundamental that new enterprises have protection against both payment default from clients and arbitrary predatory behavior from public bureaucrats.

There are additional externalities from an inefficient system. For example, Vietnam currently faces the risk of a property boom. Land prices in Hanoi are extremely high. Restrictions on investments, or excessive red tape, can lead to overvalued real estate prices because of lack of alternative investment opportunities.

<u>Privatization</u>

Privatization should not be an end goal in itself, but a means to achieve a more efficient allocation of resources. Yet other countries' experiences have shown that unless a privatization policy is well constructed it can have the opposite effect. In many countries public monopolies have just been converted into private monopolies without adequate regulation. Often this has been combined with corruption and asset stripping by new owners, with a harmful effect on competition and society. Privatization, especially when done in the absence of necessary economic and legal institutions, does not always lead to increased economic development.

Privatization was most effective in the transition economies in Central Europe, though even there, successful privatization generated many lessons and questions. For example: If you sell an enterprise, how do you value it when there is an absence of developed financial markets? If you sell an enterprise while the population doesn't have money, to whom do you sell it? Once privatization sales are announced, managers are afraid of losing their jobs and have an incentive to mismanage. What incentives can you give managers to act in the best interest of the company? Is the privatization process too slow? Or is it too fast? Where it was done more slowly, as in Poland and Hungary, the results were better.

Lessons drawn from Eastern Europe and Russia were more negative. New owners were often involved in asset stripping, destroying jobs and value from the firm. The lack of a rule of law, combined with weak property rights and a fear that policies would change, made it more profitable for owners to make quick money through asset stripping, than through restructuring and rebuilding of companies. New owners often influenced the government to avoid paying taxes. Monopolies were created and protected, with adverse effects on both the legitimacy of the government and private sector development. The impatience with privatization was wrong. Private sector development is more important for the creation of wealth, jobs and development.

There are also lessons from privatization experiences in Asia. SOEs* are not all inefficient, as can be seen in Singapore. China has been experimenting with property rights. "Stakeholders* capitalism" is another form of organization, and one of the many alternatives that Vietnam can explore.

RURAL DEVELOPMENT:

Given that over 75% of the population lives in rural areas, it is essential that the living standards of the rural sector improve. Rural development was a major theme of IPD's Country Dialogue, particularly in the meeting with the Prime Minister.

Rural-based growth and the modernization of the rural sector are crucial for sustainable development. Entrepreneurship does not come only from the skilled, urban labor force, it is also present in rural areas, and the government should encourage creativity at all levels. Reform of education should be used to improve skills in the rural sector. The rural sector also needs to be protected from unfair competition (i.e. subsidized chicken feed in the US).

The Prime Minister emphasized policies to increase welfare in the countryside. He believes Vietnam needs to double or triple income of farmers. Otherwise farmers will leave the countryside to pursue better economic opportunities in the cities. Poverty reduction programs have already achieved some success. In one program, cadres were sent to the countryside help farmers. The goal is to make production more competitive through new technology and an influx of capital. To achieve this, there must be better public facilities, schools, and improved access to electricity. To increase local government accountability, budgets and their allocation are to be published openly in villages so that local people can decide what their village should do in an open and transparent fashion.

Lessons on this can be learned from Town and Village Enterprises (TVEs*) in China. TVEs create incentives for local governments to promote growth and develop their own regions. They also provide protection against corruption -- in the past people were vulnerable to local governments taking cuts. Under this system local TVEs were protected so they could grow.

CORRUPTION:

Corruption is an impediment to economic growth that undermines confidence in government. To design policies to address corruption, we need to first analyze the sources of corruption and then develop mechanisms to attack it.

Policies that encourage transparency, such as posting of the budget, can be used to discourage corruption. In many countries the rotation of government officers increases the cost of corruption and deters its practice. Another tactic used is to give multiple government officials access to information, such as tax files, so that no one official is able to benefit from corrupt policies on his or her own, increasing the cost and reducing the benefit of corrupt actions. The implementation of computer technology can also assist in monitoring official practices by disseminating information and increasing transparency.

Corruption resistant tax systems that are less subject to individual discretion should be developed. In the Trade Agreements discussed above, there is pressure on Vietnam to reduce tariffs. Tariffs are an important source of revenue, and will need to be replaced by new taxes. The substitute taxes should take into account the level of corruption-resistance implicit in the formula. For example, the value-added-tax VAT* is *not* a corruption resistant tax. In countries that are predominantly cash economies, VAT can lead to evasion because it leaves room for judgment and discretion in reporting. A tax on easily measurable and quantifiable items, like large cars or luxury homes, is less prone to corruption. VAT works well in Europe, but it is not necessarily as well suited for countries with cash economies. In fact, VAT can be considered an anti-development tax because the formal sector is taxed, driving business into the informal sector.

To fight corruption, it is also important to have separation of powers. For example, in Italy the government was linked to the mafia and citizens lost confidence in the government. The key is to have an independent judiciary branch.

CAPITAL MARKET AND FINANCIAL MARKET LIBERALIZATION, AND CURRENCY POLICY:

Capital Market Liberalization

Other topics discussed throughout the forums were Capital Market and Financial Market Liberalization and Currency Policy.

Despite the opening of capital markets around the world over the past 15 years, there has not been a net flow of funds from rich countries to poor. At the same time, volatility in the international system and financial crises has increased. Financial liberalization was one of the main causes behind the crisis in East Asia. Given the added volatility of open capital markets, exchange rate management can become more difficult. The IPD team stressed that full capital account liberalization is risky, while the benefits of liberalizing the capital account are minimal.

Foreign Direct Investment (FDI) is more beneficial than portfolio flows since it often includes capital, access to technology, and training. But even FDI is subject to some qualifications. In countries with high savings rates there is less need for investment that does not bring technology and training. In the past FDI has included mergers and acquisitions that brought little in the way of long-term benefits.

Use of export processing zones (EPZs*) in which foreigners set up production to export products abroad has served to increase the number of new industries and the level of employment in several countries, such as Ireland and Malaysia. However, there are caveats here as well: how do you integrate these into the overall economy for long-term sustainable growth across the entire country? For example, often businesses will move on to another country when they find a better deal. An interesting alternative is the combination of joint ventures (JVs*) of domestic and foreign enterprises.

Policies that promote FDI by discriminating against Vietnamese domestic enterprises, through special privileges for foreigners, might attract FDI but also cause distortions and inefficiencies by hampering the development of domestic industries. Offering tax breaks to encourage investment from abroad can lead to "roundtrip investments", in which Vietnamese send money out of the country, and then bring it back in to take advantage of the tax breaks. This distorts capital flow numbers and can induce inadequate policy decisions.

There are additional distinctions between different types of FDI and their impacts on development. For example, FDI that is export oriented and will generate long-term positive flows of foreign exchange might be preferable to FDI that is domestically oriented. FDI can be an efficient way for a country to gain knowledge and attract capital. Effective policies should differentiate between different forms of FDI, and be geared toward attracting the types of FDI that contribute the most to development.

The Financial Sector

The objective of a strong financial sector should be to provide credit for enterprise growth and new enterprise creation. In a market economy one role of the financial system is to provide information on credit conditions, sources of funds available, and viable lending opportunities. A banking system should always be making decisions regarding the reallocation of resources, and can be a good guide for recognizing sectors in which resources are more productive.

Vietnam inherited a system that is ineffective in these respects. The banks don't function as banks: they are owned by the government and are centrally controlled; due to large portfolios of non-performing loans (NPLs*) the banks are reluctant to extend new loans to new enterprises.

Foreign banks have generally been viewed as positive for development because they bring in foreign capital and expertise. The problem with foreign banks is that they rarely lend to SMEs. In many developing countries they use their deposit base to lend primarily to multinational companies. The BTA will force Vietnam to open up to foreign financial institutions. Policy should be geared to benefiting from the advantages foreign banks offer while giving incentives to encourage lending to SMEs. As discussed above one idea is to consider the example of Community Reinvestment Act (CRA*) in the US. This Act requires a percentage of the banks' lending to be targeted to local costumers in disadvantaged areas of the country. This can be applied in Vietnam by requiring new financial institutions, both foreign and domestic, to lend to SMEs.

The implications of the Argentinean debacle should also be considered. Although foreign banks and their subsidiaries were assumed to be more stable than local banks, many foreign banks did not support their local subsidiaries during the crisis, undermining an already shaky investor confidence. The view that foreign banks would be a more stable source of capital than domestic banks was undermined.

It is difficult to develop good financial governance, but this task should be high on the list. The Enron case in the US has underscored the importance of good governance. The problems in U.S. today are result of excessive deregulation. Other countries should learn from mistakes in the US and strive to do better than what's been considered 'best practices'.

External Borrowing

As with capital account liberalization, IPD stressed the risks of borrowing in foreign currencies. At the time of the Country Dialogue, Vietnam was engaged in negotiations over the issuance of a new USD Eurobond. The IPD team stressed the risks of borrowing in foreign currency. Foreign currency debt can limit a country's freedom to use macroeconomic tools, such as fiscal, monetary, and exchange rate policies. Once a country has a significant amount of foreign debt, any devaluation of the currency increases the amount of debt as a percentage of GDP. This, is turn, raises borrowing costs, which raises the probability the country cannot repay its debt, which raises borrowing costs further. Thus, to avoid the risk of default, it becomes difficult for a country to devalue its currency or lower interest rates, even when the currency is overvalued or excessively high. In addition, there is pressure from creditors to reduce fiscal spending to maintain funds to repay debts, even in the midst of a recession.

Most of the financial crises in developing countries over the past two decades have been due to excessive dollar borrowing, often combined with open capital markets.

Given the importance the Vietnamese place on 'stability', the discussion centered on how to use flexible exchange rate policies, combined with capital account management, to avoid the kind of destabilizing financial risks that have occurred in other countries. The discussion included lessons from the Argentina default and issues of the global economy, and the implications for the developing world following September 11th. These are covered in more detail in "The Main Messages from the IPD Country Dialogue, Vietnam, March 2002".

The Vietnamese asked IPD to follow-up on many of the issues in the future. IPD will continue its relationship with Vietnam and it is likely that we will hold another series of forums in the future.